

# **Bond Case Briefs**

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## **Ballard Spahr: Where We Stand on Issue Price for Tax-Exempt Bonds.**

The U.S. Treasury Department and the Internal Revenue Service (IRS) held a public hearing on the definition of issue price for tax-exempt bonds on October 28, 2015. The hearing is another step in the process of changing what issuers of tax-exempt and tax-advantaged (tax credit bonds) will need to review and consider in structuring bond issues and executing various closing documents.

Since 1993, the general rule has been that the issue price was the first price at which a substantial amount (10 percent) of the bonds was sold to the public. With respect to those maturities in a publicly marketed transaction that did not meet the 10 percent actual sales, the issuer was permitted to rely on the reasonably expected issue price. The practice under these long-standing regulations has been for issuers to rely on underwriter certificates as to the reasonable expectations of the issue price of bonds.

Beginning in 2006, the IRS started challenging the issue price of bonds by questioning whether the information provided in underwriter certificates to the issuer regarding issue price was accurate. IRS agents routinely cited pricing information from the database maintained for securities law purposes by the Municipal Securities Rulemaking Board as proof that the issue price provided by the underwriter had not been correctly reported. The uncertainty caused by the IRS audits led the IRS to publish proposed regulations changing the definition of issue price. These regulations were widely criticized and then withdrawn and a new definition of issue price was re-proposed on June 24, 2015 (the 2015 Proposed Regulations). On October 28, 2015, the IRS held a hearing on the 2015 Proposed Regulations on the definition of issue price for tax-exempt bonds.

### **What do the Re-proposed Regulations Say About Issue Price?**

The 2015 Proposed Regulations which were the subject of the public hearing generally provide the following:

- The general rule for determining issue price remains the same as under existing regulations: the issue price of bonds issued for money is the first price at which a substantial amount (10 percent) of the bonds is sold to the public.
- The issuer cannot rely on reasonable expectations as to the issue price of those maturities that have not met the 10 percent actual sales requirement. Instead, the 2015 Proposed Regulations provide an “alternative rule” whereby an issuer may treat the initial offering price to the public as the issue price provided that the underwriter provides certifications to the issuer with respect to certain matters. This includes a certification that no underwriter will fill an order received from the public after the sale date and before the issue date at a price higher than the initial offering price, unless the higher price is the result of a market change for those bonds after the sale date, and that it will provide the issuer with supporting documentation concerning such market change.
- The term “underwriter” includes any person who contractually agrees to participate in the initial sale of the bonds to the public by entering into a contract with the issuer or into a contract with a lead underwriter to form a syndicate and any person who, on or before the sale date, directly or

indirectly enters into a contract or other arrangement to sell the bonds.

All four speakers at the hearing, including Linda Schakel from Ballard Spahr, speaking on behalf of the National Association of Bond Lawyers, agreed that 2015 Proposed Regulations present a number of challenges for issuers and several issues need to be addressed to make the rules workable:

- **What documentation should issuers review and retain?** One of the challenges with the re-proposed regulations is that they do not spell out what documentation an issuer can rely on to substantiate that 10 percent of the bonds are sold in a public offering. As written, the regulations provide no specific examples of reasonable supporting documentation that will be sufficient with respect to the general rule. The audits make it clear that a pricing wire in addition to the certifications of the underwriter have not been and will not be enough. The EMMA database has proven not to be a real-time source of pricing data that can be used to determine or support an issue price determination. The question remains what other information can issuers turn to when asked to justify their pricing and whether they need to be requesting other forms of data from underwriters. In response to this observation, John Cross III, associate tax legislative counsel at Treasury, noted that IRS and Treasury have not received suggestions as to what documentation would be useful and stated that regulators were open to hearing from the industry.
- **When has an issuer done sufficient due diligence?** One of the conditions for using the alternative method to determine issue price is that the issuer exercise due diligence in reviewing certifications as to issue price. The due diligence standard used in the alternative rule within the 2015 Proposed Regulations is more stringent than the standard applied under the regulations for all other arbitrage rules. It implies that the issuer must perform independent verification of the certifications and documentations provided by the underwriters. Speakers noted that providing examples in the regulations of the type of documentation that an issuer should review and retain to verify certifications it receives would go a long way toward assisting issuers in meeting their due diligence obligation and dealing with IRS agents who may challenge issue price during an audit.
- **Why do the Proposed Regulations not accommodate small issuers and competitive sales?** Another critique of the proposed regulations is that there is no separate rule for small issuers or issuers who sell bonds pursuant to competitive bids. Speakers pointed out that because bonds in competitive bid transactions are not presold prior to the award, a smaller percentage of the issue will meet the 10 percent actual sales requirement on the sale date. To avoid the time and expense of the alternative rule, bidders will look to increase yields or reduce bond prices to heighten their ability to sell 10 percent of each maturity, thus increasing the cost of borrowing to issuers. The IRS and Treasury questioned why the alternative rule is not the approach for dealing with competitive sales, but encouraged municipal market participants to submit to them the types of safe harbors that could work for competitive bids.

Treasury and the IRS gave no timetable for finalizing the issue price regulations. While as a technical matter an issuer could elect to apply the 2015 Proposed Regulations to bonds issued before the regulations are finalized, the unanswered questions, including those described above, may not provide the certainty as to issue price an issuer would prefer. The existing regulations from 1993, including the ability to rely on reasonable expectations, continue to apply.

Attorneys in Ballard Spahr's Public Finance Group have participated in every kind of tax-exempt bond financing. These financings include bond issues for hospitals and health care institutions, as well as universities, colleges, and student housing.

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