Proposed Issue Price Definition Eliminates Reasonable Expectation Standard for Exempt Bonds.

Proposed regulations (REG-148659-07) released September 13 would amend the definition of issue price for tax-exempt bonds, requiring them to be based on the actual sale price as opposed to reasonable expectations. The proposed regs reflect Treasury and IRS concerns that the current regulations do not produce appropriate results.

Issue price is defined under reg. section 1.148-1 as the first price at which a substantial amount of the bonds in an issue are sold to the public. The reg currently allows the price of bonds issued in a public offering to be determined as of the sale date based on reasonable expectations.

The preamble to the proposed regulations suggests that that approach may not produce a representative price, based on market data that show actual sales to the public at significantly different prices than the issue price. As such, the regs propose eliminating the reasonable expectations standard, meaning the issue price would be based on actual sales.

Scott R. Lilienthal of Hogan Lovells described the rule change as a "significant change of direction." Lilienthal, who is president of the National Association of Bond Lawyers, said that the reasonable expectation standard provided certainty for issuers, which would be lost under the proposed amendments. He added that the new rule would disproportionately affect competitive underwritings because it is more likely that the actual price will differ from the expectation of the issuer in those offerings.

Frederic L. Ballard Jr. of Ballard Spahr LLP said that the proposal would probably be criticized as administratively burdensome. "It would require bankers and lawyers to monitor trading activity in a way that is not required under the current regulations," he said.

The proposed regs provide that in the case of a refunding issue when an issuer must estimate the yield before the issue price can be determined, the issuer would be allowed to make curative payments to the IRS to reconcile differences between expected and actual issue prices.

"The regs recognize that the actual yield can be lower than an estimated yield, but they don't address the reverse situation, when the actual yield turns out to be higher," said Ballard.

David J. Cholst of Chapman and Cutler LLP noted that determining yield is not the only use of issue price. Knowing the issue price is also necessary for applying volume caps and limits on the amount of bonds. "Without knowledge of the issue price, you may think you are in compliance when you are not," said Cholst.

"We've gotten a number of comments requesting guidance on issue price over the last couple of years," said Vicky Tsilas, attorney-adviser, Treasury Office of Tax Legislative Counsel. "The proposed regulations are a result of discussions between IRS, Treasury, and industry representatives. We welcome comments and concerns."

The proposed regs also eliminate the mention of wholesaler from the issue price definition, and they define the term “underwriter” to mean any person who purchases bonds from the issuer for the purpose of effecting the original distribution of the bonds or who otherwise participates directly or indirectly in such original distribution. Lilienthal said that because of the broad definition of underwriter, there will continue to be questions about its application in some cases.

The proposed regs would also eliminate the definition of a substantial amount of an issue as 10 percent, citing instances of underwriters selling the first 10 percent at a lower price than the rest of an issue as a reason for changing the rule. Instead, the regs propose a safe harbor under which an issuer can treat the first price at which a minimum of 25 percent of bonds are sold as the issue price.

Working Capital Expenditures Proposals

The proposed regulations also amend the treatment of tax-exempt bond financings for working capital expenditures with the goal of simplifying the rules and providing objective guidelines for longer-term working capital financings.

Lorraine M. Tyson of Pugh, Jones & Johnson PC said that the proposals address many of the issues that have been raised by tax-exempt bond practitioners. “The most significant change is incorporating in the regulations an objective safe harbor against the creation of replacement proceeds for tax-exempt working capital financings with terms longer than 13 months,” said Tyson.

Arbitrage restrictions apply to replacement proceeds in order to discourage issuers from issuing tax-exempt bonds with very long maturities or from leaving bonds outstanding longer than necessary. Replacement proceeds arise if the term of an issue is longer than reasonably necessary and amounts are available for expenditures of the type being financed during the time the bond issue is outstanding beyond the reasonably necessary period.

The proposed safe harbor would require the issuer to determine the first year in which it expects to have funds available for working capital expenditures, monitor for actual available amounts beginning in that year, and apply those amounts to retire or invest in tax-exempt bonds that are not subject to the alternative minimum tax.

Tyson said that the change “recognizes the fiscal challenges many governmental issuers face with their long-term operating deficits and provides more definitive guidance to issuers who need to structure longer-term tax-exempt working capital financings.”

by Matthew Dalton