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New IRS issue price regulations for tax-exempt bonds

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In December 2016, the US Treasury Department issued final regulations (the "final regulations") on the determination of the issue price of certain types of tax-advantaged debt, including tax-exempt bonds,[1] for purposes of the arbitrage restrictions in Section 148 of the Internal Revenue Code (the "Code"). Effective for bonds sold on or after June 7, 2017, the final regulations replace existing regulations (the "existing regulations") that have been in effect for over 23 years. The final regulations impose new restrictions on the offering and sale of tax-exempt bonds and will raise a number of compliance questions.

Section 148 of the Code generally prohibits the investment of proceeds of a tax-exempt bond issue at a yield that materially exceeds the yield on the issue (the "bond yield"). In circumstances in which proceeds are permitted to be invested above the bond yield, Section 148 generally requires issuers to pay, or "rebate," the excess earnings to the federal government. For purposes of these arbitrage limits, the bond yield is computed based on the "issue price" of the bond issue. The determination of issue price is also important for sizing debt service reserve funds and certain other matters, as discussed below.

Existing regulations

Since 1993, the existing regulations have provided that the issue price of bonds that are publicly offered is the first price at which a substantial amount (defined as 10%) of the bonds is sold to the public. For this purpose, the issue price of each maturity of substantially identical bonds is determined separately, and the "public" does not include bond houses, brokers, or similar persons or organizations acting in the capacity of underwriters or wholesalers. For bonds for which a bona fide public offering is made, the existing regulations provide that the issue price is determined as of the sale date (that is, the first day on which there is a binding contract in writing for the sale or exchange of the bonds) based on reasonable expectations regarding the initial public offering price. Thus, even if less than 10% of a maturity is in fact sold to the public

1 Tax-advantaged debt includes, in addition to tax-exempt bonds, new clean renewable energy bonds, qualified energy conservation bonds, qualified zone academy bonds and qualified school construction bonds. For purposes of this alert, for ease of reference, we will use the term "tax-exempt," but the principles set forth would apply equally to other tax-advantaged debt.

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at a particular price, under the existing regulations the issue price of that maturity will be its initial public offering price if the underwriter reasonably expected as of the sale date to sell the first 10% of the maturity to the public at such price.

Summary of final regulations

Three alternative rules. The final regulations provide three alternative rules that may apply to determine the issue price of tax-exempt bonds. Those rules are described below and are referred to herein, respectively, as the "10%" rule, the "hold-the-offering-price" rule, and the "three-bid competitive sale" rule. Only the first two of these rules is available with respect to bonds sold by negotiated sale.

1. *General rule: sale of 10% of bonds to public*. Similar to the general rule in the existing regulations, the final regulations provide that, in general, the issue price of bonds issued for money is the first price at which a substantial amount (defined as 10%) of the bonds is sold to the public (the "10% rule"). For this purpose, issue price is determined separately for each maturity of bonds with the same credit and payment terms, and the "public" is defined as any person (that is, an individual, trust, estate, partnership, association, company, or corporation) other than an underwriter or a person related[2] to an underwriter. The final regulations define an "underwriter" as: (1) 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 (2) any person that agrees pursuant to a written contract directly or indirectly with a person described in clause (1) above to participate in the initial sale of the 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).[3]

   In a significant change from the existing regulations, the final regulations no longer provide (except in certain circumstances described below) that the issue price may be determined as of the sale date based on reasonable expectations regarding the initial public offering price. Rather, the final regulations provide that issuers may apply the "hold-the-offering-price" rule or, for bonds sold by competitive sale, the "three-bid competitive sale" rule to establish the issue price, as alternatives to the 10% rule.

2. *Hold-the-offering-price rule*. The final regulations permit an issuer to treat the initial offering price to the public as the issue price of the bonds if the following requirements are met (the "hold-the-offering-price" rule):

   — (1) the underwriter(s) offered the bonds to the public at a specified initial offering price on or before the sale date, and the lead (or sole) underwriter provides a certification to that effect, together with reasonable supporting documentation (such as the pricing wire); and

   — (2) each underwriter[4] agrees in writing that it will neither offer nor sell the bonds to any person (including a related person) at a price higher[5] than the initial offering price during the period beginning on the sale date and ending on the earlier of (a) the close of the fifth business day[6] after the sale date, or (b) the date on which the underwriters have sold at least 10% of the bonds (of the particular maturity) to the public at a price no higher than the initial offering price (the "hold period").

3. *Three-bid competitive sale rule*. For bonds offered in a competitive sale, as described below, the final regulations permit an issuer to treat the reasonably expected initial offering price to the public as of the sale date as the issue price if the issuer obtains from the winning bidder a certification of that reasonably expected initial public offering price upon which the winning bid is based and the issuer receives at least three bids as described below (the "three-bid competitive sale" rule). A "competitive sale" is

2 In general, two or more persons are "related" for this purpose if they are connected through direct or indirect common ownership of more than 50%.

3 Under the final regulations, a dealer that is not a party (or related to a party) to a contract directly or indirectly with the issuer or another dealer to participate in the initial sale of the bonds to the public (such as a bond purchase agreement, agreement among underwriters, selling group agreement, retail distribution agreement, notice of sale, or similar agreement) will constitute a member of the public. The final regulations provide more clarity on this question than the existing regulations, which do not contain a precise definition of "public" but rather state that the public does not include bond houses, brokers, or similar persons or organizations acting in the capacity of underwriters or wholesalers.

4 The definition of "underwriter" described above applies for purposes of this requirement. Thus, any person that agrees in a written contract directly or indirectly with the issuer or an underwriter to participate in the initial sale of the bonds to the public (including pursuant to a retail distribution agreement) must agree in writing to hold the offering price during the hold period in order for this rule to apply.

5 A sale of bonds by an underwriter during the hold period to any person at a price that is at or lower than the initial offering price to the public will not violate the hold-the-offering price rule.

6 The final regulations do not define the term "business day." Presumably, Saturdays, Sundays and federal holidays are not business days. In certain contexts unrelated to the determination of issue price, Treasury Regulations contain definitions of "business day" that exclude certain legal holidays in a state or the District of Columbia (see, for example, Treasury Regulations Section 301.6601-1 with respect to underpayments of tax and Treasury Regulations Section 31.3406(h)-1 regarding backup withholding). The final regulations do not incorporate any of those definitions and, thus, it may be necessary to consider on a case-by-case basis whether a particular non-federal holiday should be treated as a business day under the final regulations.

defined as a sale of bonds by an issuer to an underwriter that is the winning bidder in a bidding process that meets the following requirements:

- (1) the issuer offers the bonds for sale to underwriters at specified written terms and disseminates the notice of sale to potential underwriters in a manner reasonably designed to reach potential underwriters (for example, through electronic communication that is widely circulated to potential underwriters by a recognized publisher of municipal bond offering documents or by posting on an Internet-based website or other electronic medium regularly used for such purpose and widely available to potential underwriters);
- (2) all bidders have an equal opportunity to bid (for example, no bidders are given an exclusive "last look" to review other bids);
- (3) the issuer receives bids from at least three underwriters who have established industry reputations for underwriting new municipal bond issuances; and
- (4) the issuer awards the sale to the bidder who submits a firm offer to purchase the bonds at the highest price (or lowest interest cost).

Choice of rules. An issuer will be permitted to apply a different rule to different maturities of the same issue. For example, an issuer may choose to apply the 10% rule to some maturities, and the hold-the-offering-price rule to others. The final regulations require an issuer to identify in its books and records maintained for the bonds, on or before the issue date, which of the three rules (10%, hold-the-offering-price or three-bid competitive sale) it is applying to determine the issue price of bonds of the issue.

Private placements. The final regulations provide that the issue price of bonds sold in a private placement to a single buyer that is not an underwriter or related to an underwriter is the price paid by that buyer.

Effective date. The final regulations will apply to bonds sold on or after June 7, 2017. The existing regulations will continue to apply to bonds sold before that date.

Practical considerations

Importance of issue price and need for certainty. The issue price of a tax-exempt bond issue generally must be determined in order for the issuer to comply with arbitrage restrictions, including investment yield limits, rebate requirements and limits on sizing debt service reserve funds. In addition to arbitrage restrictions, issue price must be established for issuers to comply with certain other federal tax requirements. For example, issue price is relevant to determine whether certain small issuers are eligible to designate bonds as "bank qualified" obligations, and whether certain tax-exempt private activity bonds satisfy volume cap, weighted average maturity and issuance cost limits. Although the final regulations technically apply only for arbitrage purposes, it is likely that, as a matter of practice, they will be applied for these other purposes in the absence of other guidance.

In some cases, it is critical for the issue price to be determined at the time the bonds are sold (that is, the first day on which there is a binding contract in writing for the sale or exchange of the bonds). For example, in an advance refunding[7] transaction, the issue price must be known in order to determine whether the bonds comply with yield restrictions imposed by federal tax law; namely, that the yield on the investments purchased with bond proceeds for the refunding escrow does not exceed the yield on the refunding bonds. Compliance with this yield restriction requirement must be established before an issuer can enter into a binding contract to sell advance refunding bonds on a tax-exempt basis. Similar considerations apply to bonds that fund a debt service reserve fund, bonds issued as "bank qualified" obligations, and tax-exempt private activity bonds subject to volume cap, weighted average maturity and issuance cost limits.

Moreover, in nearly all transactions, the issue price ultimately must be determined to comply with Internal Revenue Service ("IRS") requirements. For example, issuers are required to report the issue price and bond yield on information returns filed with the IRS. In addition, bond counsel typically identify the issue price and bond yield in the bond documents signed at closing, in order to advise the issuer with respect to compliance with the Code and to set forth the issuer's reasonable expectations as generally required by the arbitrage regulations.

7 An "advance" refunding occurs if the refunded bonds are retired more than 90 days after the issue date of the refunding bonds.

Under the 10% rule, the issue price of an issue will be established only if at least 10% of each maturity is actually sold to the public at a particular price. Under the existing regulations, the reasonable expectations standard allows the issue price to be determined with certainty, even if less than 10% of one or more maturities of an issue is sold to the public at a particular price. Under the final regulations, the reasonable expectations standard will no longer be generally available as a backstop for establishing the issue price of unsold maturities. Rather, issuers will need to rely on the hold-the-offering price rule or the three-bid competitive sale rule to determine the issue price of maturities that do not meet the 10% rule.[8]

Hold-the-offering price rule. As noted above, an issuer will be able to treat the initial offering price to the public as the issue price of any bonds for which the hold-the-offering price rule is met. The hold-the-offering price rule will be met only if each underwriter agrees in writing that it will neither offer nor sell the bonds to any person during the hold period at a price higher than the initial offering price to the public.

Implementation of the hold-the-offering price rule will require amendments to various bond documents. For example, bond purchase agreements and agreements among underwriters will need to include procedures for identifying any maturities subject to the rule and specifying the applicable hold period, as well as covenants by the underwriters to comply with the rule. Selling group agreements and retail distribution agreements will need to contain similar provisions that restrict sales during the hold period by dealers and broker-dealers that are parties to such agreements. Issue price certificates will have to be revised to address the hold-the-offering price rule and other aspects of the final regulations. In addition, as discussed below, notices of sale for competitive offerings will need to address the hold-the-offering price rule if the issuer wishes to reserve the ability to apply it in the event less than three bids are received and the 10% rule is not met for all maturities. Industry groups are working on changes to model form documents to address these issues.

The hold-the-offering-price rule is likely to result in additional transaction costs and financing costs for issuers. In addition, the preamble to the final regulations states that an underwriter's breach of an agreement to comply with the hold-the-offering-price rule will result in a failure to establish issue price under that rule and a redetermination of issue price under a different rule.[9] Thus, a breach by an underwriter of its agreement to hold the offering price for the hold period could result in an assertion by the IRS that the issue price must be re-determined and, possibly, that such a redetermination would cause the bonds to fail to qualify for tax exemption.

Three-bid competitive sale rule. As indicated above, for bonds offered in a competitive sale that meets the three-bid competitive sale rule, the final regulations permit an issuer to treat the reasonably expected initial offering price to the public as of the sale date as the issue price. The preamble to the final regulations states that the Treasury Department and the IRS "recognize that competitive sales favor competition and price transparency that may result in better pricing for issuers."

For qualifying competitive sales, the three-bid competitive sale rule allows the issue price to be determined with certainty as of the sale date, even if less than 10% of one or more maturities is sold to the public at a particular price. On the other hand, if the issuer does not actually receive at least three bids, the three-bid competitive sale rule will not be available. Moreover, it is common in competitive sales to have unsold maturities for which the 10% rule will not be available.

To account for the possibility that it might not receive at least three bids, an issuer could include hold-the-offering-price restrictions in the notice of sale. Such restrictions could take effect, for example, if the issuer received fewer than three bids. However, any such restrictions would likely induce bidders to reduce the prices of their bids, thereby increasing the issuer's borrowing costs, and could even discourage potential bidders from submitting bids. A notice of sale might allow bidders to submit bids that may be withdrawn if (1) the issuer receives fewer than three bids, and (2) the issuer chooses to impose hold-the-offering-price restrictions. Alternatively, bidders might submit bids that (1) would be disregarded if three bids are not received, or (2) provide two alternative prices depending on whether three bids are received. There remains the question, however, continued to be analyzed by bond counsel, whether a revocable or conditional bid might not constitute a "firm" offer to purchase the bonds, as required by the three-bid competitive

8 In theory, it may be possible to establish the issue price after the issue date under the 10% rule in certain transactions if the underwriters agree to monitor actual sales and report them to the issuer. However, such reliance on post-issuance monitoring could raise compliance problems. For example, if the underwriters failed to sell to the public (even after the issue date) at least 10% of any maturity at a particular price, the issue price (and therefore the bond yield) would not be determinable. Such a failure to establish the issue price could be problematic even if the issuer expected as of the issue date that there would be no gross proceeds of the issue subject to arbitrage limits. For example, a fixed-rate current refunding issue with no debt service reserve fund could become subject to yield restriction and rebate requirements if the issuer established a sinking fund or defeasance escrow for the issue after the issue date. Moreover, as discussed above, the IRS requires issuers to report the issue price and bond yield on information returns.

9 More broadly, the preamble states that a failure to meet any specific eligibility requirement of a rule for determining issue price will result in a failure to establish issue price under that rule and a redetermination of issue price under a different rule.

sale rule. Further, such type of bid process may raise questions about compliance with state and local bidding and procurement rules. In any event, a notice of sale could allow the issuer to reject all bids in the event three bids are not received, in which case the issuer could solicit bids for the bonds at a different time.

Conclusion

The final regulations, by eliminating the reasonable expectations backstop and adding the hold-the-offering price rule and the three-bid competitive sale rule, will significantly change longstanding practices for determining the issue price of tax-exempt bonds and will result in new restrictions on the offering and sale of those bonds.

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