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Outlook: What's Ahead for Tax Regulation, Enforcement in 2016.

WASHINGTON – The biggest tax regulatory issue for municipal market participants in 2016 are the issue price rules and what changes the Treasury Department and Internal Revenue Service will make as they finalize them, dealer and issuer group representatives said in interviews about the coming year.

"Our biggest issue is the issue price rules," Michael Decker, a managing director and co-head of municipal securities for the Securities Industry and Financial Markets Association, said when asked about the tax arena.

"Issue price continues to be a big issue for underwriters and issuers," said John Vahey, director of federal policy for Bond Dealers of America.

"As far as what we can envision going on on the regulatory front in 2016, [issue price] springs to mind," said Dustin McDonald, director of the Government Finance Officer Association's federal liaison center here. "I know it's a big priority of John Cross to get it done."

Cross, the Treasury Department's associate tax legislative counsel, agreed with that assessment.

"Issue price is an important priority and broadly applicable topic," he said in an interview. He said he hopes the agencies can get those final rules out sometime in the spring of next year.

Cross told GFOA's debt committee members at their winter meeting earlier this month that tax regulatory officials "are going to take another good look at whether we can do something more on competitive sales."

"I thought John's remarks were very encouraging and hopefully we'll end up with an issue price rule that's workable," said Decker.

In addition, muni market groups have asked for some clarifications in the proposed rules, which were published in July after the Treasury and IRS withdrew earlier ones proposed in September 2013 because of complaints they were unworkable.

Issue price is important because it is used to help determine the yield on bonds and whether an issuer is complying with arbitrage rebate or yield restriction requirements, as well as whether federal subsidy payments for direct-pay bonds such as Build America Bonds are appropriate.

Under existing rules, the issue price of each maturity of bonds that are publicly offered is generally the first price at which a substantial amount, defined as 10%, are reasonably expected to be sold to the public.

But tax regulators became concerned that some dealers were "flipping" bonds — selling then to another dealer or institutional investor who then sold them again almost simultaneously, with the prices continually rising before the bonds were eventually sold to retail investors.

Treasury and the IRS tried to tighten the rules in 2013 by proposing new ones that replaced the "reasonable expectations" standard with actual sales and increased the definition of "substantial amount" to 25% instead of 10%. But those rules drew many complaints so Treasury and IRS scrapped them and proposed new rules in June, under which the issue price of a maturity would generally be the price at which the first 10% of the bonds are actually sold to the public.

If 10% of a maturity hasn't been sold by the sale date, the issue price will be the initial offering price of the bonds sold to the public, as long as the lead or sole underwriter certifies to the issuer that no underwriter filled an order from the public after the sale date and before the issue date at a higher price than the initial offering price. An exception can be made if the market moved after the sale date, but the underwriter must document any market movements justifying a higher price.

Dealers and issuers want a safe harbor or special rules for bonds sold in competitive deals, where there is less opportunity for pricing abuses.

Cross' statements on possibly considering special rules for competitive deals are "very helpful," said Stefano Taverna, a partner at McCall, Parkhurst & Horton in Dallas who heads the tax-exempt financing committee of the American Bar Association's taxation section.

"The fact that he's open to it is a good thing," said Vahey.

Muni market groups also want clarification on actions that underwriters or issuers must take if less than a 10% of a maturity is sold to the public. "I don't see him backing away from the actual sales approach," said Vahey. Other market participants said the same thing.

Political Subdivision

But the Treasury and IRS may move even earlier in the year to propose rules that will be open for public comment and prospectively effective on the definition of a political subdivision, according to Cross.

Market participants and lawmakers have been seeking guidance on the definition of a political subdivision ever since the IRS issued a technical advice memorandum in 2013 that concluded the Village Center Community Development District in Florida was not a political subdivision, and therefore could not have issued tax-exempt bonds from 1993 to 2004, because its board was and will always be controlled by the developer rather than publicly elected officials. In June, the IRS said it will not apply the TAM retroactively.

Lawyers have said that the notion that control by elected officials is necessary for an entity to be a political subdivision is a new requirement and that such changes should be made through regulatory proposals that can be commented upon rather than in a TAM. Historically, the determination of whether an entity was a political subdivision was based on whether it had the right to exercise substantial sovereign powers, such as the power to tax for services.

Cross told bond lawyers meeting in Chicago in September that the Treasury and the IRS were considering having the rules include "a possible objective governmental control standard" and other principles beyond the sovereign powers analysis.

Management Contracts

The Treasury and IRS also are working to update and liberalize safe harbors in longer term management contracts so that the contracts do not create a significant amount of private use and payments that would make tax-exempt bonds taxable.

Bond and tax lawyers have complained that the tax agencies' previous guidance on management contracts is not flexible enough to allow tax-exempt bonds to be used in transportation or infrastructure projects financed by public-private partnerships.

The IRS issued guidance in 2013, Rev. Proc. 97-13, that set up safe harbors for longer term management contracts. For a contract up to 10 years, at least 80% of the manager's annual compensation had to be based on a fixed fee. For one of 15 years, at least 95% of the annual compensation had to be based on a fixed fee.

Then in October 2014, the IRS issued Notice 2014-67 covering management contracts that included most types of fixed or variable rate compensation for contracts of five years or less. But it did not permit compensation based on a share of net profits.

Both the NABL and the ABA's tax-exempt financing committee have made recommendations on how this guidance could be modernized.

"I hope they will be able to turn to the management contract rules. I think that the White House still has a push for public-private partnerships" and these rules would help with that, said Linda Schakel, a partner at Ballard Spahr here.

Cross said there is a lot of interest at Treasury on this topic because of the work being done by a task force chaired by Treasury Secretary Jack Lew and Transportation Secretary Anthony Foxx. "This is a fairly early priority in the coming year," he said.

The Treasury and IRS also want to consider new guidance or rules that show what remedial actions could be taken with regard to leases under change of use rules so that bonds could remain tax-exempt if a bond-financed facility was leased to a private party.

"Those would be two very good pieces of guidance that we need," Taverna said, referring to management contracts and leases. "They would be particularly helpful in certain contexts, particularly with regard to transportation, water facilities and other types of long term assets."

The ABA taxation section's tax-exempt financing committee has "focused a lot over the past couple of years on transportation projects, particularly P3s and allocation and accounting and management contract" rules, he said.

The tax regulators also are considering issuing guidance or rules that would provide issuers of direct-pay bonds with an easier "cure" than a defeasance of the bonds in change of use situations, when too much private use and payments threatens the federal subsidy payments. They are exploring whether it would be possible, instead, to halt or lower subsidy payments instead of forcing the bonds to be defeased.

The Treasury and IRS are working on a big project to consolidate and finalize arbitrage rules that were proposed in 2007 and 2013. The issue price rules had been part of the 2013 arbitrage proposals, but were broken out as a separate regulatory project.

Other ongoing projects involve finalizing the so-called TEFRA rules, which implement provisions of the Tax Equity and Fiscal Responsibility Act of 1982 requiring public approval for private-activity bonds. The Treasury and IRS issued temporary rules in 1983 and then modified them in rules proposed in 2008. Muni groups seemed to like the 2008 proposed rules, but they were never finalized.

NABL submitted recommendations on the final rules to the Treasury and IRS in June.

Another ongoing project is to tweak reissuance notices published in 2008 and put them into reissuance rules for tax-exempt bonds. One incentive to get this project finished fairly soon is that a lot of debt was restructured into bank debt with shorter, five to seven year maturities in 2008 and issuers are going to want to convert that into long-term debt as it matures, Cross said.

“We’re starting to see some reissuance questions,” said Cross.

TEB

Meanwhile, IRS officials said the tax-exempt bond office is finding some ongoing problem areas in audits. These include: impermissible private use of bond-financed jails and prisons; total return swaps that result arbitrage rule violations; users of small issue industrial development bonds exceeding capital expenditure limits, direct-pay qualified zone academy bonds issued under volume cap that should not have been carried forward; arbitrage rebate payments that were not determined and paid on time; and sales of bond-financed property that created compliance issues.

The IRS tax-exempt bond office closed 568 audits and entered into 19 closing agreements during fiscal 2015, which ended on Sept. 30. An IRS spokesman said TEB will be adding market segments to audit in the coming year to those already under audit like governmental bonds, 501()(3) bonds, private-activity bonds and tax credit bonds. He was not specific about what might be added. He said TEB also is still looking at arbitrage issues and whether Form 8038-Ts on arbitrage rebate have been accurately filed.

“We’re seeing a lot of audit notices come out and it takes time for issuers to respond to them,” said Schakel, adding, “Some of the questions surprise us.” TEB entered into 105 settlements under the voluntary closing agreement program, about twice as many as in fiscal 2014.

VCAP settlements involved 501(c)(3) ownership problems, arbitrage problems, tax-credit bond issues and exempt facility bond issues. IRS officials declined to provide the dollar amounts of audit and VCAP settlements and said it would be difficult to project how many settlements might be reached in fiscal 2016.

TEB plans two substantial webcasts in 2016, but declined to specify the topics. The office plans to update publications on its website on governmental, private-activity and 501(c)(3) bonds. It is also working on an arbitrage publication.

Some lawyers noted that the costs of applying to the IRS for private-letter rulings has skyrocketed in recent years. The fee has more than doubled during the last five years, rising to $28,300 in 2015 from $14,000 in 2011. “It’s jumped dramatically over the past couple of years and I think it’s due to budget cuts, said Schakel. Issuers are supposed to seek PLRs when they fail to spend all of their proceeds for qualified school construction bonds, she said, adding, some of them don’t want to spend $28,000 over a few thousand dollars of unspent proceeds.

Finally, an IRS spokesperson said TEB is no longer sending newsletters to state and local officials because “we found that we were usually posting the same material on our website.”

The Bond Buyer

by Lynn Hume

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