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Foley & Lardner: New Regulations on Issue Price of Tax-Exempt Bonds.

On December 9, 2016, the Department of the Treasury and Internal Revenue Service (IRS) published final regulations on the definition of “issue price,” for purposes of the arbitrage rules that apply to tax-exempt bonds. A copy of the new regulations can be reviewed [here](#).

These new issue price regulations will significantly change the practices, agreements, and certifications relating to the sale of tax-exempt bonds.

June 7, 2017 Applicability Date. The new regulations apply to bonds sold on or after June 7, 2017. Accordingly, this delayed effective date will provide an opportunity for the municipal bond industry to develop approaches to respond to the new rules before they need to be applied.

Why Were New Rules Needed? The existing regulations have been in place for decades and appear to have generally worked well for issuers. The new regulations were motivated by a perception at the IRS that the existing rule based on reasonable expectations may result in abuses and is not readily administrable. Whether that is really the case is highly questionable. Nonetheless, one of the underlying themes of the new regulations is a lack of trust in rules that rely on reasonable expectations.

More Complicated Rules. The new regulations are more complicated than the existing final regulations. The existing final regulations basically provide for two different rules to establish the “issue price” of bonds sold for money: separate rules for (1) bonds for which a “bona fide public offering” is made and (2) bonds for which a bona fide public offering is not made. The first rule is generally favorable and workable for issuers because it permits the issue price to be established on the date a bond purchase contract is entered into on the basis of reasonable expectations.

The new regulations retain parts of the general framework of the existing final regulations, but are more complicated. The new final regulations provide for four different rules to establish the issue price of bonds sold for money: (1) a special rule for bonds sold in a “competitive sale”; (2) a special rule for bonds offered to the public pursuant to agreements of underwriters to hold the offering price; (3) a general rule, if the issuer chooses not to use one of the special rules described above (or is unable to qualify for one of the special rules); and (4) a rule for private placements. (Although rules (3) and (4) could be viewed as different applications of the same rule). An issuer does not need to apply the same rule for all bonds of the same issue.

The rules in the new regulations are in one way more flexible than the existing regulations, because they allow an issuer to choose which rules to apply (when bonds could qualify for more than one rule). With this additional flexibility, however, also comes additional complexity.

Maturity-by-Maturity Rules. The new final regulations provide that the issue price of bonds that do not have the same credit and payment terms is determined separately. For example, suppose a bond issue has 12 different maturities of serial bonds and two term bonds (and, for all bonds of each maturity, the credit and payment terms are the same). In a typical case, the issue price of each

maturity needs to be separately determined.

This appears to be a mere rephrasing of the same rule in the existing final regulations (which refer to establishing the issue price of “substantially identical” bonds). This rule has important ramifications under the new regulations, as described below.

The General Rule. The new final regulations provide that, unless the issuer applies a special rule, the issue price of bonds issued for money is the first price at which a substantial amount of the bonds is sold to the public. 10 percent is a substantial amount.

This general rule is similar to the rule in the existing regulations, except that it refers only to actual sales, and does not permit the use of reasonably expected sale prices. The main reason for the “reasonable expectation” rule in the existing final regulations is to permit an issuer to establish its tax plan on the sale date (that is, the date of bond purchase contract is signed), which is generally in advance of the closing date. The general rule does not accommodate the practical need to resolve important tax compliance matters on the date the bonds are priced.

The following “special rules” are basically intended to permit an issuer to establish the issue price of bonds on the sale date, but yields this desired result only under limited circumstances.

Special Rule for Competitive Sales. For bonds issued for money in a competitive sale, an issuer may treat the reasonably expected initial offering price to the public as of the sale date as the issue price of the bonds if the issuer obtains a certification of the bonds’ reasonably expected offering price to the public as of the sale date upon which the price in the winning bid is based. The winning bid must be the highest price/lowest interest cost bid. The new regulations contain a number of detailed requirements to qualify as a “competitive sale” which appear to be intended to assure that a bona fide bidding process is followed. Probably the most important (and troublesome) of these is a requirement that the issuer receives bids from at least three underwriters who have established industry reputations for underwriting new issuance of municipal bonds.

The special rule for competitive sales is helpful, but its specific requirements (particularly the three-bid requirement) appear to be unduly rigid, particularly because issue price ordinarily needs to be separately determined for each maturity. For example, if the issuer does not receive three bids for one maturity of a bond issue, the issue price of that maturity will need to be determined using one of the other permitted methods. The need to establish issue price using a “back up” method may, in some cases, substantially complicate the agreements and documentation relating to competitive sales.

Special “Hold the Offering Price” Rule. The issuer may treat the initial offering price to the public as of the sale date as the issue price if the following requirements are met: (1) the underwriters offered the bonds to the public for purchase at a specified initial offering price on or before the sale date (as established by specific certifications and documentation) and (2) each underwriter agrees in writing that it will neither offer nor sell the bonds to any person at a price that is higher than the initial offering price during a required period. The required period starts on the sale date and ends on the earlier of the close of the fifth business day after the sale date or the date on which the underwriters have sold a substantial amount of the bonds to the public at a price no higher than the initial offering price to the public.

This new rule presumably will become the preferred method for establishing issue price in negotiated sales, but will require new practices that may not always be easy to implement. In particular, new covenants in bond purchase contracts, agreements among underwriters, and retail distribution contracts would be required, and care must be taken to obtain specific and rigorous

certifications.

Also, although not entirely clear, it appears that another method must be used if an underwriter does not comply with such a written agreement and in fact sells bonds at a price higher than the initial offering price during the required period.

Clarified Definition of an "Underwriter" and the "Public." The existing regulations have long provided that the issue price of bonds issued for money is the first price at which a substantial amount is sold to the "public." Under the existing regulations, the "public" does not include "bond houses, brokers, or similar persons or organizations acting in the capacity of underwriters and wholesalers." Under the existing regulations, the scope of this exception was not clear. The new regulations simply suggest, to some degree, that the public does not include "underwriters," and otherwise clarify the exception.

The new regulations define "underwriter" by reference to whether there is a direct or indirect contract with the issuer to participate in the initial sale of the bonds. Under the new regulations an underwriter is (1) any person who agrees pursuant to a written contract with the issuer (or with the lead underwriter to form an underwriting syndicate) to participate in the initial sale of the bonds to the public and (2) any person who agrees pursuant to a written contract directly or indirectly with such a person to participate in the initial sale of bonds to the public (for example, a retail distribution agreement between a national lead underwriter and a regional firm under which the regional firm participates in the initial sale of the bonds to the public).

Although the new regulations do not apply before June 7, 2017, it is possible that this generally favorable new definition of "underwriter" will be viewed as a clarification of the standard in the existing regulations, and inform certifications and other practices prior to June 7, 2017.

Private Placements. The new regulations provide that if a bond is issued for money in a private placement to a single buyer that is not an underwriter or a related party to an underwriter, the issue price of the bond is the price paid by the buyer. It is not clear whether this is merely an example of the general rule, or is intended as a separate rule. In any event, however, the rule is similar to the treatment under the existing regulations.

Questions Not Answered. Although the new regulations are much more detailed than the existing regulations, they do not address many important questions relating to issue price. Perhaps most importantly, the new regulations apply only for purposes of the arbitrage and rebate rules that concern investments related to tax-exempt bonds. The new regulations do not answer whether they should apply for purposes of other tax-exempt bond rules, including rules relating to how bond proceeds are required to be used. One example is the rule that generally prohibits the use more than two percent of the proceeds of an issue of tax-exempt bonds (other than governmental bonds) to be used to pay costs of issuance. As a practical matter, however, most bond counsel will also look to these new regulations for purposes of complying with rules other than arbitrage.

Towards Implementation. The new regulations are doubtless more complex than the existing regulations, and will require new practices, contractual covenants, certifications and documentation. Although the new regulations are more favorable than the regulations proposed in 2013 and 2015, they appear to contain certain glitches that may be problematic. In particular, the rigidity of the three-bid requirement for the special rule for competitive sales will likely be problematic. In a different time, the Treasury and IRS might be expected to act on cleaning up the glitches before the effective date. In light of the restrictions on new regulations imposed by the new Administration, however, it would seem unlikely that corrective regulations could be published before June 7, 2017.

Article by Michael G. Bailey, David Y. Bannard, Laura L. Bilas, Dana M. Lach, Emily F. Magee & Mark T. Schieble

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