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Internal Revenue Service  
**Memorandum**

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subject: Chief Counsel Advice Memorandum

Issue

Will the legal defeasance of an issue of taxable direct pay Build America Bonds ("BABs") described in the facts below cause the defeased bonds to be reissued?

Conclusion

We conclude that the legal defeasance of the issue of taxable direct pay BABs described in the facts below is a significant modification under §1.1001-3 of the Income Tax Regulations. This modification results in an exchange of the BABs for modified instruments that differ materially either in kind or effect from the original issue of BABs and therefore causes the defeased bonds to be reissued.

Facts

In July 2009, a local government (Issuer) issued taxable direct pay BABs with an interest rate of 6.00% payable semiannually. Subsequent to the issuance date, Issuer applied for and received semiannual federal payments equal to 35 percent of the interest paid by Issuer on each interest payment date under the BABs. Because of sequestration, Issuer's July 2014 payment was reduced. This reduction triggered an extraordinary optional redemption provision applicable to the BABs. Issuer decided to issue refunding bonds and use the proceeds of the refunding bonds to redeem the BABs.

The BABs were not redeemed on the same day that the refunding bonds were issued. Instead, as permitted by the BABs documents, the proceeds of the refunding bonds were deposited in a defeasance escrow and were used to purchase government securities. The government securities were reasonably expected to provide for the debt service on the BABs that were defeased (the “defeased bonds”). After the deposits, the holders of the defeased bonds were entitled to look only to the defeasance escrow for payment and security.

## Law

Generally, under § 1.1001-3(a)(1) a significant modification of a debt instrument results in an exchange of the original debt instrument for a modified instrument that differs materially either in kind or effect. A modification is defined in § 1.1001-3(c)(i) as any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument.

Section 1.1001-3(c)(1)(ii) generally provides that alterations occurring by operation of the terms of a debt instrument are not modifications. Under § 1.1001-3(c)(2), some alterations that occur by operation of the terms of the debt instrument are nevertheless considered modifications. One such exception described in § 1.1001-3(c)(2)(i) is a change (in whole or in part) in the recourse nature of a debt instrument from recourse to nonrecourse or vice versa.

Whether a modification is significant is determined under § 1.1001-1(3)(e). Specifically, § 1.1001-3(e)(5) describes when a change in the nature of a debt instrument will be a significant modification. Under § 1.1001-3(e)(5)(ii)(A), a change in the recourse nature of a debt instrument from recourse to nonrecourse (or substantially nonrecourse) is a significant modification. As a result, a legal defeasance of a debt instrument in which the issuer is released from all liability to make payment on the debt instrument generally is a significant modification.

Section 1.1001-3(e)(5)(ii)(B) describes an exception for the defeasance of a tax-exempt bond (the “tax-exempt bond defeasance exception”). Under that exception, if the defeasance occurs by operation of the terms of the original tax-exempt bond and the issuer places in trust government securities or tax-exempt government bonds that are reasonably expected to provide for the debt service on the defeased tax-exempt bond, the defeasance is not a significant modification even though the issuer is released from any liability to make payments under the tax-exempt bond.

Section 1.1001-3(f)(5)(iii) defines “tax-exempt bond” to mean a state or local bond that satisfies the requirements of § 103(a). Section 103(a) provides, with certain exceptions, that gross income does not include interest on any State or local bond.

Section 54AA(d)(1) defines a BAB in part as an obligation on which the interest would (but for other provisions of § 54AA) be excludable from gross income under § 103. Section 54AA(f)(1) specifically provides that the interest on any BAB shall be includible in gross income. The authority to issue BABs expired on December 31, 2010.

Section 54AA(a) provides that if a taxpayer holds a BAB on one or more interest payment dates of the bond during any taxable year, there shall be allowed as a credit against income tax for the taxable year an amount equal to the sum of the credits determined under § 54AA(b) with respect to such dates. Section 54AA(g) provides that in lieu of the credit allowed under § 54AA(b), the issuer of a qualified bond shall be allowed to elect to receive a refundable credit as provided in § 6431.

Section 6431(a) provides that for certain specified tax credit bonds (including BABs), the issuer shall be allowed a credit with respect to each interest payment date. The amount of the credit is specified in § 6431(b) as 35% of the interest payable on the bond, the amount of which is to be paid to the issuer by the Secretary contemporaneously with each interest payment date under the bond (the “§ 6431 payment”). These types of bonds are commonly referred to as “direct pay” bonds. Holders of the taxable direct pay BABs are unaffected by the receipt of the § 6431 payment by the issuer of the BABs.

### Analysis

In this case, the legal defeasance of the taxable direct pay BABs, which included the deposit into the defeasance escrow of the government securities reasonably expected to provide debt service on the defeased bonds, caused the defeased bonds to become nonrecourse bonds. Under § 1.1001-3(e)(5)(ii)(A), the change from recourse to nonrecourse was a significant modification to the original issuance of the taxable direct pay BABs unless the tax-exempt bond defeasance exception applied.

Issuer points to the definition of a tax-exempt bond under § 1.1001-3(f)(5)(iii) and argues that taxable direct pay BABs are state or local bonds that must meet the requirements of § 103(a) to qualify as BABs. Thus, Issuer argues that the tax-exempt bond defeasance exception also applies to taxable direct pay BABs.

In addition to the tax-exempt bond defeasance exception, the final §1.1001-3 regulations provide a number of special rules applicable only to tax-exempt bonds. See §1.1001-3(f)(6). As explained in the preamble to the final regulations, the drafters added these rules because of concerns that certain practices typical in tax-exempt bond financings, such as defeasance, could trigger a significant modification. Modifications of Debt Instruments, 61 Fed. Reg. 32926, 32929-32930 (June 26, 1996). If there was an intervening change in law following issuance, a significant modification could “result in bonds that were tax-exempt when issued ceasing to be tax-exempt bonds.” *Id.* at 32929. Thus, the drafters were concerned about the potential loss of tax-exemption to bond holders and intended the definition of “tax-exempt bond” provided in § 1.1001-3(f)(5)(iii) to include those state or local bonds that were “tax-exempt.”

The §1.1001-3 regulations were finalized in 1996, when all state or local bonds satisfying the requirements of § 103(a) were tax-exempt. BABs became available thirteen years later, in 2009. As discussed above, BABs are taxable bonds that, for a limited time period, could be issued by state or local governments.

The definition of “tax-exempt bond” under § 1.1001-3(f)(5)(iii) did not change in 2009 to explicitly state that bonds that meet the requirements of § 103(a) to be tax-exempt bonds must, in fact, be tax-exempt. Nevertheless, given the reason the special rules for tax-exempt bonds were added to §1.1001-3, we do not believe that BABs, which are tax/able bonds and therefore do not satisfy the § 1.1001-3(f)(5)(iii) definition of “tax-exempt bond,” should be treated as tax-exempt bonds under §1.1001-3. As discussed above, without the special tax-exempt bond rules in §1.1001-3, holders of tax-exempt bonds might, through no action of their own, suffer the loss of the benefits of the tax-exemption under §103 for their tax-exempt bonds if the bonds were determined to be reissued and failed to qualify as tax-exempt under the version of § 103 in effect at the time of the reissuance. That same concern does not apply to the taxable direct pay BABs described above.

Thus, we conclude that the tax-exempt bond defeasance exception does not apply to the taxable direct pay BABs described above. We also conclude that the taxable direct pay BABs described above are significantly modified and reissued upon the deposit of the government securities in the defeasance escrow so that the bonds are legally defeased and no longer recourse to the Issuer. The reissued bonds (i.e., the defeased bonds) will not qualify as BABs because the authority to issue BABs expired on December 31, 2010, and, as a result, the issuer will no longer be able to collect the § 6431 payment upon reissuance of the bonds.

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