



**connectedthinking*

Capital Markets
Accounting Developments
Advisory 2008 - 10
July 16, 2008

Greater Flexibility for Issuers of Auction Rate Preferred Stock: IRS Notice 2008-55

Overview

The auction rate securities market has been facing an unprecedented rate of auction failures due to liquidity concerns that have frozen the trading of auction rate preferred stock. Thus far, the trend shows no signs of reversing, which is adversely affecting the value of these securities. In order to alleviate the liquidity concerns, issuers have attempted to restructure their auction rate securities.

FICG Observation: Popular restructuring methods have recently focused on introducing liquidity facilities, which effectively guarantee the purchase of the securities in case the auction fails. In essence, the liquidity facility ensures automatic liquidity to support existing transactions. However, prior to the release of the IRS Notice, tax-exempt mutual funds seeking to restructure by adding liquidity features also must contend with the risk that the IRS would call into question the treatment of these securities as equity instruments for tax purposes.

For certain auction rate securities, such as auction rate preferred stock issued by closed-end mutual funds, any restructuring or refinancing attempts have significant tax implications on the underlying characteristics of the stock. The equity treatment is important for mutual funds because the type of income is passed through to the fund's investors. For example, dividends issued by tax-exempt

Capital Markets Accounting Developments Advisory 2008 - 10 is produced by PricewaterhouseCoopers (PwC) - Financial Instruments and Credit Group to apprise PwC clients and friends on the latest news on significant accounting, auditing and regulatory matters.

funds are treated as tax-free income by the shareholder. If the same fund issued debt, the interest payments would be considered taxable income for the shareholder. Thus, given the lack of clarity and the commensurate tax risks, fund managers have been hesitant to implement restructuring proposals.

The IRS clarifies this issue in Notice 2008-55 by stating that they will not challenge, in certain circumstances, the equity characterization of auction rate preferred stock restructured with liquidity facilities.

Auction Rate Securities and Auction Failures

Auction rate securities are long-term securities that are treated as short-term securities because their interest rates reset through auctions at pre-defined intervals. The interest rates are usually set periodically at 7, 28, or 35 days while the contractual maturity of these bonds is long-term, ranging from 10 to 30 years. The resulting security establishes a structure that provides issuers with funds of long maturities while the holders receive short-term investments.

Another characteristic of auction rate securities is their perceived liquidity. These securities are traded through auctions and holders can easily buy or sell the securities according to their investment preferences. Since American Express issued the first auction rate preferred stock more than twenty years ago, these securities have generally been marketed to investors as cash-equivalents due to an active market. Historically, issuers have been able to raise capital at a lower rate for longer periods, while investors have been able to achieve a higher rate of return on liquid, short-term holdings.

The auctions had worked smoothly because of the matching of supply and demand until the credit crunch changed the market landscape. The growing liquidity concerns led to auction failures starting in early fall 2007; by February 2008, the failures became a widespread epidemic. Nevertheless, the majority of the securities continued to maintain high credit ratings and distribute interest to holders according to schedule.

FICG Observation: The value of auction rate securities is predicated on the assumptions of high liquidity and continuous demand. Therefore, the auction rate system fails if there is a mismatch of buyers and sellers. However, an auction failure does not indicate that the securities are in default. Instead, the issuer is required to pay a higher interest rate as a penalty for the failed auction and to attract new bidders. As a result, the issuer is left with limited options. They may choose to pay the increased interest rate while waiting for the auction to pass and the rates to decrease. Or instead, they may move to an alternative interest rate

that has been preauthorized in the security's documents. Nevertheless, both options bear significantly higher interest rates to the detriment of the issuer.

Auction Rate Preferred Stock

Auction rate preferred stocks are similar to other auction rate securities, but their form indicates equity rather than a note or other debt instrument. These securities are typically issued by closed-end mutual funds, which benefit from not only the lower dividend rate, but also the lower asset coverage ratio requirement as compared to issuing debt.

Tax-exempt mutual funds find the issuance of auction rate preferred stock attractive because the stocks allow a pass-through of the tax-exempt interest from the underlying municipal bonds as tax-exempt dividends to the investors. In short, the stocks allow the mutual funds to leverage municipal bonds at tax-exempt short term rates, thereby decreasing the cost of capital and increasing potential returns to their shareholders.

When an auction fails, the fund still pays a dividend to the holders of the securities, but the dividend rate is reset to a maximum applicable rate, or a certain fail rate outlined in the prospectus. The holder will continue to receive the dividend rate until the next successful auction or upon redemption by the issuer. This policy has posed a significant problem for tax-exempt closed-end funds since rates have reached 20% for some issuers.¹ Tax-exempt mutual funds face additional challenges as they explore alternative forms of financing to respond to the market disruption.

Liquidity Facilities Feature and Liquidity Providers

Liquidity facilities are agreements designed to provide liquidity to the holders of the auction rate preferred stock. In conditions similar to the current market, the liquidity facility binds the liquidity provider to purchase the shares when there is a shortfall of interested bidders in an auction.

The liquidity facilities are provided by a third party, such as a bank. In short, the holder of the security typically has the right to sell the stock to the "liquidity provider at a price equal to the stock's liquidation preference" if one of the following two trigger events occurs:

- (1) a failed auction or remarketing, or
- (2) a failure to renew, replace, or extend an existing liquidity facility.

¹ Moody's. "Frequently Asked Questions Regarding the Auction Rate Securities Market and the Impact on ARPS Issued by Closed-End Funds."

FICG Observation: In the past, auction rate securities have used liquidity facilities to ensure the liquidity of the investments. However, due to the robust auction market, liquidity facilities were often deemed unnecessary. Accordingly, many issuers decided to eliminate the facilities to avoid the fees, and instead, enacted provisions for higher penalty and interest rates in the event of an auction failure. Now that the auction market is no longer as active, most restructuring proposals are resorting back to the use of liquidity facilities.

IRS Notice 2008-55

The IRS issued the Notice to resolve the confusion and uncertainties of whether the addition of a liquidity facility to auction rate preferred stock would jeopardize their existing favorable tax treatment as equity that passes through as tax-exempt income to investors. The Notice states that the IRS will not challenge the preferential tax treatment of auction rate preferred stock with liquidity facilities for federal income tax purposes if certain terms are met. The key conditions are outlined below:

- The issuer must be a closed-end management company that is a regulated investment company and invests exclusively in tax-exempt or taxable debt.
- The auction rate preferred stock has to be outstanding on February 12, 2008, or if issued after that date, its purpose must solely be to refinance stocks outstanding before that date.
- The liquidity facility must be an initial liquidity facility that is entered into between February 12, 2008 and December 31, 2009.
- The issuer must also declare dividends and pay dividends out of legally available funds for payment as stipulated in applicable state law.
- The liquidity provider must be an unrelated party to the issuer, meaning that the relationship would not result in a disallowance of losses.
- The liquidity facility must provide the stockholder a tender option only if one of the two trigger events occurs: a failed auction or the liquidity facility is not renewed.
- The contractual right of the liquidity provider to require the issuer to redeem or repurchase the stocks is only valid if the provider has held the stocks for at least a year and made good faith efforts to resell them in periodic auctions at the liquidation preference price. In cases where no provisions are made for the liquidity provider to sell the stocks back to the issuer, state law restrictions on the redemption of these stocks must be met.

FICG Observation: The IRS identified a specific list of criteria that must be met in order to qualify under the Notice. Any changes to outstanding auction rate

preferred stock should be carefully analyzed to ensure that the protection offered by the Notice applies. If a modification is outside of the scope of the Notice, it may trigger redemption of tax-exempt stock which would result in adverse tax consequences.

Conclusion

The IRS Notice addresses critical concerns of both issuers and holders of auction rate preferred stock and attempts to alleviate some of the liquidity pressures currently faced by the market. The IRS Notice comes at an urgent time when the auction rate securities market is in need of intervention. It provides substantial relief and allows different issuers, especially tax-exempt closed-end mutual funds, to employ new methods to restructure outstanding auction-rate preferred shares.

Questions

Questions regarding this Advisory, financial instruments or credit in general may be directed to:

Trent Johnson (202-414-1484) trent.h.johnson@us.pwc.com