IRS Takes Another Stab at Proposed Issue Price Regulations – A Step in the Right Direction, but Practical Questions Remain

Overview

In response to heavy criticism following the release of its proposed Treasury Regulations in 2013 relating to issue price (the "2013 Proposed Regulations"), the Internal Revenue Service, has once again published proposed Treasury Regulations (the "2015 Proposed Regulations") concerning the definition of "issue price" for purposes of arbitrage investment restrictions on tax-exempt bonds,[1] which withdraw the 2013 Proposed Regulations and introduce a new approach to the determination of issue price. While members of the bond industry generally agree that the 2015 Proposed Regulation are marked improvement over the 2013 Proposed Regulations and provide helpful definitions of "public" and "underwriter," the 2015 Proposed Regulations continue to impose an "actual sales" standard and the alternative method of establishing issue price introduced by the 2015 Proposed Regulations introduce more complexities and ambiguities into the mix.

In considering the 2015 Proposed Regulations, it is important for transaction participants to note that, although the 2015 Proposed Regulations would apply prospectively if and when they are made final, issuers may nevertheless rely on the 2015 Proposed Regulations in connection with any bonds issued after June 24, 2015. Accordingly, issuers, underwriters, and financial advisors should generally be aware of the 2015 Proposed Regulations because other transaction participants may wish to apply the 2015 Proposed Regulations.

2015 Proposed Regulations Continue Move Away from "Reasonable Expectations" to an "Actual Sales" Test

The 2015 Proposed Regulations parallel the currently applicable Treasury Regulations made final in 1993 (the "Current Regulations") in that the issue price for which a bona fide public offering is made continues to be defined as the first price at which a substantial amount (defined as 10%) of the bonds is sold to the "public" (see discussion below regarding the term "public"). However, the 2015 Proposed Regulations require that ***actual sales*** determine issue price, whereas the Current Regulations allow the issue price to be determined as of the sale date based on ***reasonable expectations*** regarding the initial public offering price at which 10% of the bonds of each maturity would be sold.

In moving to an actual sales test in the 2013 Proposed Regulations, the IRS noted that it was addressing its concern that the reasonable expectation test does not always produce a representative price for an issue of bonds because the underwriters may actually sell such bonds at higher prices, thereby resulting in the issue price of the bonds established pursuant to the reasonable expectations test to be a lower price than is representative of the prices at which the bonds were actually sold. The 2013 Proposed Regulations would have eliminated the perceived problem by requiring that issue price be determined by actual sale prices to the public instead of reasonably expected sale prices, but also imposed a new requirement that a minimum of 25% (as opposed to 10%) of the bonds be actually sold to the public as the issue price.

In response to the 2013 Proposed Regulations, commentators criticized the new 25% threshold, noting that 25% of an issue of bonds is often not in fact sold to the public on the sale date. Because there are a number of tax rules that benefit from certainty regarding issue price prior to issuance, commentators noted the impracticality of the 2013 Proposed Regulations and predicted that the new requirement would result in significant changes in the marketing of tax-exempt obligations, potentially resulting in higher costs to issuers.

With the above background in mind, most industry participants acknowledge that, although the 2015 Proposed Regulations include an actual sales test, the reduction from 25% to 10% of sales to establish issue price is an improvement over the 2013 Proposed Regulations. However, as described immediately below, the introduction of an alternative method of determining issue price in cases when the 10% actual sales threshold is not met brings with it its own set of challenges.

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[1] The 2015 Proposed Regulations, REG-138526-14, were published in the Federal Register on June 24, 2015.

Alternative Method of Determining Issue Price

Acknowledging that there are instances when an underwriter may not be able to sell even 10% of an issue of bonds to the public prior to the issue date and that an issuer may require certainty regarding the issue price prior to closing, the 2015 Proposed Regulations offer an alternative method for determining the issue price.

The alternative method requires that the underwriters (i) fill all initial-offering-price orders placed by the public and received by the underwriters on or before the sale date, and (ii) do not fill any order received by the underwriters on or before the sale date at a price higher than the initial offering price. Further, the lead (or sole) underwriter is required to provide certification of the following: (i) the initial offering price, (ii) that the underwriters met the requirement to fill all orders at the initial offering price placed by the public and received by the underwriters on or before the sale date at the initial offering price, (iii) that no underwriter will fill an order received from the public after the sale date and before the issue date at a price higher than the initial offering price, unless the higher price is the result of a market change for those bonds after the sale date (e.g., a change in interest rates), and (iv) that the lead (or sole) underwriter will provide the issuer with supporting documentation for the matters covered by the certifications. The 2015 Proposed Regulations go on to provide that an issuer must not know or have reason to know, after exercising due diligence, that the certifications are false.

While perhaps well intended, the alternative method raises more questions than it provides answers. Some (but certainly not all) of the questions raised by the alternative method under the 2015 Proposed Regulations include:

- Can the issuer choose to elect the general method and/or the alternative method on a maturity-by-maturity basis?
- What kind of due diligence is required in connection with the underwriter's certifications, and how is it best accomplished? Is relying on EMMA reasonable? Is something higher than the "reasonably prudent person" test required?
- Who should perform the required due diligence?
- Will lead underwriters feel comfortable to giving representations that cover actions of other members of an underwriting syndicate? What kind of provisions should be included in the Agreement Among Underwriters with respect to the alternative method? Will an issuer need to chase down separate certifications from each member of the underwriting syndicate?
- What kind of provisions should be included in the bond purchase agreement concerning the alternative method?

In addition to these questions, commentators have also noted that the alternative method under the 2015 Proposed Regulations is not appropriate for competitively bid deals, and have suggested alternative safe harbors that may be appropriate in those circumstances.

Because of the questions and ambiguities with respect to the alternative method, the general industry consensus seems to be that, unless and until the 2015 Proposed Regulations are made final, issuers should continue to rely on the reasonable expectation test in cases in which the 10% actual sales test is not satisfied (i.e., not elect the alternative method).

Definitions of "Public" and "Underwriter"

The 2015 Proposed Regulations also include changes to the definitions of "public" and "underwriter" as they relate to issue price. Specifically, the term "public" for purposes of determining issue price includes any person other than an underwriter or a related party to an underwriter. An "underwriter" includes (i) any person that contractually agrees to participate in the initial sale of the bonds to the public by entering into a contract with the issuer or into a contract with a lead underwriter to form an underwriting syndicate and (ii) any person that, on or before the sale date, directly or indirectly enters into a contract or other arrangement to sell the bonds with any of the foregoing (for example, a retail distribution contract between a member of an underwriting syndicate or selling group and another dealer that is not in the syndicate or selling group).

In general, the changes made to the definition of underwriter have received a generally favorable market response, as the definition included in the 2013 Proposed Regulations was viewed as overly inclusive.

Questions Remain, but Welcome Improvement

While the 2015 Proposed Regulations introduce new interpretive questions and some practical challenges, participants in the tax-exempt bond market have generally agreed that the 2015 Proposed Regulations are an improvement over the 2013 Proposed Regulations. Nevertheless, as 2015 Proposed Regulations are put into practice and are ultimately tweaked before they are finalized, we expect that they will have an impact on certain longstanding practices in the tax-exempt bond market.

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