The folowing article written by David A. Walton appeared in the Public Finance Advisor, Volume I, Issue 8 (November, 1996). Mr. Walton is a member of the Editorial Board of the Public Finance Advisor.

TAX NOTES - November, 1996 Issue

Tax Effects of Modifying Optional Redemption Provisions

By David A. Walton
David A. Walton is a partner at Jones Hall, A Professional Law Corporation, in San Francisco

Background

Most issues of tax-exempt bonds have "call protection" wherein the bonds may not be called (*i.e.,* redeemed) by the issuer for a specified period after the date of issue. A typical call protection period on a 30-year bond is the first 10 years after the issue date. After this initial period, many tax-exempt bonds contain optional redemption provisions which permit the issuer to call the bonds prior to maturity. These optional redemption provisions usually contain call premiums which decrease over time. For example, a bond issued in 1996 with a 30-year maturity may be callable at a price of (i) 102 (*i.e.,* par-100, plus 2 percent of the principal amount called) in 2006, (ii) 101 percent in 2007, and (ii) 100 percent in 2008 and thereafter.

As a bond approaches its call date, if interest rates have decreased since the bond was issued (causing the bond to have an above market rate of interest), the bonds will most likely be called by the issuer. Generally, the issuer will issue lower rate current refunding bonds (*i.e.,* bonds that redeem another bond within 90 days of the date of issue of the refunding bonds) and use the proceeds thereof to call the outstanding bonds.

In some instances, current bondholders, not wanting to lose the above market rate of interest on their bonds, may offer an issuer a payment in exchange for the issuer's agreement to waive its rights to call the bonds. Often, a bondholder will "strip" a bond once the call provisions have been waived. Stripping involves the sale by a bondholder of the bond's coupons (*i.e.,* the cash flow stream) to other investors. Investors generally will not

invest in stripped coupons if there is a risk that the underlying bonds may be called away by the issuer.

The amount of the “call waiver” payment is usually determined by a number of factors such as: (i) interest rate savings available to the issuer if it refunds the outstanding bonds; (ii) the period of time to the call date; (iii) the risk that interest rates may rise before the issuer can issue current refunding bonds; and (iv) the transaction costs associated with the issuance of a current refunding bond.

Tax Consequences of Call Waivers

A call waiver may result in an adjustment to the yield on the bonds, and in the bonds being treated as being “reissued”. Under §1.148-4(b)(3) of the Treasury Regulations relating to arbitrage restrictions (Arbitrage Regulations), generally the yield on a fixed rate bond is computed once as of the date of issue and is not recomputed thereafter. An exception to this general rule is contained in §1.148-4(b)(4) of the Arbitrage Regulations which provides that the yield on a bond is recomputed “as of the date of any transfer, waiver, modification, or similar transaction (collectively, a transfer) of any right that is part of the terms of a bond or is otherwise associated with a bond (*e.g.,* a redemption right)”. Note that the transfer of a redemption right (*i.e.,* a call waiver) is given as an example of a transfer. The regulation further states that on the date of the transfer of this right “the issue is treated as if it were retired and a new issue issued on the date of the transfer (reissued)”.

When an issuer agrees to waive a call right, under the Arbitrage Regulations on the date of the call waiver (i) the bonds are treated as retired at a price equal to their stated redemption price (presumably par or the present value of the bonds on that date), and (ii) new bonds are treated as being issued on that date for a purchase price equal to the deemed retirement price of the old bonds plus the amount received in consideration for the call waiver. This may result in a lower yield being attributable to the pre-call waiver bonds because the longer (higher rate) maturities of the issue will not be taken into account for the entire original term of these bonds. This may also result in a lower yield being attributable to the “new” bonds because the call waiver premium is taken into account as additional purchase price on these bonds.

Therefore, at minimum, a call waiver may result in higher rebate liability and at worse it may cause the bonds to violate arbitrage yield restriction limitations. These results could be especially severe if the bonds were advance refunding bonds because of the yield sensitivity of the refunding escrow.

The final debt reissuance regulations under section 1001 of the Internal Revenue Code of 1986 (Reissuance Regulations) released by the Internal Revenue Service (IRS) on June 26, 1996, contain specific rules with respect to call waivers (see *PFA* August, p.13, for a detailed discussion of the Reissuance Regulations). Under the Reissuance Regulations, if a modification to a bond issue is “significant”, the issue is deemed to be exchanged for a new issue containing the modification. The mechanics of this deemed exchange are similar to the deemed exchange procedure under the yield recomputation rules discussed in the preceding paragraph and the bond yield consequences on the pre-waiver and post waiver bonds are the same.

The significant difference in effect between the Reissuance Regulations and the Arbitrage Regulations is, if a reissuance is deemed to occur under the Reissuance Regulations, new bonds are actually deemed to be issued which replace (refund) the old bonds. This could have significant adverse tax consequences for bonds subject to a change in law (*e.g.,* bonds issued before the Tax Reform Act of 1986) for which no transition rules or inadequate transition rules are provided. In this regard, it should be noted that there are generally no transitional rules exempting a refunding bond from the rebate requirement. Also, under a reissuance pursuant to the Reissuance Regulations, depending on the deemed sales price and the bondholder's basis in the bonds, the bondholder may recognize taxable gain or loss on the transaction.

Under §1.1001-3(e)(1) of the Reissuance Regulations, as a general rule a modification is significant and results in reissuance “if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant”. Also, under §1.1001-3(e)(2) of the Reissuance Regulations, a modification which results in a change in yield of the issue by more than the greater of 25 basis points or 5 percent of the annual yield is a significant modification resulting in reissuance. Example 1 in §1.1001-3(g) of the Reissuance Regulations poses the example of a 30-year bond callable at a premium of 102 after 10 years and a

premium of 101 after 20 years. Eight years after the issue date the bondholder pays the issuer a fee to waive the 10 year call provision. The example states that if the call waiver payment is a significant modification (*i.e.,* if it causes a change in yield in excess of the greater of 25 basis points or 5 percent of annual yield) then the call waiver will cause a reissuance. The change in yield is measured by treating the call waiver payment as a reduction in interest paid on the bonds as of the date of receipt. The example also states that if the change in yield is not significant, the elimination of the call right "must also be tested for significance" by applying the general economic significance standard. The example does not state whether the call waiver in the example was economically significant but, in this regard, one should always ask why a bondholder would pay for a call waiver if it was not economically significant.

Because of the different standards under the Arbitrage Regulations and the Reissuance Regulations, it is possible that a call waiver may result in an adjustment to bond yield under the Arbitrage Regulations without resulting in a reissuance under the Reissuance Regulations. For example, if a call wavier payment does not result in a significant change in bond yield (as determined under the 25 basis points and 5 percent thresholds) and is not economically significant, then no reissuance is deemed to occur under the Reissuance Regulations. The Arbitrage Regulations however, contain no threshold standard and any call waiver is treated as a transfer resulting in recomputation of bond yield. In practice, this situation may rarely arise since the economic significance standard under the Reissuance Regulations is vague and most bond counsel may find it difficult not to find economic significance.

Avoiding Treatment as a Call Waiver

In light of the possible adverse consequences of a call waiver, different structures have been proposed which would accomplish some or all of the desired economic effects of a call waiver without being technically classified as a call waiver. A structure often discussed is the use of a taxable advance refunding to accomplish a call waiver. An advance refunding bond which does not call the refunded bonds on the first call date, in essence, operates like a call waiver with respect to all optional calls occurring before the actual call made with refunding proceeds because the refunding assures that said

optional calls will not be exercised. Section 149(d) of the Internal Revenue Code of 1986 (Code) generally requires that tax-exempt refunding bonds call the refunded bonds on the first call date upon which there is debt service savings. By using a taxable advance refunding bond, the first call date requirement is avoided (taxable bonds are not subject to Section 149(d) of the Code) and the refunded bonds can be defeased to maturity resulting, in effect, in a waiver of all of the optional calls from the date of the refunding to the maturity date of the refunding bonds.

The following is an example of a taxable advance refunding used as a call waiver technique: County issued 8.0%, 30-year, $25,000,000 principal amount of bonds in 1987 (1987 Bonds) to finance a governmental project. The 1987 Bonds are subject to optional redemption in 1997. Because of a decrease in interest rates, the 1987 Bonds are now trading at 108 (taking into account the optional call in 1997). The County issues $22,000,000 of 8.5% taxable advance refunding bonds (1996 Taxable Refunding Bonds) at par and uses all of the proceeds thereof plus $2,000,000 "contributed" by the 1987 bondholders to fund an escrow which defeases the 1987 Bonds to their maturity in 2017 (not to their first call date in 1997). The defeasance escrow is invested at an unrestricted yield (remember the 1996 Taxable Refunding Bonds are taxable and are not subject to arbitrage yield restriction) and because of this unrestricted yield, only $24,000,000 is needed to fund the escrow. The 1987 bondholders are willing to "contribute" $2,000,000 to the escrow because they can strip and resell the 1987 Bonds for a price of 125 ($31,250,000) because the 1987 Bonds are now defeased to maturity, rated at the highest investment grade, and there is no risk of call. Doing the math, the 1987 bonds were worth $27,000,000 (108) before the refunding, the 1987 bondholders sold them for $31,250,000 after the refunding, and contributed $2,000,000 to the escrow leaving the 1987 bondholders with $2,250,000 for their trouble. The County defeases its $25,000,000 of outstanding 8.0%, 1987 Bonds with $22,000,000 of 8.5%, 1996 Taxable Refunding Bonds and realizes significant debt service savings.

Will this structure result in a reissuance? The first question one should ask is why the 1987 bondholders are "contributing" $2,000,000 to the defeasance escrow. If this contribution is paid as an inducement to the issuer to defease the 1987 Bonds to maturity thereby resulting in all of the intervening optional redemption rights being waived, then there is a risk that

the IRS would characterize it as a payment for a call waiver. If it is a payment for a call waiver, then it may result in the 1987 Bonds being treated as reissued, and the reissued bonds being treated as being advance refunded by the 1996 Taxable Refunding Bonds. There are many other variations on this structure, but the economics of all these structures rely heavily on the fact that all optional calls prior to the call by the refunding escrow are in essence waived. Care should be exercised when analyzing any transaction involving a defeasance escrow going past the first call date of the refunded bonds to assure that a disguised call waiver is not occurring.