NOW + NEXT

PUBLIC FINANCE LAW ALERT | NIXON PEABODY LLP

DECEMBER 13, 2016

NP

Final issue price regulations

On December 8, 2016, the IRS issued final regulations (the Regulations), which redefine the “issue price” of tax-exempt bonds for purposes of the arbitrage regulations. These Regulations bring to a close a long-standing effort by the IRS to redefine issue price in a manner that reduces reliance on reasonable expectations as of the sale date and, instead, focuses on the price of actual sales of bonds. The final rules apply to bonds sold on or after June 7, 2017.

Background

The arbitrage yield restriction and rebate rules limit the ability of issuers of tax-exempt bonds to profit from investing tax-exempt bond proceeds at a yield in excess of the yield on the issuer’s bonds (bond yield). Bond yield is based, in part, on the issue price of the bonds (where bond yield is the rate that discounts the debt service on the bonds to the issue price). Moreover, the amount of volume cap required for certain qualified private activity bonds has also historically been determined by reference to the issue price of those bonds. For many years, issuers have been permitted to either base the issue price of bonds on the first price at which the bonds were sold, or for bonds sold in a public offering, on the price at which the bonds were reasonably expected to be sold to the public (that is, the initial offering price) regardless of the price at which the bonds were actually sold. The reasonable expectations rule enabled issuers to conclusively determine a bond’s issue price on the sale date of the bonds. The IRS, however, became concerned that these rules were, in some cases, being abused by some market participants who would purchase bonds at the initial offering price and immediately resell those bonds at a higher price. In 2013 and 2015, the IRS issued two separate sets of proposed regulations attempting to address these concerns by changing the focus of the regulations to the price at which bonds were actually sold to the public, rather than the reasonable expectations of what the bonds would be sold at on the sale date.

The Regulations generally retain the requirement from the proposed regulations that issue price be determined based on the prices of actual sales of bonds. In response to public comments, however, the Regulations contain two important exceptions to this general rule as described below. Although the Regulations are an improvement over the regulations proposed in 2013 and 2015, concerns remain that the Regulations could adversely affect the manner in which bonds are priced and sold so as to increase borrowing costs to issuers.

General rule

The Regulations generally provide that the issue price of bonds of a particular maturity is equal to the first price at which at least 10 percent of those bonds are sold to the public. As described below, “public” means the ultimate investors, not underwriters or other intermediaries. For a bond issued in a private placement to a single buyer, the issue price is the price paid by that buyer.

Exception 1—Initial offering price to the public

In response to public comments, the Regulations permit a bond’s issue price to be determined based on the initial offering price to the public on the sale date. This new rule applies only if each underwriter agrees in writing to hold the price of the bonds of a maturity at a price no higher than the initial offering price for five business days after the sale date, or until the date on which at least 10 percent of that maturity is sold to the public, if earlier. Unlike the proposed regulations, this “hold the price” rule applies even if there are intervening changes in the market. In this regard, the IRS rejected a proposed approach under which the sale of a specified minimum percentage of an entire issue would then permit reliance on the initial offering prices for the entire issue.

Analysis

Throughout the comment process, many expressed concerns that any rule mandating sales at specified prices or requiring that prices be held at specified levels would negatively impact bond issuers. The required five-day price holding period places a risk on underwriters that they will be forced to hold bonds in a declining market and raises the concern that, in response, underwriters will either set initial offering prices low enough (i.e., with higher yields) to ensure sufficient sales or pass on to issuers the cost of hedging against price risks.

Exception 2—Competitive sales

In response to public comments, the Regulations include a rule under which the issue price for bonds sold on a competitive basis can be based on the reasonably expected initial offering price to the public as set forth in the winning bid, but only if certain requirements are met. Most importantly, this rule only applies if the issuer receives at least three bids for the bonds pursuant to the competitive sale.

Analysis

The inclusion of a special rule for competitive sale transactions is an important and positive change from the proposed rules. Concerns have been raised, however, that a substantial portion of smaller bond issues will not be able to satisfy the three-bid requirement, and thus may be required to apply the general rule.

Definitions and certifications

As indicated above, the issue price of bonds is determined based on sales to the public, which excludes sales to underwriters (or a related person). The Regulations helpfully clarify that underwriters (or a related person) are limited to any person that contractually agrees with the issuer to participate in the initial bond sale (or with the lead underwriter to form an underwriting syndicate) or a person that directly or indirectly enters into a contract with any such person to participate in the initial sale of the bonds.

The Regulations permit issuers to rely on underwriter certifications and the pricing wire as part of establishing a bond's issue price provided that a prudent person in the issuer's circumstance would reasonably rely on that certification. The Regulations retain the proposed rule that the issuer remains at risk for a violation if the underwriter does not comply with its obligations regarding issue price determinations such as the "hold the price" rule.

Conclusions

The Regulations are an improvement over the proposed rules in several important ways. In many cases, under current market conditions where negative arbitrage is the norm, the issue price of a bond issue will have little or no significance. For example, a new money or current refunding bond issue may not necessitate a conclusive yield determination of issue price on the sale date and the need to look to actual bond sales may not have significant consequences. For advance refunding issues, private activity bonds subject to volume cap and other transactions where it is necessary to determine issue price on the sale date, the Regulations may result in higher borrowing costs in negotiated transactions for issuers as they and their underwriters seek to comply with the rule under which bond prices must be held for five days. The requirements for competitive sales may also create some difficulties in those sales. It is unfortunate that the IRS seems to have not fully responded to these concerns in finalizing the Regulations.

For more information on the content of this alert, please contact your Nixon Peabody attorney or:

— Mitch Rapaport at **mrapaport@nixonpeabody.com** or 202-585-8305

— Bruce M. Serchuk at **bserchuk@nixonpeabody.com** or 202-585-8267

— Carla A. Young at **cyoung@nixonpeabody.com** or 202-585-8340

— Travis C. Gibbs at **tgibbs@nixonpeabody.com** or 415-984-8336

— Amy Phuong Pham at **apham@nixonpeabody.com** or 213-629-6091

— Praveen Ayyagari at **payyagari@nixonpeabody.com** or 202-585-8025