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Issue Price Definition in Proposed Exempt Bond Regs Must Go, Witnesses Say.

Treasury should scrap a new definition of issue price contained in proposed regulations (REG-148659-07) that address arbitrage restrictions on tax-exempt bonds, witnesses at a February 5 IRS hearing recommended unanimously.

The focus of the hearing, which took place at IRS headquarters in Washington, was on the proposed definition of issue price, which according to the existing regs is "the first price at which a substantial amount of bonds is sold to the public," with substantial amount defined as 10 percent. Under the proposed regs, the 10 percent figure would be replaced by a safe harbor that would allow an issuer to treat as the issue price the first price at which a minimum of 25 percent of the bonds in an issue is sold to the public, so long as all orders at that price received from the public during the offering period are filled. Also, the determination of issue price would be based on actual sale prices to the public, not on reasonably expected sale prices as it is now.

Allen K. Robertson of the National Association of Bond Lawyers disputed the notion expressed by the IRS and Treasury that an actual sales approach is required to make the issue price definition more consistent with current regulations under section 1273 and section 1274. "Unless Treasury believes that it lacked authority to adopt the existing regulations, then determination of the issue price for publicly offered municipal bonds is not required to be determined based on an actual sales approach," he said.

Robertson also said the proposed definition is not administrable by issuers under existing law and market practices, both because issuers and bond counsel do not have the information necessary to determine issue price based on actual sales to the public as defined in the proposed regs and because the proposed definition does not ensure that the issue price of publicly offered municipal bonds can be determined as of the sale date. He explained that determination of issue price as of the sale date is important because without it, issuers may unintentionally violate state or federal law, and because bond counsel have to confirm on the sale date whether they can give an unqualified approving opinion at closing.

Robertson also predicted that attempts to comply with the proposed definition will prove very expensive to issuers. "If the proposed definition is adopted and municipal bonds continue to be marketed in ways that result in unsold maturities at sale date, issuers will bear substantial additional expense attempting to determine issue price based on actual sales to the public," he said. "To eliminate unsold maturities on the sale date in negotiated underwritings, issuers would be forced to accept lower prices at higher yields. And because issuers may not be able to eliminate the possibility of unsold maturities in competitively sold deals, the ability of issuers to sell bonds competitively may be limited."

That remark prompted questions from one of the government panelists, Vicky Tsilas, an attorney-adviser in Treasury's Office of Tax Legislative Counsel. She said she understood the proposed definition presents challenges for competitively sold deals but asked for elaboration on commentators’ concerns regarding negotiated transactions.

“Over the years, the comments we had heard were that when an underwriter prices the bonds . . ., 80 percent of the bonds in the maturities are sold,” Tsilas said. “So the idea of having unsold maturities, while that certainly happens, we were told is a very, very small percentage.”

Johanna Som de Cerff, branch 5 senior technician reviewer, IRS Office of Associate Chief Counsel (Financial Institutions and Products), asked if unsold maturities occur in negotiated transactions. Robertson said they do.

Susan Collet of the Bond Dealers of America also expressed concerns about increased costs to issuers.

“We . . . feel that if market participants are compelled to use a 25 percent or even 10 percent safe harbor based on actual sales rather than the reasonable expectations standard as tied to a point in time, the result is going to be increased borrowing costs for the issuers as the issuers are compelled to increase interest rates to establish an issue price,” Collet said.

After Tsilas remarked that she still had trouble understanding how the proposed definition would increase costs to issuers, Collet said part of the answer has to do with enforcement and how it affects issuers. Issuers in negotiated sales may feel that to reach the 25 percent threshold and protect themselves in the event of an audit, they need to set prices lower than they otherwise would.

Other witnesses were also critical of the proposed definition. Michael Decker of the Securities Industry and Financial Markets Association said compliance would be impossible because of the elimination of the reasonable expectations standard and the proposed definition of underwriter as any person who purchases bonds from the issuer to carry out the original distribution of the bonds or who otherwise participates in the original distribution, regardless of whether that individual is in the underwriting syndicate.

“Looking at those two provisions, there is simply no way to comply with the rule as proposed,” Decker said.

Mark Kim of the Government Finance Officers Association urged the government panelists to consider the unintended consequences of the proposed definition and suggested that its adoption would create more complexity and uncertainty for all issuers. It also could have a significant economic impact on many state and local governments and entities in the form of increased administrative burdens, greater compliance costs, and higher yields on their bonds, he said.

Witnesses encouraged the IRS and Treasury to look at their organizations’ written comments for recommendations on what should be in the final regs.

by Fred Stokeld