SQUIRE SANDERS

PROPOSED ARBITRAGE REGULATIONS RELEASED SEPTEMBER 16

September 2013

The Treasury Department has issued new proposed arbitrage regulations. The new regulations do not apply until Treasury finalizes them, but issuers generally are permitted to apply them to transactions occurring after September 16, 2013. The new regulations propose a number of changes to the arbitrage rules, some issuer-friendly and some not.

Under the proposed regulations, issuers would not be able to rely on reasonable expectations to determine issue price."

Currently, the "issue price" of publicly offered bonds is the price at which the issuer reasonably expects to sell at least 10% of the bonds to the public, even if it actually sells less than 10% at that price. The proposed regulations would not allow an issuer to rely on its (or the underwriter's) expectations regarding issue price but would look to actual sales to establish issue price. Also, the percentage of bonds sold that would be required to establish issue price generally would be increased from 10% to 25%.

This proposed change will undoubtedly prove to be highly controversial. The inability to rely on reasonable expectations presents several problems, including that an issuer must monitor bond sales beyond the initial sale date until those sales, at a particular price, amount to 25% of the bonds. This practice would be required separately for each maturity of bonds in a bond issue. This would be further complicated by the issuer's inability to know whether a purchaser acquired a bond to hold for investment, such that the purchase could be taken into account to establish the issue price.

In a typical underwritten deal, the issuer currently determines on the initial sale date whether it satisfies many tax requirements that are based on the issue price of a bond issue. If an issuer is no longer permitted to rely on reasonable expectations in establishing issue price, and actual sale prices exceed expected prices, the arbitrage yield of the issue will be lower than expected, which could unexpectedly cause the yield of an advance refunding escrow to exceed the permitted yield limit. Further, in the case of tax-exempt private activity bonds, the unexpected higher issue price could prevent an issue from satisfying the 2% limit on issuance costs if the unexpected portion of the issue price is retained by an underwriter or dealer of the bonds. A change in issue price would likely also change the weighted average maturity of the issue, thereby jeopardizing satisfaction of the maturity limitation applicable to private activity bonds. Also, an unexpected increase in issue price could cause the $10 million limit on "bank qualified bonds" (i.e., qualified tax-exempt obligations) to be exceeded. Limited relief from certain of the arbitrage consequences of an increased issue price is included in the proposed regulations by way of permission to make "yield reduction payments" to Treasury that will be treated as reducing the yield of yield-restricted investments (e.g., investments held in an advance refunding escrow) under these circumstances, but no relief is provided for the other potential consequences of a change in issue price.

The proposed regulations would broaden the IRS' "anti-abuse" powers.

The proposed regulations broaden the general arbitrage anti-abuse rule by authorizing the IRS to depart from the arbitrage rules as necessary to prevent issuers from obtaining arbitrage benefits that are "inconsistent" with the arbitrage rules. If implemented, this rule purports to allow the IRS to disregard the arbitrage rules if it feels that is necessary to prevent a material financial advantage that is inconsistent with those rules. While this may sound reasonable in spirit, it would greatly reduce the degree of certainty available to an issuer upon entering into a novel financing structure that complies with the myriad technical arbitrage rules but may, in the often-unpredictable view of the IRS, produce results that are inconsistent with the objectives of the arbitrage rules.

The proposed regulations would extend the period during which an issuer may identify a hedge (such as a swap) to be integrated with tax-exempt bonds, and they would simplify the rules regarding deemed termination of hedges.

Under the current arbitrage regulations, a hedge (such as an interest rate swap) may be integrated with tax-exempt bonds and, thus, taken into account in determining the yield of the bonds if, among other requirements, the issuer of the bonds identifies the hedge within three calendar days after the issuer (or conduit borrower of bond proceeds) and hedge provider enter into the hedge agreement. The proposed regulations would liberalize this requirement for hedge integration by extending the identification period from three calendar days to 15 calendar days. The proposed regulations would continue the current requirement that the issuer of the bonds, rather than a conduit borrower, identify the hedge. The proposed regulations would also change this identification requirement to mandate that the hedge provider certify various characteristics of the hedge. Although obtaining these certifications from the hedge provider is a recommended practice under the current regulations, it is not presently a requirement for the hedge to be integrated with tax-exempt bonds.

Under the current arbitrage rules, a material modification of a hedge or a refunding of bonds subject to a hedge generally results in the complexity of a deemed termination and reacquisition of the hedge. The deemed termination and reacquisition produce deemed termination and reacquisition payments that must be addressed in complicated arbitrage calculations. In a helpful change, the proposed regulations provide that if the modified hedge or the hedge associated with the refunded bonds continues to be a "qualified hedge" under the arbitrage rules (determined without regard to whether the hedge is then on-market), then no such deemed termination and reacquisition is deemed to occur for tax purposes. The identification requirement would apply by treating the modification date of the hedge or the issuance date of the refunding bonds, as applicable, as the date the issuer and hedge provider entered into the hedge agreement. The requirement of the hedge provider's certification would not apply in this context.

The proposed regulations would clarify the treatment of bond-financed grants.

Currently, bond proceeds are treated as spent when they are granted to an unrelated party. Thus, for example, the grantee may invest the grant free of any arbitrage yield restriction or rebate obligation. However, this rule leaves unanswered the question of whether the use of the grant by the grantee is relevant for other tax purposes. For example, what "temporary period" is available to the issuer prior to granting bond proceeds? Is the use of the grant by the grantee for a private business use relevant to the issuer? And is the useful life of financed assets for purposes of the limitation on the maturity of the bonds determined based on the lives of the assets acquired by the grantee with the grant?

The proposed regulations would answer these questions by providing that a grantee's use of the grant is taken into account in determining which tax rules are applicable to the issue and whether those rules are satisfied. The proposed regulations, however, do not change the favorable current rule that proceeds are treated as spent when they are used to make a grant.

The proposed regulations contain helpful clarifications and changes to the working capital financing rules.

Typically, an issuer cannot use tax exempt bond proceeds for working capital expenditures (e.g., operating expenses) unless the issuer has no other "available amounts" that it could use for those expenditures. However, Treasury commentary accompanying the proposed regulations acknowledges that an issuer "need not be broke to borrow" for working capital purposes. Under the existing regulations, an issuer may maintain a working capital reserve that is not treated as a part of its available amounts. The proposed regulations liberalize and simplify the limit on the permitted reserve. Under the proposed regulations, the limit would generally be 5% of the issuer's working capital expenditures paid from tax and operating revenues in its previous fiscal year; the extent to which the issuer previously maintained such a reserve or cash balances would not impose a further limitation as it does under the current regulations. The proposed regulations also establish the first set of rules addressing long-term working capital financings.

The proposed regulations would allow issuers a more favorable method of valuing investments of tax-exempt bond proceeds where the tax-exempt bonds are refunded by taxable bonds.

In an issuer-favorable change, the proposed regulations would permit an issuer to value investments allocable to a tax-exempt bond issue at their present value rather than their fair market value when the investments become transferred proceeds of a taxable refunding bond issue that refunds the tax-exempt bond issue. The current regulations require that these investments be valued at their fair market value when they become transferred proceeds of the taxable refunding issue, but they allow the investments to be valued at their present value when they become transferred proceeds of a tax-exempt refunding issue. This proposed change is favorable because, in some circumstances, it will allow an issuer to avoid an imputed gain that could arise under fair market valuation and that would be allocable to the tax-exempt refunded issue, thus, potentially subject to rebate, upon such a transfer to the taxable refunding issue. This proposed change therefore seeks to put taxable and tax-exempt refundings of tax-exempt bonds on an equal footing in terms of the potential rebate consequences with respect to the investments acquired with proceeds of the tax-exempt refunded bonds.

The proposed regulations generally do not apply until after Treasury finalizes them, but issuers may elect to apply them now.

The proposed regulations are generally applicable to bonds sold 90 days or more after Treasury finalizes and publishes them in the Federal Register. The proposed regulations applicable to hedges generally apply to hedges entered into or modified, or bonds subject to qualified hedges that are refunded, 90 days or more after such publication. However, issuers are permitted to apply these proposed regulations by substituting September 16, 2013, for the effective date described in the preceding sentence.