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IRS Releases Proposed Issue Price Rules, Draws Concerns.

The Treasury Department and Internal Revenue Service have proposed long-awaited rules on arbitrage restrictions for tax-exempt bonds, including issue price, as well as rules on arbitrage rebate overpayments.

The rules, which are to be published in the Federal Register on Monday, are scheduled to be the focus of a public hearing that is to be held on Feb. 5. In addition, public comments are due on the arbitrage rules 60 days after publication in the Federal Register and must be received by Dec. 16 on arbitrage rebate overpayment rules.

The proposed rules on issue price are more stringent than existing rules in an effort to address agency concerns. But market participants say they would represent a major change in the way the market works and question whether they would even be workable.

Issue price is extremely important because it is used to help determine the yield on bonds and whether the issuer is complying with arbitrage rebate or yield restriction requirements, as well as federal subsidy payments in the case of direct-pay bonds such as Build America Bonds. Issue price also plays a role in complying with other rules such as the 2% limit on issuance costs for private activity bonds and the size of debt service reserve funds.

Current tax rules say that the issue price of bonds that are publicly offered is the first price at which a substantial amount of the bonds is reasonably expected to be sold to the public, with substantial defined as 10%.

But in their 56-page proposal on arbitrage restrictions, the agencies say they “are concerned that the 10% test does not always produce a representative price for the bonds.”

The agencies also say they are concerned about flipping. They do not use the term, but describe the behavior.

“Underwriters of tax-exempt bonds may sell bonds of an issue with the same payment and credit terms in an initial public offering at different prices, but execute the first 10% of the sales of those bonds at the lowest prices (and thus the highest yield), causing the issue price of the bonds to be a lower price than is representative of the prices at which the remaining bonds are sold,” they said in the proposed rules.

The agencies said that improvements in price transparency, such as the muni prices reported on the Municipal Securities Rulemaking Board’s EMMA system “has led to heightened scrutiny of issue price standards.”

“The reported data has shown, in certain instances, actual sales to the public at prices that differed significantly from the issue price used by the issuer,” they said. “These price differences have raised questions about the ability of the reasonable expectations standard to produce a representative issue price. The reported trade data has also called into question whether sales to underwriters and

security dealers have been included as sales to the public in determining issue price in certain instances."

In the proposed rules, the agencies remove the reasonable expectations standard and substitute actual sales. They eliminate the reference to "publicly offered" so the rules would clearly cover private placements as well as public offerings.

The new rules would state: "The issue price of tax-exempt bonds issued for money is the first price at which a substantial amount of the bonds is sold to the public," with substantial meaning 25% instead of 10% of the bonds.

The current rules disregard sales to underwriters or wholesalers when determining issue price.

The proposed rules state "the public" would be any person other than an underwriter. The term underwriter would be defined as "any person that purchases bonds from the issuer for the purpose of effecting the original distribution of the bonds, or otherwise participates directly or indirectly in the original distribution."

The term would include the lead underwriter, any syndicate member, or "a securities dealer (whether or not a member of the issuer's underwriting syndicate) that purchases bonds (whether or not from the issuer) for the purpose of effecting the original distribution of the bonds." Also, "An underwriter generally includes a related party to the underwriter," the proposed rules say.

Several lawyers have concerns and questions about the proposed rules.

"I think the market will act adversely to the proposed regulations," said Rick Ballard, a partner at Ballard Spahr. "Financial and legal professionals would like to be able to determine issue price on the initial sale date and not have to worry about what happens later," he said "You're going to have to do a lot of post-tracking of sales on EMMA and figure you when you hit the 25%. It's going to increase the amount of work and make it a lot more complicated."

Scott Lilienthal, president of the National Bond Lawyers Association and a partner at Hogan Lovells US LLP, agreed, "We're concerned about his move away from the reasonable expectations standard," he said. "I'm worried that it's going to create new problems for issuers."

Lilienthal said, for example, that issuers trying to structure advance refunding escrows are not going to know what the issue price until later, and while the IRS permits issuers to make yield reduction payments if their estimates are wrong, they won't be able to gauge the savings they will achieve until they know whether they have to make such payments.

Lilienthal also said the definition of underwriter is still somewhat ambiguous. "There's a lot of interpretation that has to be done," he said.

The proposal will create uncertainties for issuers and market participants trying to comply with other rules that rely on issue price such as limits on cost of issuance and the sizing of debt service reserve funds, he added.

The proposed arbitrage rules also codify private-letter ruling guidance on working capital financings, clarify issues related to qualified hedges and cover the valuation of investments.

The other set of proposed rules sets forth procedures for recovering overpayments of arbitrage rebate on tax-exempt bonds and other tax-advantaged bonds.

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