

# IRS Issue Price Regulations



**National Association of Municipal Advisors**

**WEBINAR**

**March 2, 2017**

# Speakers

- John Cross, Associate Tax Legislative Counsel, Office of Tax Policy, U.S. Department of the Treasury
- Cliff Gerber, Partner, Norton Rose Fulbright LLC; President, National Association of Bond Lawyers
- Erik Kelly, President, Blue Rose Advisors

# Overview of Regulations

## John Cross

- General Rule
- Private Placements
- Special Rule for Initial Public Offering Price – Hold the Price Limit
- Competitive Transactions
- Underwriter Definition

**Final Regulation** - <https://www.gpo.gov/fdsys/pkg/FR-2016-12-09/pdf/2016-29486.pdf>

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# **The Final Issue Price Regulations – What Municipal Advisors Need to Know**

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# A Brief (Quarter Century) History - the 1993 Arbitrage Regulations – Basic Rule

Section 148 of the Internal Revenue Code covers "arbitrage."

Reg. § 1.148-1 (prior to the December 2016 final regulations):

- Issue price means, except as otherwise provided, issue price as defined in sections 1273 and 1274 of the Code.
  - Generally, the issue price of bonds that are publicly offered is the **first price** at which a **substantial amount** of the bonds is sold to the public.
  - **Ten percent** is a substantial amount.
  - The **public** does **not** include bond houses, brokers, or similar persons or organizations acting in the capacity of underwriters or wholesalers.
  - The issue price **does not change** if part of the issue is later sold at a different price. The issue price of bonds that are **not substantially identical is determined separately**. The issue price of bonds for which a **bona fide public offering** is made is **determined as of the sale date based on reasonable expectations** regarding the initial public offering price.
  - **Rule of application:** The 10% threshold applies separately to groups of substantially identical bonds (*e.g.*, separate maturities).

# A Brief (Quarter Century) History - the 1993 Arbitrage Regulations – Using Actual Sales

Cross-reference in 1993 Section 148 regs to Section 1273 (including its regulations):

- Reg. § 1.1273-2(a)(1) provides that “if a substantial amount of the debt instruments of an issue is issued for money, the issue price of each debt instrument in the issue is the **first price** at which **a substantial amount** of the debt instruments is sold for money.”
- An overlooked aspect of this regulation: The first price at which a substantial amount is sold is narrower than the first price at **or below** which a substantial amount is sold.
  - **Example 1:** Offering price of the 2025 maturity of an issue is 100. Underwriter sells 11% of the maturity at 100, then sells 25% of the maturity at 102. Issue price = 100.
  - **Example 2:** Same offering price – 100. Underwriter sells 8% of the maturity at 100, sells 3% of the maturity at 99%, then sells 25% of the maturity at 102. Issue price = 102. (This is the view of many bond counsel.)
  - **Example 3:** Same offering price – 100. Underwriter sells 8% of the maturity at 100 and sells 3% of the maturity at 99%, but there is thereafter no single price at which more than 10% of the maturity is sold. Is there no issue price for this maturity?
    - Backstop under the 1993 regulations: One may rely on reasonable expectations as of the sale date.
    - **Key point:** The final regulations (discussed below) no longer have a reasonable expectations principle.

# A Brief (Quarter Century) History - the 1993 Arbitrage Regulations – Fast-Forward 20 Years

- Many years of discussion of whether and how to “fix” 1993 arbitrage regulations
- Countless seminars and panels devoted to issue price
- IRS examinations challenging issue price
- Various comment projects
  - NABL
  - ABA Tax-Exempt Financing Committee
- Upshot: Two sets of proposed regulations:
  - September 2013: Proposed issue price regulations (part of a larger set of arbitrage regulations)
  - June 2015: Proposed issue price regulations
- . . . . And a set of final regulations:
  - December 2016: Final issue price regulations

# The 2013 and 2015 Proposed Regulations

## The two sets of proposed regulations:

- The September 2013 proposed regulations
  - “Safe harbor” required the sale of 25% of each maturity.
  - Issue price based on actual sales; no substitute for reasonable expectations test.
  - Subject to significant comment and criticism within the bond community.
- The June 2015 proposed regulations
  - Significant improvement from the 2013 regulations
  - First appearance of a “hold the offering price” (“HTOP”) rule
    - Hold the price through the bonds’ issue date.
    - Element of randomness, depending on period between sale and issuance.
    - HTOP could theoretically influence behavior in setting the closing date.
  - Ability to deviate from HTOP to reflect market changes
    - Additional layer of potential complexity.
    - How would market changes be determined, and who would be responsible for demonstrating them?



# Context – Affected Parties

- Affected parties
  - Issuer
  - Conduit borrower (conduit financings)
  - Underwriter(s)
- The “dynamic”
  - The behavior of the underwriter, or the members of the selling group or syndicate, could potentially affect the tax-exempt (or tax-advantaged) status of the bonds.
- Relevant issues
  - Arbitrage – yield restriction and rebate, sizing of reserve funds
  - Other? Volume cap, 2% costs of issuance limit for PABs, Forms 8038/8038-G
- The advisors
  - Bond counsel is the legal advisor to the issuer (or the conduit borrower).
  - The municipal advisor is the financial advisor to the issuer (or the conduit borrower).
    - The \$64,000 question: What is the municipal advisor’s role in advising the issuer (or the conduit borrower) with respect to compliance with the issue price regulations?
- “Risk transference”

## Context – Municipal Advisor Role/Responsibilities

- Will these new regulations affect the issuer's decision whether to pursue a negotiated vs. a competitive sale?
- Will compliance – e.g., with the HTOP rule – affect pricing? (More on this below.)
- Will compliance affect how many potential bids the issuer may expect in a competitive sale?
  - Can we expect to see “conditional bids”?
  - Bids with alternative pricing (depending on HTOP)?
- Will municipal advisors be required to verify the actual sales of bonds to the public? (More on this below.)
- More generally, to the extent compliance with the final issue price regulations produces more obligations on the issuer, does that create a collateral obligation for the municipal advisor?
- Should issuers consider amending their debt issuance policies to address new considerations under the final issue price regulations?

# The December 2016 Final Regulations

- Three distinct rules
  - Two available for negotiated sales
  - Three available for competitive sales
- The rules:
  - 1. Actual sale to the “public” of 10% of each maturity
    - First price at which 10% of each maturity is actually sold
  - 2. The “hold the offering price” rule (discussed below)
  - 3. Special 3-bid rule for competitive sales
- Rule of application:
  - Rules applied to groups of bonds with the same credit and payment terms (*e.g.*, separate maturities).

# The “Hold the Offering Price” (“HTOP”) Rule

- The benefit and the requirements of HTOP:
  - The issuer may treat the initial offering price to the public as of the sale date as the issue price of the bonds if the following requirements are met:
    - 1. The underwriter(s) offered the bonds to the public at a specified initial offering price on or before the sale date.
    - 2. The lead underwriter in an underwriting syndicate or selling group, or the sole underwriter provides, on or before the issue date, a certification to the effect of 1. above, together with “reasonable supporting documentation” for that certification, such as a copy of the pricing wire (or equivalent communication).
    - 3. **Each underwriter** agrees in writing that it will neither offer nor sell the bonds **to any person** at a price higher than such bonds’ initial public offering price from the sale date until the earlier of:
      - a. the close of the 5th business day after the sale date, and
      - b. the date on which the underwriters have sold at least 10% of the bonds (of the particular maturity) at or below such bonds’ initial public offering price.

# The “Hold the Offering Price” (“HTOP”) Rule (continued)

- Advantage of rule: Enables the issuer (and, as applicable, the conduit borrower) **not** to have to look to actual sales of bonds.
  - Serves as a “backstop” (reasonable expectations formerly served as one).
- Potential disadvantages of rule:
  - Pricing
  - Time and expense in additional negotiations with the underwriter
  - An underwriter’s unwillingness to bid in a competitive sale
  - If HTOP is not employed, will there be more pressure for municipal advisors to monitor or verify actual sales on each maturity on EMMA? And for how long?
    - Theory: Without a reasonable expectations backstop, absence of HTOP can leave issue price unresolved – for days, even indefinitely.
  - An underwriter’s failure to comply could adversely affect tax exemption.

## HTOP Diligence and Documentation

- Whose responsibility will it be to ensure that each document – e.g., the BPA and the AAU – contain the requisite provision obligating each underwriter not to sell bonds at a price higher than the initial offering price?
- If a financing does not have HTOP, will there be more pressure to verify the underwriter's sales of bonds?
  - **Statements in the regulations' preamble:**
    - **ON THE ONE HAND:** [T]he Final Regulations omit the proposed special standard for reliance on underwriters' certifications. Instead, the existing due diligence standard under the Existing Regulations for reasonable expectations or reasonableness will apply to any certification under the Final Regulations.
    - **ON THE OTHER:** [F]ailure to meet a specific eligibility requirement of a rule for determining issue price, such as an underwriter's breach of its hold-the-offering-price agreement under the special rule for use of initial offering price, will result in a failure to establish issue price under that rule and a redetermination of issue price under a different rule.

## 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:
  - 1. There is a bidding process in which the issuer offers the bonds for sale to underwriters at specified written terms.
  - 2. The issuer disseminates the notice of sale to potential underwriters in a manner that is reasonably designed to reach potential underwriters. Examples in the regs:
    - a. Electronic communication that is widely circulated to recognized publisher of municipal bond offering documents.
    - b. Posting on an Internet-based website or other electronic medium that is regularly used for such purpose and is widely available to potential underwriters.
  - 3. The issuer obtains from the winning bidder a certification of the bonds' reasonably expected initial offering price to the public as of the sale date upon which the price in the winning bid is based.
  - 4. All bidders have an equal opportunity to bid.
  - 5. The issuer receives bids from at least three underwriters that have established industry reputations for underwriting new issuances of municipal bonds.
  - 6. The issuer awards the sale to the bidder that submits a firm offer to purchase the bonds at the highest price (or lowest interest cost).
    - TIC, NIC, arbitrage yield, other
    - Deference to state and local practices

# Competitive Sales – Pricing (and Related) Considerations

- A bidder may choose to condition the pricing in its bid on the receipt by the issuer of three bids. What happens if the issuer receives fewer than three bids?
  - Was the winning bidder’s bid conditional? Could it pull out of the deal?
  - Did the winning bidder’s bid contain alternative pricing should three bids not be received to “compensate” for agreeing to hold the price?
    - What if the adjusted price makes the winning bidder’s price no longer the best price?
  - The actual sales rule is technically available but not likely to be met as of the sale date in the typical competitive sale.
- A bidder may choose to pass on bidding should the notice of sale contain a hold the offering price restriction (even if HTOP is triggered only upon the receipt of fewer than three bids).
- Competing considerations for large issuers with good credit and established market reputation
  - Risks vs. benefits of **NOT** incorporating HTOP



# Competitive Sales – Pricing (and Related) Considerations (continued)

- More likely in large transactions if at all, a bidder may enter into a hedge to cover market fluctuations during the period between the award and the bidder's sale of the bonds. The bidder wants to be able to settle the hedge without a loss should the price of the bonds rise (and the bidder is in the red on the hedge). Is the bidder's cost of hedging passed on to the issuer through pricing?
- Conditional bid vs. ability to revoke upon issuer notification that it will require HTOP
  - **Scenario: Only 2 bids are received.**
  - Conditional bid: The bid by its terms is conditioned on there being at least 3 bids. If fewer bids are received, the condition is not satisfied and the bidder may withdraw/revoke its bid.
  - Compare: The notice of sale provides that, upon the receipt of fewer than 3 qualifying bids, the issuer is permitted, but not required, to impose HTOP.
    - Should the issuer notify the winning bidder that it will not require HTOP, the bidder is required to buy the issuer's bonds.
    - Should the issuer notify the winning bidder that it will require HTOP, the winning bidder may withdraw/revoke its bid.

# Taking a Step Back

- Is issue price important in every bond financing?
  - No proceeds (e.g., current refunding)
  - New money financing that will qualify for a rebate expenditure exception (e.g., an acquisition)
  - Advance refunding with significant negative arbitrage
  - No funded DSRF
- The above are arbitrage-related considerations.
- The final regulations state that they are applicable for purposes of Section 148 of the Code – *i.e.*, for arbitrage purposes.
  - **Preamble to regulations:** [S]ome commenters recommended allowing the use of issue price as defined for arbitrage purposes **in applying various limitations for other tax-exempt bond purposes, such as those based on principal amounts, face amounts, and sale proceeds.** The Final Regulations **do not adopt this recommendation** because it raises issues that are **beyond the scope** of the 2015 Proposed Regulations, and the recommended extension of the application of the definition of issue price beyond arbitrage purposes appropriately warrants a separate opportunity for public comment. The Treasury Department and the IRS, however, **expect to consider this recommendation in connection with future guidance.**

# Non-Arbitrage Rules

- So what do we turn to for the application of other rules where issue price has been relevant?
  - Volume cap
  - 2% costs of issuance limitation – applicable to all private activity bonds, including qualified 501(c)(3) bonds (hospitals, universities)
  - The possible return of direct subsidy bonds (BABs under ARRA, 2009-2010): Basic qualification depended on a limitation on issue price.
- Unless/until there's additional guidance, will we use the 2016 regulations?
  - Conversely, is it justifiable to use a different rule, including an older issue price rule that will have been superseded?
- Forms 8038 and 8038-G: What figure will be provided on such forms, which require issue price to be stated?
  - Signature line: “Under penalties of perjury . . . . “true, correct, and complete.”

## Mix & Match

- What happens when:
  - Certain maturities of the issue reach the 10% threshold as of the sale date, and
  - Other maturities of the issue do not?
- An issuer may apply a different one of each of the above rules to different maturities.
- On or before the issue date of the bonds, the issuer must identify the rule selected for the particular maturity of the bond issue in its books and records maintained for the bonds.
  - In practice, this is likely to be documented in the issue price section of the issuer's Tax Certificate.

# Private Placements / Direct Purchases

- The final issue price regulations provide:
  - If a bond is issued for money in a “private placement” to a single buyer that is not an underwriter, the issue price of the bond is the price paid by that buyer.
    - Note the use of the term “single buyer.”
    - What if there are two (or more) buyers for the same bonds – *i.e.*, bonds with the same payment terms?
  - The final issue price regulations do not define “private placement.”
  - So what makes a sale of bonds a private placement?
    - If there is no bona fide public offering, does that alone make the transaction a private placement?
    - Do we know a private placement when we see it?

# Important Definitions

- “*Public*” means any person other than an underwriter or a “related party to an underwriter.
- “*Underwriter*” means:
  - (i) any person that 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
  - (ii) any person that agrees pursuant to a written contract directly or indirectly with a person in (i) above to participate in the initial sale of the bonds to the public.
    - *E.g.*, 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 bond to the public.
- “*Related party*” is defined in Reg. § 1.150-1(b). Through a series of Internal Revenue Code and regulation cross-references, the test for for-profit entities, is that relatedness will typically be determined to exist in situations involving entities that are “linked” through greater than 50% ownership (*e.g.*, stock ownership, partnership capital and profits interests).

# Conclusions/Takeaways

- Reasonable expectations historically provided a backstop in case there were insufficient sales to the public. No longer.
- The only backstop may be the HTOP rule (even for competitive sales).
- It will remain to be seen how HTOP provisions will be negotiated between issuers (and their financial advisors) and underwriters.
- Pricing considerations will need to be balanced with tax risk.
- Issuers might consider amending their debt issuance policies to address issue price.
- Municipal advisors might best serve their issuers, in addition to understanding the new regulations, by anticipating the possible scenarios that will arise.
  - Many of these scenarios cannot yet be predicted.



# Presenter



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# New Issue Price Rules – A Municipal Advisor’s Perspective

- General Comments on Issue Price Rules
- Municipal Advice Considerations: Competitive Vs. Negotiated Sale Method
  - Example: an advance refunding
  - Potential Solution: a negotiated sale?
- Municipal Advisor Business Considerations: Pricing Opinions And/Or Issue Price Certifications
  - Example: request to validate pricing or secondary market trading activity
  - Potential Solution (MuniPriceTracker)
- Concluding Thoughts: Mas Need To Be Prepared For The New Issue Price Rules That Become Effective On June 7<sup>th</sup>