Public Finance Advisory

MINTZ LEVIN
Mintz Levin Cohn Ferris Glovsky and Popeo PC

MAY 13, 2011

Amended IRS Regulation Facilitates Tax-Exempt Bond Restructurings

BY LEONARD WEISER-VARON AND MAXWELL D. SOLET

Restructurings of tax-exempt bonds payable by an entity experiencing financial difficulties typically feature the *yin* of an obligor seeking debt relief that will permit it to operate without the stigma of potential insolvency and the *yang* of creditors who may wish to accommodate but do not want to leave money on the table. This frequently leads to an agreement between the obligor and the bondholders to reduce or defer principal and/or reset the interest rate. It also may lead to some variant on an "A/B" structure involving a reduced amount of debt that is unconditionally payable (the "A piece") and a balance that is deferred and often payable on a flexible schedule dictated by available cash flow (the "B piece").

However, maintaining tax-exemption of the bonds often presents obstacles to restructurings, including A/B restructurings. If principal is deferred beyond a safe harbor period and/or the interest rate is altered, the restructured bonds may be considered "reissued" for tax purposes. A tax reissuance generally is not overly problematic for financially healthy bonds, as in most cases it merely requires the filing of an IRS tax report (Form 8038) by the issuer, some due diligence by bond counsel, and the issuance of a new tax opinion confirming that the reissued bonds are tax-exempt. In the case of a financially troubled obligor, however, a reissuance has raised vexing questions as to whether the restructured bonds continue to qualify as debt.

Tax practitioners generally consider a reasonable expectation of full repayment a significant factor in distinguishing a debt investment from an equity or other non-debt investment. Restructurings that involve a tax reissuance, therefore, have presented the dilemma of requiring a high degree of confidence as to the repayment of the restructured debt in the face of financial difficulties that are causing the debt to be restructured. Even if the restructuring involves a mere deferral of scheduled principal payments or resetting of interest outside the reissuance safe harbors, a need to update the repayment expectations as of the reissuance date can be problematic.

Although the expectation of repayment requirement creates tax-exemption opinion issues for a variety of restructurings, it has been of particular concern in A/B restructurings, where there is almost by definition a reduced expectation of repayment of the "B piece," which is sometimes referred to as a "hope note" and often represents more a wish than an expectation of repayment. If bond counsel is uncertain as to whether an instrument is debt at the time it is issued, bond counsel will be unable to give an unqualified opinion that the payments on such instrument constitute interest or tax-exempt interest. In fact, because the A and B pieces are issued simultaneously, in some circumstances a tax-exemption question relating to the B piece may also affect the ability to obtain a tax-exemption opinion on the A piece.

An IRS regulation finalized earlier this year substantially simplifies the tax analysis for restructurings of tax-exempt debt involving principal deferral or reduction and/or interest resets outside the reissuance safe harbors. The new regulation also may facilitate A/B restructurings involving tax-exempt bonds. The regulation amends the § 1.1001-3 tax regulations governing modifications of debt instruments to make the expectation of repayment at the time of a bond restructuring unnecessary provided that such an expectation existed at the time the bonds were originally issued. More specifically, the regulation states:

> … [I]n making a determination as to whether an instrument resulting from an alteration or modification of a debt instrument will be recharacterized as an instrument … that is not debt, any deterioration in the financial condition of the obligor between the issue date of the debt instrument and the date of the alteration or modification (as it relates to the obligor's ability to repay the debt instrument) is not taken into account. For example, any decrease in the fair market value of a debt instrument … between the issue date of the debt instrument and the date of the alteration or modification is not taken into account to the extent that the decrease in fair market value is attributable to the deterioration in the financial condition of the obligor and not to a modification of the terms of the instrument.

The above relief from the debt repayment expectation is not available in cases involving a change in the debt obligor(s). It also remains the case, as noted in the preamble to the new regulation, that "all relevant factors (for example, creditor rights or subordination) other than any deterioration in the financial condition of the issuer are taken into account in determining whether a modified instrument is properly classified as debt…" Accordingly, the restructured instrument must promise repayment by some maturity date, even if the repayment schedule is flexible and even if the financial ability of the obligor to make such repayment is questionable as a practical matter (i.e., the failure to repay the bond at maturity must constitute a default and entitle the holder to exercise remedies). In addition, although subordination is not inconsistent with debt treatment, the reference to subordination as a relevant factor in the regulatory preamble may cause practitioners to look carefully at subordination features in the restructuring context. So there will still be some tax-related constraints around the structuring of a "B piece" in an A/B restructuring. However, through this new regulation, the IRS has put an important new tool into the tool box for bondholders of distressed debt by favorably addressing a long-standing problem facing workout practitioners.

* * *

For more information, please contact the authors or your Mintz Levin attorney.

Please click here to learn more about our Public Finance Practice.

Click here to view Mintz Levin's Public Finance attorneys.
