REPORT #621

TAX SECTION

New York State Bar Association

Report on IRS Notice 88-130

July 11, 1989

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New York State Bar Association

July 11, 1989

The Honorable Fred T. Goldberg, Jr.
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Commissioner Goldberg:

Enclosed is a Report by our Committee on Tax Exempt Bonds on IRS Notice 88-130 concerning the determination of reissuance and retirement of tax exempt obligations for purposes of Sections 103 and 141-150 of the Internal Revenue Code of 1986, as amended. The principal draftsman of this Report is Edward J. Rojas, with assistance from Henry S. Klaiman and Stephen P. Waterman.

The Report notes that the Notice is helpful in clarifying the ambiguity concerning reissuance that existed under the standards arising under Section 1001 of the Code. It recommends, however, that the relationship between the Notice rules and Section 1001 be clarified and that certain industry practices established in order to comply with Section 1001 be permitted to continue under the Notice. Among the Report's specific recommendations are that the Notice be amended so that (i) the determination of sinking fund maturity schedules is permitted either by formula or objective standards, (ii) serialization of term bonds is treated as a qualified tender change when done in conformity with a sinking fund schedule established for the bonds on the date of issue, (iii) the standards under which changes in the security for tax-exempt bonds result in a reissuance are clarified, (iv) bonds whose interest rate is determined pursuant to a “dutch auction” procedure qualify as qualified tender bonds, and (v) certain technical amendments are made to clarify the Notice.

Sincerely,

Wm. L. Burke
Chair

WLB/JAPP
Enclosure
4398r

cc: Kenneth Klein, Esq.
Acting Associate Chief Counsel (Technical)
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

George P. Kelley, Esq.
Office of Assistant Chief Counsel
(Financial Institutions and Products)
CC: FI&P: BR5 (Room 4011)
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Peter K. Scott, Esq.
Acting Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Kenneth W. Gideon, Esq.
Assistant Secretary of the Treasury
for Tax Policy
3120 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dana L. Trier, Esq.
Acting Assistant Secretary of the
Treasury for Tax Policy
U.S. Treasury Department
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20280

Ronald A. Pearlman, Esq.
Chief of Staff
Joint Committee on Taxation
1015 Longworth Building
Washington, D.C. 20515

Tax Report #621

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on IRS Notice 88-130

July 11, 1989

Introduction[1]

On December 14, 1988, the Internal Revenue Service released Notice 88-130[2] (the “Notice), which sets forth guidelines to be used by issuers of state and local obligations and their counsel in determining when tax-exempt obligations are retired and reissued for purposes of Sections 103 and 141-150 of the Internal Revenue Code of 1986, as amended (the “Code”).[3] The Notice states that the rules contained therein will be published in regulations under Section 150. This Report addresses certain issues raised by the Notice which the Committee on Tax Exempt Bonds of the Tax Section of the New York State Bar Association (the “Committee”) believes should be clarified in the forthcoming regulations.

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1 This Report was drafted by Edward J. Rojas, with assistance from Henry S. Klaiman and Stephen P. Waterman, co- chairs of the Committee. Helpful comments were received from Jeffrey H. Aminoff, Sharon Stanton White, Patti T. Wu, Clifford M. Gerber, Linda L. D'Onofrio, Dale S. Collinson, William L. Burke, Howard Zucker, Ralph Winger, Tom Glenn, Eileen Heitzler and Mark Shifke.

2 1988-52 I.R.B. 12.

3 Except as otherwise noted, all section references set forth herein refer to the Internal Revenue Code of 1986, as amended.

Summary and Conclusions

The Report is divided into four sections. Section I sets forth the provisions of the Code affected by the Notice and defines the concept of reissuance and its importance and describes the prior law reissuance standards under Section 1001. Section II sets forth the Notice's operating rules and describes qualified tender bonds and the events resulting in their reissuance. Section III presents the Committee's concern that the relationship between the Notice rules and Section 1001 is unclear and should be clarified. Section IV sets forth specific areas where the Notice should be amended. In particular, the Report recommends that the Notice be amended so that (i) the determination of sinking fund maturity schedules is permitted either by formula or objective standards, (ii) serialization of term bonds is treated as a qualified tender change when done in conformity with a sinking fund schedule established for the bonds on the date of issue, (iii) the standards under which changes in the security for tax-exempt bonds result in a reissuance are clarified, (iv) bonds whose interest rate is determined pursuant to a “dutch auction” procedure qualify as qualified tender bonds, and (v) certain technical amendments are made to clarify the Notice.

Discussion

I. The statutory Framework

Section 103(a) provides a general exclusion from gross income for interest payable with respect to any state or local bond.[4] Sections 141-150 set forth the requirements that must be satisfied by issuers of state or local bonds in order to exclude the interest thereon from gross income under Section 103(a).[5] Section 1001 provides for the determination of the amount of gain or loss from the sale or other disposition of property. For purposes of recognizing gain or loss under Section 1001, material changes to the original terms of a security are treated as resulting in a taxable exchange and in the issuance of a new security. The standards under Section 1001 are unclear, but the Internal Revenue Service has stated that in general, a change in

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4 Section 103(c)(1) defines “state or local bonds'* as an obligation of a state or political subdivision thereof. Section 103(c)(2) provides that the term “state” includes the District of Columbia and any possessions of the United States.

5 These requirements include, among others, the volume cap limitation in Section 146 for certain private activity bonds, and the requirement to rebate arbitrage profits to the United States government for certain state or local bonds in Section 148. The requirements that must be satisfied by a particular bond issue vary according to its characterization based on use of the bond proceeds.

the interest rate is the most critical factor for purposes of determining whether a taxable exchange occurs under Section 1001.[6]

Prior to release of the Notice, court decisions, published rulings and private letter rulings under Section 1001 have provided guidance for determining when bonds were deemed exchanged and reissued for purposes of Sections 103 and 141-150 of the Code and Sections 103 and 103A of the Internal Revenue Code of 1954, as amended (the "1954 Code").[7]The rulings under Section 1001 were used by bond counsel as analogies even though the rulings themselves often did not address Section 103.

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6 See General Counsel Memorandum 37002 (Feb. 10, 1977); Private Letter Ruling 7845001 (June 23, 1978); Private Letter Ruling 7902002 (June 29, 1978). See also Private Letter Ruling 8540090 (July 12, 1985) (renegotiation of the interest rates on qualified mortgage bonds subsequent to the date of issue results in a new obligation). Compare Private Letter Ruling 8834090 (June 3, 1988) (0.2% change in interest rate is a reissuance) with Private Letter Ruling 8835050 (June 8, 1988) (0.03% change in interest rate is not a reissuance).

7 See, e.g. Rev. Rul. 87-19, 1987-C.B. 249, in which the waiver of an interest rate adjustment clause providing for a higher rate of interest on a bond issue in the event of a change in the maximum marginal federal income tax rate was deemed a taxable exchange and reissuance of the bond issue within the meaning of Section 1001; Rev. Rul. 81-169, 1981-1 C.B. 429, in which a change in the interest rate on a bond issue from 9% to 8.5% coupled with a 10-year extension in the maturity of the bond issue and the elimination of sinking fund provisions was deemed a taxable exchange and reissuance of the bond issue within the meaning of Section 1001. A discussion of the historical guidelines of what has been deemed a taxable exchange under Section 1001 and reissuance in general is contained in Winterer, Reissuance and Deemed Exchanges Generally, 37 Tax Lawyer 509 (1984).

If a bond is deemed retired and simultaneously reissued, the reissued bond is characterized as a current refunding of the original bond. The exclusion from gross income for federal income tax purposes of the interest on the reissued bond depends on the law in effect at the time of such bond's reissuance. Therefore, changes in law that occur between the date of original issuance of a bond and the date of its reissuance may have an adverse impact on the reissued bond unless the reissued bond complies with a transition rule for current refundings or the reissued bond satisfies rules imposed subsequent to the issuance of the original bond.

II. Reissuance Under the Notice

The Notice creates a category of indebtedness which it names “qualified tender bonds”. The Notice then provides guidelines for determining when qualified tender bonds are deemed to be retired and reissued. These guidelines are designed to permit particular events or changes, to deny others, and otherwise to fall back on the still undefined facts and circumstances determinations under Section 1001.

These rules apply solely for purposes of Sections 103 and 141-150. These provisions do not apply to other sections of the Code concerning tax-exempt bonds. In order to provide consistent treatment to those provisions of the Code dealing with tax-exempt bonds, these rules should also apply for purposes of determining items of tax preference under Section 57 and the bank qualified bond provisions under Section 265.

The Notice defines a qualified tender bond as a bond (i) subject to a tender right; (ii) the interest on which accrues at a “tender rate”; (iii) the interest on which is due at periodic intervals of one year or less; and (iv) which matures no later than the earlier of 35 years from the date of issue or the reasonably expected period required to carry out the governmental a purpose of the bond.[8]

A bond is subject to a tender right if the bondholder may or must tender the bond for purchase or redemption at par pursuant to the terms of the bond on one or more tender dates before the final stated maturity.

Interest on bonds accrues at a “tender rate” if the terms of the bond provide that (i) the interest rate to the first tender date is set on or after the sale date at the lowest rate that would enable the bond to be marketed at par (plus accrued interest) on the date of issue, and (ii) the interest rate for

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[8] The Notice provides a safe harbor of 120 percent of the average reasonably expected economic life of the facilities financed with the proceeds of the bonds (determined under the standards set forth in Section 147(b)) for determining whether the maturity of the bonds exceeds the “reasonably expected period.” It is of interest to note that certain types of bonds are excluded from the scope of the Notice. For example, bonds which bear a fixed interest rate from the date of issue until their maturity are excluded as are bonds having a maturity in excess of 35 years.

each period between tender dates is reset for each period at the lowest rate that would enable the bond to be remarketed at par (plus accrued interest) at the beginning of the period. Minimum and/or maximum rate limitations, including interest rate “collars”, are a permissible component of the “tender rate” as long as such limitations are not designed to front-load or back-load interest; however, interest rates that are set as a percentage of a bank's prime lending rate or some other external index not subject to modification by any parties having an interest in the bond issue (such as the Bond Buyer 40 index) do not accrue at a “tender rate”[9] nor does an interest rate on bonds that is set by an auction procedure as further described in Section IV(4) of this Report.

The Notice provides that qualified tender bonds are generally deemed to be retired and reissued[10] when:

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9 In contrast, however, the original issue discount rules under Section 1275 provide that interest payments on variable rate obligations must be based on current values of an objective interest index such as LIBOR, bank prime lending rates or the applicable Federal rate or such payments will be treated as contingent payments. Proposed Treasury Regulations §§ 1.1275-5(a) and 1.1275-5(b).

10 The Notice actually states that qualified tender bonds will be treated as retired “only if” one of the described conditions exist. The phrase “if and only if” should be substituted for “only if”.

(a) they are purchased or otherwise acquired by or on behalf of the issuer or a true obligor that is a governmental unit or an agency or instrumentality thereof (except a “qualified tender purchase” of a qualified tender bond) or otherwise retired or redeemed;

(b) there is any change to the terns of the bonds (other than a “qualified corrective change”) made in connection with a “qualified tender change” that increases the tender period from less than one year to more than one year or decreases the tender period from more than one year to less than one year;

(c) there is a change in the period between tender dates that is not a “qualified tender change”; or

(d) there is a change to the terms of the bonds (other than a qualified corrective change) which would cause disposition of the bond under Section 1001 without regard to the exercise of the tender right.

A “qualified tender purchase” is defined as any purchase of a qualified tender bond that is pursuant to a tender right in the bond terms requiring that best efforts be used to remarket the bonds, provided the bonds are in fact remarketed within 30 days of the date of purchase. If the bonds are not remarketed within 30 days of the date of purchase, the bonds are deemed retired on the date of purchase and reissued upon remarketing.

A “qualified corrective change” is any change that does not materially alter the rights or remedies of the bondholder or that corrects a term of the bonds to eliminate a result that could not reasonably have been intended on he date of issue of the bonds. It also includes any change necessary solely by reason of circumstances occurring after the date of issue of the bonds that (a) could not have been reasonably anticipated on the date of issue of the bonds, (b) is not related to bond market conditions or the creditworthiness of the issue, and (c) is not within the control of the issuer, any bondholder, any person related to the foregoing under Section 147(a)(2), anyone acting on behalf of such persons, or any combination of the aforementioned persons (“Controlling Parties”).

A “qualified tender change” is any change in the period between tender dates (including the final period to maturity) that occurs pursuant to the terms of the bonds as in effect on the date of issue. The Committee understands that the words “pursuant to” include voluntary, in addition to automatic, actions, as long as such actions are permitted or contemplated by the bond documents.

The Notice defines the term “change” with respect to the terms of the bonds, for purposes of subsection (b) of the second previous paragraph to mean any discretionary alteration in the legal rights or remedies of the bondholder that occurs after the date of issue. Any alteration is discretionary unless it is totally outside the control of the Controlling Parties. Examples of a “change” include changes in:(i) the final stated maturity date of the bonds, (ii) the interest rate on the bonds, (iii) the payment date on the bonds, (iv) the security for the bonds and (v) the provisions concerning defaults under the bond documents.

III. Relationship of the Notice Rules to Section 1001

As noted above, Section 1001 has provided guidance under which municipal bond professionals have structured bond financings for purposes of avoiding reissuance. The Notice is quite helpful in that it provides a safe harbor for determining that certain variable rate obligations (commonly called “low floaters” or variable rate demand notes) may be converted, pursuant to the term of the instruments, to fixed rate bonds without causing a deemed reissuance of the bonds. However, the relationship of the Notice rules to sale or exchange treatment under Section 1001 is unclear. This raises the question whether particular transactions might be considered (1) to be taxable sales or exchanges under Section 1001, but not reissuances under the Notice or (2) reissuances under the Notice but not taxable sales or exchanges under Section 1001.

This ambiguity can be illustrated through examination of the effective date provision for the application of one of the most important rules in the Notice, Section A(2.2(a)). That section provides that a qualified tender bond will be considered to be retired and reissued if the tender period is changed from a period not exceeding one year to a period exceeding one year (or vice versa) and, in connection with such change in the tender period, there is any other change in the terns of the bonds (other than a qualified corrective change). In the case of bonds secured by a letter of credit, the Notice indicates that the discretionary substitution of a “AAA” rated bank for a “AA” rated bank is such a change. It is doubtful whether such a change in the letter of credit bank would, in itself, cause a Section 1001 disposition.

Thus, if Section A(2.2(a)) applies in such as case, the bonds will be treated as retired and reissued. But the effective date rules in Section C of the Notice provide that (1) section A(2.2(a)) does not apply to bonds sold before December 14, 1988 and (2) a change (the “Related Change”) that would otherwise cause a bond to be considered retired under Section A(2.2(a)) will result in a retirement and reissuance only if the Related Change would result in a disposition of the bond for purposes of Section 1001. At the same time, all of the other rules of the Notice apply to tender bonds, including the rule in Section A(2.3) that “a qualified tender bond will not be treated as retired merely by reason of:(a)the existence of the tender right; (b) a qualified tender purchase; (c) a qualified tender change; (d) a qualified corrective change; or (e) any combination of the foregoing.”

The described effective date provision is itself ambiguous in many respects. But it appears to be the case that in deciding whether a reissuance of a grandfathered qualified tender bond has occurred, Section 1001 is to be applied by examining only the Related Change and not the combination of the Related Change and the change in the tender period. If so, bonds may be considered not to be reissued even though a sale or exchange has occurred under Section 1001. On the other hand, if one takes the position that a conversion from a variable rate to a fixed rate is not, per se, a sale or exchange under Section 1001, then Section A(2.2(a)) may require reissuance treatment in some circumstances where no Section 1001 sale or exchange has occurred.

The Committee understands that a deliberate decision was made in the preparation of the Notice to formulate reissuance rules for purposes of the tax-exempt bond rules that were not directly linked to the Section 1001 rules. The resulting possible conflict between reissuance analysis and Section 1001 analysis should generally not present significant problems. Because the bonds in the variable rate mode (and at the time of the conversion to fixed rate bonds) are structured to be worth par, sale or exchange treatment would normally not result in the recognition of gain or loss. It is generally expected that when variable rate bonds convert to fixed rate, the existing holders (often tax-exempt money market funds) will tender the variable rate bonds and new investors will acquire the fixed rate bonds.

Thus, the investors' holding period will generally not be affected by the existence or absence of sale or exchange treatment under Section 1001.

However, the existence or absence of sale or exchange treatment under Section 1001 could affect the application of other provisions relating to the consequences of owning tax-exempt bonds. For example, a financial institution's holding period for tax-exempt bonds determines whether the bonds are grandfathered from the amendment to Section 265 (respecting disallowance of interest deductions) enacted by Section 265 of the Tax Reform Act of 1986. See General Explanation of the Tax Reform Act of 1986, at 564.

We recommend, therefore, that the Notice be amended to clarify the relationship between its rules and Section 1001.

IV. Specific Comments

1. Mechanical Changes and Establishing Sinking Fund Schedules According to Formula or Objective Standards

Under Section A(2.3) of the Notice, a qualified tender change will not by itself result in a reissuance or retirement of a qualified tender bond. A qualified tender change that increases the period between tender dates from over one year to under one year or vice versa does not cause the bonds to be deemed retired and reissued unless some other change occurs in connection with this qualified tender change. As mentioned above, a “change” is defined under the Notice (specifically in Section B(5.1)) as a discretionary alteration in the legal rights and remedies of the bondholder that occurs after the date of issue. A change is not discretionary if all of its elements are outside of the control of Controlling Parties. The Notice specifically provides that the resetting of the interest rate on a bond to a tender rate from another tender rate pursuant to the terms of the bonds, while remaining in the same interest rate mode is not a change, nor is the accrual of a higher rate of interest, pursuant to the terms of the bonds, when “bank bonds” are held by the guarantor of an issue pending remarketing. The automatic alteration in the security for a bond occurring when the interest rate converts from a variable rate to a fixed rate is also not an exchange.[11]. In addition, qualified corrective changes are deemed “changes” for these purposes which do not result in a retirement and reissuance of a bond. All of these are examples of what can be termed “mechanical” changes, which are not viewed as altering the rights of the bondholders.

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11 Such an alteration often occurs when a bond in a short-term variable rate mode secured by a letter of credit automatically drops the letter of credit upon conversion to a long-term fixed rate. Bond documents commonly provide that when a letter of credit is no longer required (as is often the case when bonds convert to a long-term fixed rate) it is automatically eliminated.

The Notice should expand upon the concept of mechanical changes to include certain alterations to the terms of the bonds that occur after the date of issue pursuant to a formula or to objective standards that are established on the date of issue. One such alteration could involve qualified tender bonds where the sinking fund maturity schedule is established on the date these bonds convert from a short-term variable rate to a long-term fixed rate pursuant to a formula which is established on the date of issue. This formula could require, for example, that the sinking fund maturity schedule be established in such a manner so as to result in the debt service schedule that most closely approximates level debt service. This formula would serve to restrict the ability of Controlling Parties to amend the sinking fund schedule since level debt service must be maintained while at the same time allowing the sinking fund schedule to be established upon conversion in a manner which reflects current market conditions.

Another possibility would be to gauge the sinking fund maturities according to the economic life of the bond financed facility at the conversion date. In this manner, Controlling Parties could only amend the sinking fund schedule to reflect the current remaining economic life of the facility. Another approach could be based upon anticipated tax receipts in general obligation issues. If upon conversion, these tax receipts are less than anticipated on the date of issue, the sinking fund schedule can be lengthened as necessary to lower debt service on the bonds to prevent budgetary deficits. Since tax receipts often vary according to the composition of the tax base within the issuer's jurisdiction and this is not subject to modification by Controlling Parties, the sinking fund schedule could be modified to reflect any budgetary constraints in effect on the conversion date.

2. Serialization

The Notice provides a situation in Example 4 where the “serialization” of a qualified tender bond results in a reissuance. In the example, $100 million of qualified tender bonds issued on July 15, 1989, initially bear interest at a weekly rate. The terms of the bonds permit conversion of the interest rate to a rate that is fixed to maturity and, in that event, 20 percent of the bonds must be called for redemption on July 1, 1999. The bond documents provided that bonds must be selected for redemption and bondholders must be notified of this selection at least 60 days prior to the call date. On July 1, 1991, the issuer converts the entire issue to a fixed interest rate and at that same time selects by lottery 20 percent of the bonds to be called on July 1, 1999, thereafter notifying the appropriate bondholders.

The advanced selection of bonds to be redeemed on July 1, 1999 effectively achieves a serialization of the term bonds (since all of the bonds would otherwise mature on July 1, 2014).

The example concludes that the entire $100 million of bonds is deemed to be reissued on July 1, 1991, because this serialization is a change to the terms of the bonds occurring in connection with a qualified tender change that increases the period between tender dates from a period not exceeding one year to a period in excess of one year.

Although it is not specifically stated in the example, the serialization presumably results in a reissuance because it is considered a discretionary change at a time that was not intended when the issue was originally sold, even though one could technically accomplish such a result under the original terms of the bonds. In Example 4, the serialization occurs when the selection of bonds which would be serial bonds was determined on July 1, 1991 (i.e. the date the bonds were converted from a variable to a fixed rate) instead of approximately 60 days prior to July l, 1999, as originally contemplated in the transaction. Thus, the issuer retained the discretion to determine when the bonds would be called for redemption, i.e. any time between the conversion date to 60 days before the call date for the bonds.

Example 4 of the Notice implies no reissuance would have occurred on the conversion date if the bonds, by their terms, provided for serialization according to fixed sinking fund maturities on the date of issue. In that event, the element of discretion would have been eliminated with regard to establishing the maturities of the bonds. In order to clarify the intended scope of Example 4, this alternative set of facts should be added to reflect an alternative result where the serialization has been fixed on the date of issue. The Committee also believes that the issuer should be allowed to provide for serialization of the bonds in any manner it chooses as long as this conforms with the sinking fund maturity schedule established for the bonds on the date of issue. The Committee believes that the provision for serialization of the bonds constitutes a "qualified tender change." Upon conversion to a fixed rate, the creation of each sinking fund maturity constitutes a change in the period between tender dates (i.e. to final maturity).

3. Changes in Security

Section A(2.2) of the Notice provides that a discretionary change in security for qualified tender bonds results in a reissuance of the bonds when it occurs in connection with a qualified tender change that increases the period between tender dates from a period not exceeding one year to a period exceeding one year or vice versa. Section B(5.4) of the Notice provides an example of a change in security that could result in reissuance. In this example, the terms of a bond initially secured by a "AA" rated guarantor require that on March 15, 1989, the issuer remarkets the bond to a long-term fixed interest rate and obtain a guarantee of debt service on the bond from either a "AA" or "AAA" rated guarantor. On March 15, 1989, the bond is remarketed with a guarantee from a "AAA" rated guarantor. This is deemed to be a discretionary alteration in the security for the bond, which is a change for reissuance purposes. Example 3 of the Notice presents a similar set of facts in which qualified tender bonds are initially secured by a “AAA” rated guarantor, the issuer has the option of selecting either a “AA” or “AAA” rated guarantor, and upon remarketing the bonds the issuer chooses a “AA” rated guarantor. There, the discretionary change in security also resulted in a reissuance on the date of the remarketing.

The example in Section B(5.4) of the Notice should be clarified to describe the amount of detail the terms of the bonds should provide regarding the security for the bonds after remarketing in order to avoid a reissuance. It should state whether or not the terms of the bonds must provide, for example, that after remarketing the bonds they must be secured by a “AAA” rated guarantor. It should also state whether the terms of the bonds need to provide specifically that the bonds are to be secured solely from project revenues when the initial letter of credit or bond insurance drops off upon remarketing to a long-term fixed rate mode. This example should also clarify whether there is a change if (i) the bonds are initially secured by a “AAA” rated guarantor, that subsequently is downgraded to a “AA” rating, and upon conversion to a fixed rate, the bonds are secured by a “AAA” rated guarantor. It should also clarify whether there is an exchange if the bonds are originally secured by a debt service reserve fund funded with a bank letter of credit and upon conversion to a fixed rate the bonds are secured by a debt service reserve fund which is funded with cash, and whether the existence of a change depends on the credit rating of the letter of credit bank and the investments purchased to fund the debt service reserve fund.

The Committee believes the intent behind this rule is to prevent a change in the credit rating of the bond issue as distinguished from a change in the type of security for the bond issue. Thus, the existence of an option to change is not a problem, only its exercise which creates a change in credit.

4. Dutch Auction Bonds

Dutch Auction Bonds are bonds the interest rate on which is periodically reset through an auction procedure. Bondholders may tender their bonds on the dates that the interest rate is to be reset only if there are buyers willing to purchase their bonds at the reset rate. Otherwise, the existing bondholders must keep their bonds.

Dutch Auction Bonds are not “tender bonds” or “qualified tender bonds” because they do not afford the bondholder a right to tender the bond (i.e., a “tender right”). Often, however, the issuer of Dutch Auction Bonds has the right to convert the bonds to a rate fixed to maturity or to another rate mode. Typically, the bonds are subject to mandatory tender on the conversion date. Therefore, on the conversion date, the bonds will be subject to a “tender right” and the conversion date will be a “tender date.”

However, in order to be a “tender bond” and therefore under certain conditions a “qualified tender bond” addressed by the Notice, the bond must be subject to a tender right and all interest on the bond must accrue at a tender rate. Under the language of the Notice, it is unclear whether interest on a Dutch Auction Bond accrues at a tender rate. Interest accrues at a tender rate, as explained above, if (i) for interest accruing to the first tender date, the rate is set on or after the sale date at the lowest rate that would enable the bond to be marketed at par on the date of issue and (ii) for interest accruing for the periods between tender dates, the rata is reset for each such period at the lowest rate that would enable the bond to be remarketed at par. The language implies that the interest rate on a tender bond is to be set on the date of issuance and on each subsequent tender date and is to be fixed until the next tender date. With a Dutch Auction Bond, however, although the initial interest rate is set to allow the bonds to be sold at par on the date of issuance, that initial rate is not maintained until the conversion date but instead is reset periodically in accordance with the auction procedures.

The definition of “tender rate” should be clarified to provide that, although the interest rate determined on the date of issuance or any tender date must be a rat* that allows the bonds to be marketed at par, that interest rate need not be maintained until the next tender date.

5. Transition Rule Bonds

The definition of “qualified tender bond” contains a safe harbor for determining if the maturity of the bonds is the date reasonably expected to be required to carry out the governmental purpose of the issue of which the bond is a part. The safe harbor provides that a bond will be deemed to meet this requirement if the average maturity of the issue of bonds does not exceed 120% of the average reasonably expected economic life of the facilities being financed with the bond proceeds. Certain of the transition provisions of the Tax Reform Act of 1986 provide maturity limitation alternatives that would allow transition rule bonds to mature later than the date that is 120% of the average reasonable expected economic life of the financed facilities. Therefore, bonds that are eligible for transition rule relief may be precluded from using both this safe harbor and certain of the maturity limits provided by the transition rules. The safe harbor should be expanded to include the same maturity limitations as are provided by the transition rules.

6. Effective Dates

The rules set forth in the Notice apply to any bond originally sold after December 14, 1988. With respect to any bond subject to a tender right that would qualify as a qualified tender bond and which was sold on or before December 14, 1988, all of the rules set forth in the Notice apply to such bond except that the event of reissuance arising from a change to the terns of the bond in connection with a qualified tender change that increases the tender period from less than a year to more than a year, or vice versa, shall not be deemed to cause a retirement of the bond unless such a change would result in a disposition for purposes of Section 1001.

With respect to any bond subject to a tender right that is not a qualified tender bond and was sold on or before December 14, 1988, all of the rules set forth in the Notice apply except that such bond will not be treated as retired on a tender date solely by reason of the existence or exercise of the tender right.

In a multi-modal or a commercial paper mode transaction where the debt was issued prior to December 15, 1988 and would still not qualify as a qualified tender bond (for example, because its maturity exceeded 35 years from the date of issue), there is some question as to whether the existence and exercise of the multi-modal election (i.e., a tender change) may be effected without constituting a reissuance by reason of the effective date provisions. The question arises because of a perceived ambiguity in the effective date provision in Section C of the Notice. It states that “(1) no bond that is subject to a tender right will be treated as if retired on a tender date solely by reason of the existence or exercise of the tender right”. This provision can be corrected to protect such pre-December 15th issues by adding the words “or tender change”.

7. Technical Amendments

Section A(2.2)(c) of the Notice should be amended by striking out the word “disposition” and replacing it with “sale or exchange”. This will serve to clear up some confusion because the word “disposition” is used in Section 1001(a) which provides for the determination of gain or loss from a “sale or other disposition” of property. Also, Section 1001(c) is the applicable subsection of Section 1001 which is used for determining reissuance under Section 1001 and provides for the recognition of gain or loss on the “sale or exchange” of property.

There is also some confusion as to whether a bond may qualify as a qualified tender bond if interest on the bond is set on a date other than the tender date. An example of such a bond would be a bond which is tendered on seven days' notice but the interest on which is set on some date other than the tender date. It would be helpful to receive some clarification on this question in the forthcoming regulations. For example, the regulations could provide that the term “qualified tender bond” includes certain commonly offered securities which are tendered weekly for which the interest rate is initially set on each Monday but for which the bond documents provide that the tender date can be any day which is seven days after providing notice.

In addition section A(1.2) of the Notice should be amended to change “purchased” to “retired” in the final sentence. This will be more consistent with the resulting termination of the debt.

The Notice should also clarify whether “qualified tender change” includes a situation where on the date of issue, the bond documents provide that the tender date may be changed during a tender period (e.g., 30-year bonds are initially issued in a 3-year mode and at the end of the second year, the issuer converts the bonds to a long-term fixed-rate mode). The Committee believes that such a change should constitute a qualified tender change.