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U.S. Treasury Releases More Workable Proposed Regulations on ‘Issue Price’ for Municipal Bonds

On June 24, 2015, the U.S. Department of the Treasury (Treasury) published in the Federal Register new proposed regulations (the New Proposed Regulations) under Section 148 of the Internal Revenue Code of 1986, as amended (the Code) amending the definition of “issue price” (issue price) in its current regulations under Section 148 of the Code. Treasury simultaneously withdrew its previously promulgated September 2013 proposed regulations (Prior Proposed Regulations). Establishing issue price is essential to determining yield on municipal bonds. The New Proposed Regulations contain a more favorable approach to the definition of issue price than had been presented in the Prior Proposed Regulations, which had been almost universally criticized as unworkable. The New Proposed Regulations retain certain aspects of the current regulations covering issue price (Current Regulations), while introducing certain new requirements.

Current Definition of Issue Price

Under the Current Regulations, issue price is determined generally following the definition of such term for purposes of computing original issue discount under Sections 1273 and 1274 of the Code. Issue Price in a *bona fide* public offering is the price at which a substantial amount of bonds is sold to the public, using the reasonable expectations of the underwriter as of the sale date generally reflected in the “offering price” (rather than a standard based on actual sales). The Current Regulations define “substantial amount” as 10 percent, with separate issue prices being established for bonds with different maturities, as well as payment and credit terms, and define “public” as not including bond houses, brokers, or similar persons or organizations acting in the capacity of underwriters or wholesalers.

Desire for Change

The use of a reasonable expectations standard has raised concerns from the enforcement division of the Internal Revenue Service (IRS). Although the basic elements of issue price, as described above, have been in use since at least 1982, the

enforcement division (TEB) of the (IRS) has, over the past several years, expressed concern about heavy reliance by bond counsel and issuers on underwriter certifications that are difficult to substantiate. The New Proposed Regulations represent Treasury's latest attempt to address these concerns. The New Proposed Regulations retain the ability of issuers to rely on the "offering price" of a municipal obligation as long as certain criteria are met. These criteria are designed to allay concerns that the "offering price" may be lower than the actual stated sales price of an obligation, which would result in a higher bond yield.

Prior Proposed Regulations

The Prior Proposed Regulations had substantially altered both the standard and the overall definition of issue price. Although retaining the rule that issue price is generally to be determined under Code Sections 1273 and 1274, the Prior Proposed Regulations provided a safe harbor for determinations of issue price that changed both the standard from "reasonable expectations" on the sale date to "actual sales," and the definition of "substantial amount" from 10 percent to 25 percent. In addition, the Prior Proposed Regulations defined "public" to mean any person other than an underwriter, and defined "underwriter" to include the lead underwriter, any member of a syndicate contractually agreeing to participate in the underwriting, and any securities dealer (whether or not a member of the syndicate) that purchases bonds (whether or not from the issuer) for the purpose of originally distributing bonds.

Comments to Treasury on the Prior Proposed Regulations were generally very negative, stating that issue price must be determined on the sale date to provide certainty on whether bonds would be tax-exempt; expressing concern on the new definition of "underwriter" as too broad, ambiguous, and unworkable in the context of a rule that relies on actual sales and noting that the use of actual sales prices rather than reasonable expectations would likely result in lower bond offering prices to insure compliance with the 25 percent standard, thus reducing bond proceeds; increasing bond yields for arbitrage purposes; and increasing federal tax subsidies—all being contrary to the stated goals of the Prior Proposed Regulations and TEB's concerns.

New Proposed Regulations

The New Proposed Regulations attempt to address these concerns. They retain the rule that issue price is generally to be determined under the rules of Code Sections 1273 and 1274, and parallel the Current Regulations by providing that issue price is the first price at which a substantial amount of the bonds is sold to the public, using actual sales as provided under Code Section 1273, and retaining the Current Regulations' standard of 10 percent as a substantial amount, determined separately for bonds with different payment and credit terms. In addition, the New Proposed Regulations redefine the word "underwriter" for purposes of the definition of "public" as (i) any person in direct contract with the issuer, or who enters into an underwriting syndicate, who agrees to sell the bonds; or (ii) who directly or indirectly enters into a contract to sell the bonds with any of the foregoing. Last, to address the stated concern of the need for certainty on the sale date of publicly-offered bonds, the New Proposed Regulations provide an alternative method for determining issue price where a substantial amount of bonds is not sold by orders received on the sale date.

Alternative Method

Under the alternative method, the issuer may treat the initial offering price to the public as the issue price, provided that (i) the underwriters fill all orders received by them on or before the sale date at the initial offering prices—and not at higher prices; (ii) the lead underwriter provides a certification at closing on certain matters, including that no underwriter will fill an order received after the sale date and before the issue date at a price higher than the initial offering price—unless such higher price is the result of a market change, such as a change in interest rates; and (iii) the underwriter provides the issuer with supporting documentation for the matters covered in the certifications, including pricing information and information regarding market changes. In addition, and significantly, the issuer must not know or have reason to know, after exercising due diligence, that the certifications are false. While the alternative method does rely on underwriter certifications, these certifications are now substantiated with supporting documentation, which should alleviate TEB's concern.

Assessment of New Proposed Regulations

Although certain areas under the New Proposed Regulations appear to need clarification, such as (i) the extent of documentation that underwriters must supply to establish issue price; (ii) the extent of the due diligence that issuers must do to insure that they do not have “reason to know” that an underwriter’s certification is false; and (iii) exceptions to the general provisions that might be needed to insure compliance with technical securities law rules, the New Proposed Regulations initially have been received and viewed as significantly more workable than the Prior Proposed Regulations had been. Comments and a hearing on the New Proposed Regulations have been scheduled: comments are due by Sept. 23, 2015; the public hearing is on Oct. 28, 2015, where presumably these open questions and others will be presented for consideration by Treasury.

Effective Date

The New Proposed Regulations will not be effective until 90 days after final regulations are adopted. The preamble to the New Proposed Regulations, however, permits issuers to elect to use them from and after June 24, 2015, until the effective date of final regulations.

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