

Office of Chief Counsel  
Internal Revenue Service  
**Memorandum**

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date: May 23, 2012

to: Manager, Tax Exempt Bonds  
Compliance & Program Management

from: Associate Chief Counsel  
(Financial Institutions & Products)

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subject: Dissolution of California Redevelopment Agencies

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

1. Where the State of California, by legislative act, dissolved all of its redevelopment agencies and vested all of their authority, rights, powers, duties, and obligations in successor agencies, does the change in obligor result in a reissuance of tax-exempt and build America bonds previously issued by the dissolved redevelopment agencies?
2. Where such a dissolved redevelopment agency elected the direct payment subsidy under section 6431 of the Internal Revenue Code (the "Code") with respect to its build America bonds, is the successor agency entitled to claim the refundable credit allowed under section 6431?

CONCLUSIONS

1. No, regardless of whether the bonds are recourse or nonrecourse, the change in obligor does not result in a reissuance of tax-exempt and build America bonds issued by the dissolved redevelopment agencies.
2. Yes, the successor agency is entitled to claim the refundable credit allowed under section 6431.

## FACTS

A city (the “City”) located in a county (the “County”) in the State of California (the “State”) authorized the creation of a redevelopment agency (the “RDA”) pursuant to one of the following parts of the California Health and Safety Code: Part 1, Part 1.5, Part 1.6, or Part 1.7. To finance its redevelopment activities, the RDA issued bonds that were tax-exempt under section 103 of the Code. The RDA also issued build America bonds under section 54AA, which are taxable bonds. For each issuance of build America bonds, it elected the direct payment subsidy option under section 6431. Some of the tax-exempt and build America bonds issued by the RDA are nonrecourse for purposes of section 1.1001-3 of the Income Tax Regulations and others of the tax-exempt and build America bonds are recourse for purposes of section 1.1001-3.

The State concluded that certain local governments were using redevelopment agencies to shield local real property tax revenue from State laws that divert a portion of that revenue away from the local government. See California Redevelopment Association v. Matosantos, 267 P.3d 580 (Cal. 2011). In response, the State, by legislative act, dissolved all redevelopment agencies and vested all of the redevelopment agencies’ authority, rights, powers, duties, and obligations in certain successor agencies. The City will be the RDA’s successor agency, or if it elects not to be the successor agency, a designated local authority formed in the County will be the successor agency. The State has also transferred all assets, properties, contracts, leases, books and records, buildings, and equipment of the RDA (including cash, cash equivalents, and amounts owed to the RDA) to the control of the successor agency. The successor agency is required by the State law to continue to pay and secure debt service on the bonds issued by the RDA, to maintain reserves as required by documents governing the issuance of the bonds, and to perform any other obligations required pursuant to the bonds. The State has further provided that the RDA’s dissolution should not affect either the pledge of revenues associated with the bonds, the legal status of that pledge, or the stream of revenues available to meet the requirements of that pledge. The tax increment revenues that would have been allocated to the RDA and that are necessary to pay debt service on the bonds must be allocated for that purpose.

Despite these events, the successor agency’s capacity to meet the payment obligations under the bonds issued by the RDA continues to be adequate.

## ISSUE 1

### **Law**

Section 34172(a)(1) of the California Health and Safety Code (West 2012) (the “Health and Safety Code”) provides in part that all redevelopment agencies created under Part 1, Part 1.5, Part 1.6, and Part 1.7 are dissolved and no longer exist as a public body. Section 34172(b) of the Health and Safety Code provides that all authority or powers previously granted to these redevelopment agencies is withdrawn.

Section 34173(a) of the Health and Safety Code provides that successor agencies are designated as the successor entities to the former redevelopment agencies. Section 34171(j) of the Health and Safety Code defines a successor agency as the county, city, or city and county that authorized the creation of each redevelopment agency. Section 34173(d)(1) of the Health and Safety Code provides in part that a city, county, or city and county, that authorized creation of a redevelopment agency can elect not to serve as a successor agency. Section 34173(d)(3) of the Health and Safety Code provides in part that, if no local agency elects to serve as a successor agency for a dissolved redevelopment agency, then a public body, called a “designated local authority,” will be formed immediately in the county and vested with all the powers and duties of a successor agency.

Section 34173(b) of the Health and Safety Code provides that all authority, rights, powers, duties, and obligations previously vested with the former redevelopment agencies are vested in the successor agencies. Section 34175(b) of the Health and Safety Code provides that all assets, properties, contracts, leases, books and records, buildings, and equipment of a former redevelopment agency (including cash, cash equivalents, and amounts owed to the former redevelopment agency) are transferred to the control of the successor agency.

Section 34177 of the Health and Safety Code requires successor agencies to continue to make payments due for enforceable obligations, to maintain reserves as required by indentures or other documents governing the issuance of outstanding bonds, and to perform obligations required pursuant to any enforceable obligation. As defined in section 34171(d)(1) of the Health and Safety Code, an enforceable obligation includes any bonds, notes, interim certificates, debentures, or other obligations issued by a redevelopment agency, as well as the required debt service, reserve set-asides, and any other payments required under the indenture or similar documents governing the issuance of the outstanding bonds of the former redevelopment agency.

Section 34175(a) of the Health and Safety Code declares the statutory intent that the dissolution of a redevelopment agency not affect either the pledge of revenues associated with the enforceable obligations of the redevelopment agency, the legal status of that pledge, or the stream of revenues available to meet the requirements of that pledge. Section 34182(c)(1) of the Health and Safety Code provides in part that the tax increment revenues that would have been allocated to the redevelopment agency be deposited in a trust fund created and administered by each county. Section 34172(d) of the Health and Safety Code further requires that all such funds necessary to pay debt service on the former redevelopment agencies' bonds must be allocated for that purpose.

Section 1.1001-3(b) of the Income Tax Regulations provides that 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 in extent; a modification that is not a significant modification is not an exchange. Section 1.1001-3(c)(1)(i) defines a modification 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, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise. Section 1.1001-3(c)(1)(ii) provides that, except as provided in section 1.1001-3(c)(2), an alteration of a legal right or obligation that occurs by operation of the terms of a debt instrument is not a modification. Section 1.1001-3(c)(2)(i) provides that an alteration that results in the substitution of a new obligor, the addition or deletion of a co-obligor, or a change (in whole or in part) in the recourse nature of the debt instrument (from recourse to nonrecourse or from nonrecourse to recourse) is a modification, even if the alteration occurs by operation of the terms of a debt instrument. Section 1.1001-3(f)(6)(i) provides that, for purposes of section 1.1001-3, the obligor of a tax-exempt bond is the entity that actually issues the bond and not a conduit borrower of bond proceeds. Section 1.1001-3(c)(2)(ii) provides that an alteration that results in an instrument or property right that is not debt for Federal income tax purposes is a modification unless the alteration occurs pursuant to a holder's option under the terms of the instrument to convert the instrument into equity of the issuer.<sup>1</sup>

Section 1.1001-3(e) provides rules for determining whether a modification is significant. Section 1.1001-3(e)(4)(i)(A) provides in part that, except as provided in sections 1.1001-3(e)(4)(i)(C) or (D), the substitution of a new obligor on a recourse debt instrument is a significant modification. Section 1.1001-3(e)(4)(i)(C) provides that the substitution of a new obligor is not a significant modification if the new obligor acquires substantially all of the assets of the original obligor, the transaction does not result in a change in payment expectations, and the transaction does not result in a significant alteration. Section 1.1001-3(e)(4)(i)(E) defines a significant alteration as an alteration that would be a significant modification but for the fact that the alteration occurs by operation of the terms of the instrument.

Section 1.1001-3(e)(4)(vi)(A)(1) provides that a change in payment expectations occurs if, as a result of a transaction, there is a substantial enhancement of the obligor's capacity to meet the payment obligations under a debt instrument and that capacity was primarily speculative prior to the modification and is adequate after the modification. Section 1.1001-3(e)(4)(vi)(A)(2) provides that a change in payment expectations occurs if, as a result of a transaction, there is a substantial impairment of the obligor's capacity to meet the payment obligations under a debt instrument and that capacity was adequate prior to the modification and is primarily speculative after the modification. Section 1.1001-3(e)(4)(vi)(B) provides that the obligor's capacity includes any source for payment, including collateral, guarantees, or other credit enhancement. The preamble to final regulations under section 1001 further clarifies that "there is no change in payment expectations . . . if the obligor has at least an adequate capacity to meet its payment obligations both before and after the modification." 61 Fed. Reg. 32926, 32929 (June 26, 1996).

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<sup>1</sup> Based on the facts described in this memorandum, the change in obligor on the bonds does not result in the bonds being recharacterized as instruments that are not bonds for federal tax purposes. See section 1.1001-3(f)(7).

Section 1.1001-3(e)(4)(i)(D) provides that the substitution of a new obligor on a tax-exempt bond is not a significant modification if the new obligor is a related entity to the original obligor as defined in section 168(h)(4)(A) and the collateral securing the instrument continues to include the original collateral. Section 1.1001-3(f)(5)(iii) defines a tax-exempt bond as a state or local bond that satisfies the requirements of section 103(a). Section 168(h)(4)(A) provides in part that each governmental unit and each agency or instrumentality of a governmental unit is related to each other such unit, agency, or instrumentality which directly or indirectly derives its powers, rights, and duties in whole or in part from the same State.

Section 1.1001-3(f)(6)(ii)(A) provides that, for purposes of section 1.1001-3, a tax-exempt bond that does not finance a conduit loan is a recourse debt instrument. Section 1.1001-3(f)(6)(ii)(B) provides that, for purposes of section 1.1001-3, a tax-exempt bond that finances a conduit loan is a recourse debt instrument unless both the bond and the conduit loan are nonrecourse instruments. Section 1.1001-3(e)(4)(ii) provides that the substitution of a new obligor on a nonrecourse debt instrument is not a significant modification.

## **Analysis**

### *Tax-exempt bonds*

The RDA issued some tax-exempt bonds that were recourse for purposes of section 1.1001-3. The change in obligor on these tax-exempt bonds is a modification. Because the RDA, the City, and any designated local authority formed in the County are all units, agencies, or instrumentalities that directly or indirectly derive their powers, rights, and duties in whole or in part from the State, the RDA and the successor agency, regardless of whether it is the City or a designated local authority, are related within the meaning of section 168(h)(4)(A). Because the successor agency must now, under State law, pay and secure debt service on the bonds from the same assets and revenues that the RDA used to pay and secure the bonds prior to dissolution, the collateral securing the bonds continues to include the original collateral. Therefore, because the RDA and its successor agency are related and the original collateral continues to secure the bonds, the substitution of the new obligor is not a significant modification to these bonds. Because the modification resulting from a change in obligor on these bonds is not significant, it does not constitute a reissuance of the bonds.

The RDA also issued some tax-exempt bonds that were nonrecourse for purposes of section 1.1001-3. The change in obligor on these bonds is a modification. The substitution of a new obligor on a nonrecourse bond is, however, not a significant modification. Because the modification resulting from a change in obligor on these bonds is not significant, it does not constitute a reissuance of the bonds.

*Build America bonds*<sup>2</sup>

The RDA issued some build America bonds that were recourse for purposes of section 1.1001-3. The change in obligor on these bonds is a modification. Under the State law, the successor agency acquired all of the RDA's assets. Because the successor agency must now, under State law, pay and secure debt service on the bonds from the same assets and revenues that the RDA used to pay and secure the bonds prior to dissolution, there has been neither enhancement nor impairment of the obligor's capacity to meet payments such that payment expectations have changed. Additionally, the successor agency's capacity to meet the payment obligations under the bonds issued by the RDA continues to be adequate, so no change in payment expectations has occurred. Therefore, because the successor agency acquired all of the assets of the RDA, the transaction did not result in a change in payment expectations, and the transaction did not result in a significant alteration, the substitution of the new obligor was not a significant modification to these bonds. Because the modification resulting from a change in obligor on these bonds is not significant, it does not constitute a reissuance of the bonds.

The RDA also issued some build America bonds that were nonrecourse for purposes of section 1.1001-3. The change in obligor on these bonds is a modification. The substitution of a new obligor on a nonrecourse bond is, however, not a significant modification. Because the modification resulting from a change in obligor on these bonds is not significant, it does not constitute a reissuance of the bonds.

ISSUE 2**Law**

The provisions of the Health and Safety Code set forth in Issue 1 are also relevant for Issue 2.

Section 54AA(d)(1) defines "build America bond" in part as an obligation on which the interest would (but for other provisions of section 54AA) be excludable from gross income under section 103. Section 103(a) provides in part that gross income does not include gross income on any State or local bond. Section 103(c) defines "State or local bond" as an obligation of a state or political subdivision thereof.

Section 54AA(g) provides that, upon election, in lieu of the credit allowed with respect to a qualifying build America bond issued before January 1, 2011, the issuer of the bond shall be allowed a credit as provided in section 6431. Section 6431(a) provides that the issuer of such a qualified build America bond shall be allowed a credit with respect to each interest payment under the bond. Section 6431(b) provides that the Secretary

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<sup>2</sup> Although the RDA issued build America bonds under the facts of this advice, the analysis of whether the change in obligor results in reissuance would be the same if the RDA had issued any variety of the qualified tax credit bonds described in section 54A(d).

shall pay (contemporaneously with each interest payment date under the bond) the issuer of such bond (or any person who makes such interest payments on behalf of the issuer) 35 percent of the interest payable under such bond on such date.

***Analysis***

The RDA elected to receive the direct payment subsidy under section 6431 for its build America bonds and was required to file Form 8038-CP to claim the credit with respect to each interest payment. Under the Health and Safety Code, the successor agency is required, as successor in all respects to the issuer of the bonds, to pay interest on the bonds. In addition, under sections 103 and 54AA of the Code, the successor agency is a political subdivision of the State, and as such would itself have qualified as an issuer of build America bonds. As successor in interest to the issuer of the bonds under State law and as an entity qualified to issue build America bonds under Federal tax law, the successor agency is allowed the credit under section 6431(a) with respect to each interest payment under the bonds issued by the RDA. The successor agency is allowed both the unclaimed credit for interest paid by the RDA prior to its dissolution as well as the credit for interest paid by the successor agency after the dissolution of the RDA. The Service may prescribe procedures detailing how a successor agency, as successor in interest to the RDA, must complete Form 8038-CP.

Please call (202) 622-3980 if you have any further questions.

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