IRS

Qualified Mortgage Bonds – Current Refunding/ Replacement Refunding Structure

Description

Certain current refundings of qualified mortgage bonds ("QMBs") may qualify for an exception to the volume cap requirement. Repayments of mortgage loans made with QMBs may be used to make new loans, with certain limitations.

This issue snapshot addresses the refunding structure which enables issuers to refund bonds using the volume cap requirement exception and also use repayments of mortgages that were financed by the refunded bonds to make new mortgage loans. This type of refunding is commonly referred to as a "replacement refunding."

IRC Sections and Treasury Regulations

Section 141(e) (volume cap requirement applicable to QMBs)
Section 143 (general requirements for QMBs and 10 year rule)
Section 146 (general volume cap requirements and 32 year rule)
Treas. Reg. Section 1.148-9 (arbitrage rules for refunding issues)
Treas. Reg. Section 1.150-1(d)(1) (definition of refunding)
Treas. Reg. Section 1.150-1(d)(3) (definition of current refunding)

Resources (Court Cases, Chief Counsel Advice, Revenue Rulings, Internal Resources)

n/a

Summary

Overview of Structure:

- Issuer receives principal repayments or prepayments on mortgage loans financed with an outstanding bond issue
- Issuer issues refunding bonds
- Refunded bonds are redeemed within 90 days from proceeds of the refunding bonds
  - Refunded amount corresponds to amount of mortgage principal repayments or prepayments not required by 10 year rule to be used for redemption
- Upon use of refunding proceeds to pay refunded bonds, principal repayments and prepayments and other proceeds become transferred proceeds of refunding bonds

- Transferred proceeds used to originate or acquire new mortgages
- Compliance issues
    - Volume cap is not required to the extent that the amount of the refunding bond does not exceed the outstanding amount of the refunded bond, if the bonds comply with maximum maturity limitation (32 year rule)
    - Use of mortgage repayments to make new mortgages only allowed during first 10 years following issuance
        - For refunding bonds, period begins on the date of original bond
    - After 10 years, repayments must redeem bonds of the issue
- Complexity increases with refundings of multiple prior issues

Analysis

Volume Cap exception/32 year rule: Pursuant to Section 146, issuance of QMBs requires an allocation of tax-exempt private activity bond volume cap. An exception is provided for current refunding bonds, providing the amount of the refunding issue is not greater than the amount of the refunded bonds. For the exception to apply to QMBs, the maturity date of the refunding bond must not be later than the later of (A) the average maturity date of the refunded QMBs, or (B) the date 32 years after the date the refunded bond was issued (or in the case of a series of refundings, the date on which the original bond was issued). This is commonly referred to as the "32 year rule." (NOTE: The transition rules for refunding bonds under the Tax Reform Act of 1986 (the "1986 Act") include a different 32 year rule, see Section 1313(a) of the 1986 Act.)

Current refunding mechanics. Issuers of QMBs frequently issue bonds using the current refunding exception for volume cap under Section 146(i)(1) and (3). In these financings, the issuer issues refunding bonds in an amount that, while not greater than the outstanding amount of bonds to be refunded, will be sufficient to redeem the refunded bonds within 90 days. Because the repayment/prepayment rate of the mortgages financed by an issue of QMBs can fluctuate, QMBs are typically subject to a "special redemption" (not customary in other tax-exempt bond issues) in an amount that corresponds to the amount of certain mortgage principal payments received on the mortgage loans. The issuer will apply the proceeds of the refunding bonds to redeem the refunded bonds, and the mortgage principal payments received on the mortgage loans originally financed with proceeds of the refunded bonds will become transferred proceeds of the refunding bonds and be used to make new mortgage loans allocable to the refunding bond issue.

"10 year rule" prevents certain mortgage repayments from being used to make new mortgage loans. One of the QMB requirements under Section 143 is that repayments of principal (subject to a de minimis exception) on financing provided by the issue must be used not later than the close of the 1st semiannual period beginning after the date the prepayment (or complete repayment) is received to redeem bonds which are part of the issue. A significant exception to this requirement is that it does not apply to amounts received within 10 years after the date of issuance of the issue (or, in the case of refunding bond, the date of issuance of the original bond). Taken together, these provisions allow issuers to make new loans from repayments for 10 years from the date of issuance of the original bond and thereafter, require that repayments of principal be used to redeem bonds. This is commonly referred to as the "10 year rule". Since no new loans may be originated with repayments of principal after the end of the 10 year period, the replacement refunding structure is not used to refund bonds after the 10 year window has passed for those bonds.

Issuers must satisfy both the 32 year rule and the 10 year rule. Bonds structured using the replacement refunding structure must satisfy both the 10 year rule and the 32 year rule.

Complex transactions. Frequently, a QMB issue has characteristics that create complexity in analyzing compliance with these requirements, such as multiple refunded issues or new money portions. Each component of the bond issue must meet the 32 year rule requirements (if it's a refunding component) and the 10 year rule requirements.

Bond Redemptions. Failure by an issuer to use repayments of mortgage principal to redeem bonds as required under the 10 year rule is a violation. Issuers include specific special redemption requirements in bond indentures or resolutions (and disclose them in official statements) to redeem bonds from repayments of principal as necessary to satisfy the 10 year rule. These redemption provisions often include a requirement that repayments of principal in excess of a certain amount be used on certain semi-annual redemption dates to redeem bonds – these contractual requirements are designed to result in the application of principal repayments to redeem bonds as required by the 10 year rule.

Reserve fund transfers. Often, a portion of the proceeds of the refunded bonds will include proceeds in a reserve fund. The refunding will result in a reduction in the reserve requirement for the issue that included the refunded bonds. The current refunding issue may include bonds the proceeds of which will be used to redeem bonds allocable to the portion of the reserve fund that is no longer needed for the refunded bonds. The corresponding portion of the reserve fund will then become transferred proceeds of the refunding issue and is typically deposited in the reserve fund for the refunding bonds.

Application of transferred proceeds rules. Treas. Reg. Section 1.148-9(b)(1) provides that when proceeds of a refunding issue discharge outstanding principal, proceeds of the refunded bonds become transferred proceeds of the refunding bonds. The amount of proceeds that becomes transferred proceeds is equal to the proceeds of the prior issue on the date of that discharge multiplied by a fraction the numerator of which is the principal amount of the prior issue discharged with proceeds of the refunding issue on the date of that discharge and the denominator of which is the total outstanding principal amount of the prior issue on the date immediately before the date of the discharge. This rule applies to allocate transferred proceeds and corresponding investments to a refunding issue on any date required before the application of the universal cap rule of Section 1.148-6(b)(2) to reallocate any of those amounts.

Application of temporary periods to transferred proceeds to be used to make new mortgage loans. Treas. Reg. Section 1.148-9(d)(2)(ii)(A) provides that, except as otherwise provided in that section, the temporary period for proceeds (other than transferred proceeds) of a current refunding issue is 90 days. Treas. Reg. Section 1.148-9(d)(2)(iii)(A) provides that each available temporary period for transferred proceeds of a current refunding issue begins on the date those amounts become transferred proceeds of the refunding issue and ends on the date that, without regard to the discharge of the prior issue, the available temporary period for those proceeds would have ended had those proceeds remained proceeds of the prior issue. Treas. Reg. Section 1.148-2(e)(4)(iv) provides that the temporary period for proceeds from the sale, prepayment, or repayment of any qualified mortgage loan that are reasonably expected to be used to make or finance new qualified mortgage loans is 3 years.

Issue Indicators or Audit Tips

Qualified mortgage bond issuers are motivated to get the most use out of their volume cap allocation, since it enables them to maximize the volume of below market rate mortgage loans they can make to low- and moderate-income borrowers. Through the volume cap exception for current refundings of tax-exempt bonds previously issued with volume cap to finance qualified mortgage loans and the recycling of mortgage repayments into new mortgage loans, issuers can finance more qualified mortgage loans without requiring additional volume cap. Many QMB issues will include both a "new money" component that requires a volume cap allocation from their state or local allocating authority and a "replacement refunding" component that meets the volume cap exception.

Current refundings of QMBs in a replacement refunding transaction can be distinguished from current refundings for other purposes. A replacement refunding transaction will include provisions relating to the origination of mortgages after the refunding.
As with any current refunding, examiners should confirm that the redemption of any bonds refunded by the bond issue occurred within 90 days of the date of issuance of the refunding bonds.

Issuers will typically include a "32 year rule report" in their bond transcripts, possibly as an attachment to the tax certificate or arbitrage yield compliance report. The 32 year rule report should demonstrate compliance with the 32 year rule by aligning the maturity dates of all of the bonds currently refunded by the refunding bond issue (or of the original bonds in a series of refundings) with those of the refunding bonds.

Issuers will typically include a "10 year rule report" in their bond transcripts, possibly as an attachment to the tax certificate or arbitrage yield compliance report. The 10 year rule report will typically list the characteristics of the refunded bonds relevant to the 10 year rule (the "10 year rule characteristics") and specify the dates on which repayments of principal on loans related to particular refunded bonds are required by the 10 year rule to be used to redeem bonds. To ensure compliance with the 10 year rule, issuers will typically use the information in the 10 year rule report to create special redemption requirements for the refunding bonds that require redemptions to be made from repayments of principal in amounts that comply with the 10 year rule. Examiners can compare the special redemption provisions set forth in the bond indenture or resolution (and described in the official statement) to the 10 year rule report to determine whether the issuer has established a process likely to result in compliance with the 10 year rule requirements.

The accuracy of the characteristics listed in the 10 year rule report can be confirmed by analyzing the issue date of the refunded bonds and their 10 year rule characteristics (for example, were they "new money" bonds such that the applicable 10 year period is measured from their date of issuance, or were they also current refunding bonds, in which case the applicable 10 year period would be measured from the date of issuance of the original bonds).

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