

Public Finance Alert: IRS Publishes Notice 2008-27 to Facilitate Certain Restructurings of Tax Exempt Bonds

2/26/2008

On February 19, 2008, the Treasury and IRS published Notice 2008-27 (the "Notice") in response to requests for relief from "reissuance" treatment of restructurings of tax exempt obligations by issuers seeking to replace, wrap or remove damaged credit facilities and convert tender option bonds ("VRDBs") or auction rate securities ("ARS") to more marketable interest modes.

The effect of avoiding a reissuance is that restructurings can be accomplished without subjecting the restructured bonds to certain tax requirements associated with refundings, such as accelerating rebate payments to the federal government, truncating bond yield and/or loan yield calculation periods with potential adverse effects, and application of new tax requirements to the "reissued" bonds. Although reissuance is a highly technical area, its avoidance can favorably impact the timing and economics of a restructuring.

Generally, the Notice clears the way for most mode changes and security changes without the risk of triggering adverse tax consequences by causing the bonds to be deemed reissued, and therefore refunded, under Sections 103 and 141 through 150 of the Internal Revenue Code as a result of such modifications. In particular, the Notice clarifies that conversions from ARS to other interest modes, and most amendments in connection with a conversion from a short-term interest mode to a long-term interest mode, will not be treated as a reissuance for federal tax purposes. Although the Notice does not resolve non-tax issues associated with attempts to cancel or suspend bond insurance from mono-line bond insurers experiencing ratings difficulties and/or introducing bank letters of credit as additional security on bonds backed by such bond insurers, it does facilitate many such restructurings from a tax perspective.

The Notice may be relied upon by issuers immediately and can be applied retroactively to actions taken on or after November 1, 2007. Both Notice 2008-27 and prior Notice 88-130 addressing reissuance in the context of VRDBs may be relied upon until the effective date of anticipated future regulations.

The Notice accomplishes two major objectives. First, it updates Notice 88-130 by:

- synchronizing it with final regulations issued by the IRS in 1996 under Section 1001 of the Code ("1001 Regulations") governing when modifications to debt instruments are treated as an exchange of the original debt for a new debt instrument;
- expanding its application to certain ARS that may be converted to another interest rate mode; and
- expanding its application to bonds issued with or convertible into additional variable interest rate modes as long as the interest rate is a "qualified floating rate."

Second, it generally provides that the 1001 Regulations apply to all modifications other than the preauthorized mode changes and authorized tenders which are protected under the Notice.

To further facilitate interest rate and credit enhancement changes on ARS and VRDBs precipitated by bond insurer downgrades and related concerns about liquidity facilities on VRDBs, the Notice also allows:

- a temporary waiver of an interest rate cap between November 1, 2007 and July 1, 2008, to be ignored for reissuance purposes;
- a modification to a qualified hedge (e.g., an interest rate swap) that is not expected to change the yield on the hedged bonds over their term by more than 25 basis points to be not treated as a termination of the hedge, in order to accommodate minor rate adjustments related to credit modifications (provided such adjustment is taken into account for arbitrage purposes);
- the application of the Notice to bonds with a term of up to 40 years (prior to the Notice, bonds with a term of over 35 years were treated less favorably for reissuance purposes); and
- all tax exempt bonds to be treated as "recourse debt" under the more favorable rules applicable under the 1001 Regulations to modifications in security or credit enhancement. This last special rule, in combination with other provisions of the Notice, provides significant relief to issuers because, under the Notice, most modifications of security or credit enhancement will not be treated as a reissuance unless they result in a "significant modification," which will only occur if such modification causes the payment prospects of such bond to change from speculative (below investment grade) to non-speculative or vice versa.

Representative Restructurings Now Possible under the Notice

The following are examples of transactions that can be implemented under the Notice without causing a reissuance and which, prior to the Notice, either could not be completed without causing a reissuance, or as to which there was lack of clarity regarding the feasibility of avoiding a reissuance in certain circumstances:

- Enhancement of marketability of tax exempt bonds through removal, replacement or addition of insurance, letters of credit or liquidity facilities
- Conversion of ARS to another already authorized mode such as VRDBs or a fixed rate under a multimodal indenture
- Temporary waivers of interest rate caps

Analysis

The Notice provides timely guidance to issuers who may be converting their tax exempt debt to new modes to eliminate interest rate spikes and other negative consequences flowing from auction failures and failed remarketings precipitated by bond insurer downgrades. It also provides relief to certain tax exempt bonds undergoing a change in security or credit enhancement. The Notice is expected to be turned into proposed regulations by the end of June 2008.

Although intended by Treasury officials to provide broad and comprehensive assistance to issuers struggling with the impact of the subprime/bond insurer crisis, the Notice does not provide reissuance relief for all potential restructurings. For example, while the Notice includes a provision permitting "exchanges" of bonds that do not trigger a reissuance in certain limited instances, it does not appear to grant relief for conventional refundings, which in some cases may be the most expeditious way of addressing the necessary restructuring of credit enhancement absent bond insurer consent. The Notice also does not provide relief for (i) bonds with modes based on objective interest rates such as the CPI and inverse floating rates, or (ii) amendments to bonds which provide for the addition of new modes or maturities.

For further guidance concerning the impact of the Notice on possible restructuring transactions, you are invited to call your regular contact in the Public Finance Section of Mintz Levin or any other attorney in the Section listed below.

Jeremy A. Spector
212.692.6283 | JASpector@mintz.com

Mike Solet

Len Weiser-Varon
617.348.1758 | LWeiser-Varon@mintz.com

Jon Ballan
212.692.6772 | JABallan@mintz.com

Katie Bench
617.348.1658 | KPbench@mintz.com

Meghan Burke
617.348.1663 | MBBurke@mintz.com

Charles Carey
617.348.1616 | CECarey@mintz.com

Mark Dutkewych
617.348.3035 | MYDutkewych@mintz.com

Elissa Flynn-Poppey
617.348.1868 | EFlynn-Poppey@mintz.com

Ann-Ellen Hornidge
617.348.1657 | AHornidge@mintz.com

Rich Moche
617.348.1696 | RMoche@mintz.com

Colleen Murphy
617.348.1836 | CAMurphy@mintz.com

Poonam Patidar
617.348.3083 | PPatidar@mintz.com

Linda Port
617.348.1718 | LPort@mintz.com

John Regier
617.348.1720 | JRRegier@mintz.com

Greg Sandomirsky
617.348.1730 | GASandomirsky@mintz.com

Miyoko Sato
617.348.1896 | PMSato@mintz.com

Rob Senzer
212.692.6738 | ROSenzer@mintz.com

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