Bloomberg BNA

Daily Tax Report®

The Treasury Department Sept. 16 published long-awaited proposed regulations (REG-148812-11) under the ''arbitrage'' rules, which generally restrict the permitted investment yield that can be earned on proceeds of tax-advantaged state and local debt, including tax-exempt and tax credit bonds. One proposed regulation in particular has provoked significant outcry in the public finance community—the removal of the reasonable expectations standard for determining the issue price of publicly offered bonds, which is a key factor in determining the yield of a bond issue.

Under the proposed regulations, the ''issue price'' of bonds would no longer be based on the reasonably expected price at which the first 10 percent of those bonds will sell to the general public if in fact less than 10 percent of the bonds were actually sold at that price. Instead, the proposed regulations, if adopted as final regulations, would require issuers to base the issue price on the actual price at which at least 25 percent (up from 10 percent) of a given maturity of the bonds first sells to the general public.

In this article, Johnny Hutchinson, Mike Cullers and Bob Eidnier of Squire Sanders explain the pitfalls that this proposal creates. In addition, the article analyzes the other proposed changes under the proposed regulations. Those other changes include a new rule that enhances the ability of the Internal Revenue Service to disregard the arbitrage rules to attack perceived arbitrage abuses and generally favorable changes to the rules for grant financings, ''qualified hedges'' and working capital financings.

Treasury Issues Long-Awaited Issue Price, Other Arbitrage Proposed Regulations: What You Need to Know and a Call to Action

By Johnny Hutchinson, Mike Cullers and Bob Eidnier

Johnny Hutchinson, Mike Cullers and Bob Eidnier are with the Tax Strategy & Benefits Practice at Squire Sanders.

For years, Internal Revenue Service and Treasury Department officials have told the public finance community that they were working on a package of arbitrage regulations, particularly on the subject of the ''issue price'' of an issue of bonds—the topic came up at conference after conference, and year after year it appeared in the IRS work plan.

 ISSN 0092-6884

Despite these announcements, public finance practitioners were stunned when Treasury finally issued the proposed arbitrage regulations (REG-148659-07) in September.

The proposed regulations would spruce up a scattered array of arbitrage provisions dealing with bonds issued to fund working capital expenditures or grants, with hedges and dealing with certain arbitrage issues that can arise when an issuer uses taxable debt to refund tax-advantaged debt. If Treasury finalizes these regulations as proposed, however, the regulations would also gut the current issue price regulations, which have existed in similar form for decades, and undermine the concepts underlying those regulations, which can be traced all the way back to the Internal Revenue Code of 1954.

This article describes these proposed changes in detail below. Before sharpening pitchforks and lighting torches in response to the proposed changes, it should be kept in mind that these are only proposed regulations. IRS and Treasury officials have repeatedly requested specific suggestions for improvement of the proposed regulations. This should be taken as an invitation to offer specific suggestions or, more fundamentally, to persuade Treasury and the IRS that certain portions of the regulations are irredeemably flawed, cannot be improved and must be abandoned.

Moreover, it wouldn't be unheard of for Treasury to abandon the proposed regulations and start over. It has done so in the past, and it did so for recent regulations governing solid waste disposal facility bonds after public outcry.[1]

It wouldn't be unheard of for Treasury to abandon the proposed regulations and start over. It has done so in the past, and it did so for recent regulations governing solid waste disposal facility bonds after public outcry.

The proposed regulations, if finalized, would generally apply to bonds sold 90 days or more after Treasury publishes the regulations as final. The regulations on hedges, however, would apply to hedges entered into or modified, or bonds subject to qualified hedges that were refunded, 90 days or more after Treasury published them.

Currently, before Treasury finalizes the proposed regulations, issuers are authorized to apply the proposed regulations to bonds sold on or after Sept. 16, 2013, or, for the rules on hedges, to hedges entered into or modified on or after Sept. 16, 2013. Thankfully, the proposed regulations allow an issuer to pick and choose among the provisions—an issuer can apply the helpful rules on working capital financings, for example, while forgoing the new issue price regime.

With that as background, a discussion of the specific proposals follows.

[1] See REG-140492-02 (Sept. 16, 2009).

No Reliance on Reasonable Expectations

Under the proposed regulations, issuers couldn't rely on reasonable expectations to determine ''issue price.''

Currently, the issue price of publicly offered tax-advantaged bonds is the first price at which the issuer reasonably expects to sell at least 10 percent of the bonds to the public, even if it actually sells less than 10 percent at that price.[2] In a typical transaction, the bond underwriter signs a certificate documenting those reasonable expectations, and the issuer relies on that certificate in providing its own certifications and filing the required IRS information return (i.e., Form 8038, 8038-G, etc.) for the bond issue.

The proposed regulations would no longer allow an issuer to rely on this certificate to establish its expectations regarding issue price. Instead, the proposed regulations would look to the prices at which the bonds were actually sold to establish issue price. Also, the percentage of bonds sold that would be required to establish issue price would be increased from 10 percent to 25 percent.

In addition, the proposed regulations provide that the 25 percent ''safe harbor'' can be applied only if all public orders within the offering period at that price are filled (to the extent those public orders don't exceed the amount of bonds offered). If the safe harbor isn't met, it is unclear what percentage will constitute a substantial amount that would determine the issue price.

Problems With the Proposed Regulations On Issue Price

The switch from reasonable expectations to actual facts creates significant problems for issuers, underwriters and their counsel. From a purely economic perspective, if the bonds were actually sold at a price higher than that expected by the underwriter and relied upon by the issuer, the issuer would suffer the cost of a higher issue price (resulting in a decreased permitted investment yield on the bond proceeds) without receiving a corresponding benefit in the form of additional proceeds to be used to accomplish the governmental purposes of the bonds.

The switch would require an issuer to monitor the sale prices of each maturity of a bond issue until 25 percent of that maturity sells at the same price. The arbitrage regulations have never before required an issuer to monitor these facts, and it isn't clear in many cases how the issuer will obtain this information.

In addition, under present law, an issuer determines on the pricing date of an underwritten deal whether the bonds satisfy many tax requirements that are based on the issue price of a bond issue. If the issue price of a maturity is no longer what the issuer reasonably expected on the sale date but is instead a different price, it can throw months of sensitive tax planning for the issue into disarray and, more importantly, jeopardize the tax status of the bonds. The following discussion highlights a few examples.

The investment yield that an issuer is permitted to earn on unspent bond proceeds is generally restricted to the bond yield, which depends on the bonds' issue price. This is because the yield on an issue of tax-advantaged bonds, which generally sets the issuer's

[2] Treas. Reg. Section 1.148-1(b).

ISSN 0092-6884

permitted investment yield, is generally the discount rate that equates the present value of the principal and interest payments on the bond issue to the issue price of the 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 yield of the bond issue will be lower than expected (because the bondholders are paying more for the same economic return on the bonds). For situations where there is little margin for error—such as advance refunding escrows—this unexpectedly high issue price/low bond yield could cause the yield of the escrow to exceed the permitted investment yield and jeopardize the tax exemption of the bond interest.

The proposed regulations would provide limited relief from this and other arbitrage consequences of an increased issue price—an issuer can 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). This is little solace to the issuer, however, as the issuer may have no resources for this payment, and in any event the issuer entered into the bond transaction in the first place based on a certain level of economic savings, which would be reduced and potentially eliminated entirely by this payment.

In addition to yield restriction, there are other requirements that depend on issue price, and unlike the above yield reduction payment there is no means of ''fixing'' violations of these other requirements caused by an unexpectedly high issue price. (These requirements also aren't mooted by the pitifully low investment yields that issuers are currently earning on invested bond proceeds.)

The switch from reasonable expectations to actual facts creates significant problems for issuers, underwriters and their counsel.

For example, in the case of tax-exempt private activity bonds, including bonds issued for Section 501(c)(3) charitable organizations, an unexpected higher issue price could cause the issue to exceed the 2 percent of proceeds limit on issuance costs assuming, as currently occurs, that the unexpected portion of the issue price is retained by the underwriters or dealers of the bonds.[3] 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, or resulting in replacement proceeds for an issue of governmental bonds.[4]

Also, an unexpected increase in issue price could cause the $5 million limit for the small issuer rebate exception and the $10 million limit on ''bank qualified bonds'' (i.e., qualified tax-exempt obligations) to be exceeded.[5]

In sum, the switch from reasonable expectations to actual facts ignores many of the practical realities of a bond issuance. The proposed regulations seem not to appreciate that an issuer must calibrate its compliance with the complex array of tax requirements in advance of the bond issuance based on projections reflecting the reasonable expectations of the issuer and its professional advisers. The proposed regulations are insensitive to the frantic pace that already pervades the time between the sale date and the issue date of a bond issue—even when the issue price is held in place by the issuer's reasonable expectations on the sale date. Comments, documents and e-mails whir around as the parties work day and night to finalize the transaction. Turning the issue price into a moving target threatens to turn this already frantic pace into a barely controllable chaos.

The Rationale of Treasury and the IRS

Why, then, did Treasury issue proposed regulations making this switch from reasonable expectations to actual facts? The preamble to the proposed regulations gives some explanation, and personnel from Treasury and the IRS have also provided reasons in public comments.

Although the switch surprised everyone, the IRS has previously expressed the same concerns that permeate the proposed regulations. For example, in connection with the Build America Bonds program of several years ago, the IRS expressed concern about underwriters buying the bonds and immediately selling them at a substantial markup, referred to as ''flipping'' the bonds. The IRS expressed these same concerns in the proposed regulations. In addition, the IRS has expressed concern about underwriters refusing to sell bonds to willing customers or prioritizing certain customers (for example, dealers) over others.

In public comments, IRS and Treasury officials have also stated that the existing rule ''isn't working,'' and that the proposed regulations are an attempt to align the calculation of issue price for tax-advantaged bond purposes with the calculation of issue price for purposes of the original issue discount rules in Section 1273. Of course, this ignores the fact that the consequences of the definition of issue price—in particular, the yield—carry significantly more weight for purposes of the tax-advantaged bond rules than for the original issue discount rules, justifying differences between the two sets of rules.

As for the increase from 10 percent to 25 percent of each bond maturity as the determinant of the issue price of that maturity, and the conversion of the 25 percent threshold to a safe harbor that applies only if certain conditions are satisfied, IRS and Treasury officials have stated in public comments that they didn't believe that 10 percent of a maturity was truly a ''substantial amount'' that would be sufficient to establish the issue price.

In fact, the preamble to the proposed regulations states specifically that Treasury and the IRS believe that some underwriters may be deliberately setting expectations to sell the first 10 percent of a maturity to create an artificially low issue price (knowing that this will be sufficient to set the issue price for tax purposes), and then selling the remaining 90 percent of that maturity at a higher issue price. Because 10 percent was chosen essentially as a matter of administrative convenience,

[3] Code Section 147(g).

[4] Code Section 147(b); Treas. Reg. Section 1.148-1(c)(4)(i)(B).

[5] Code Sections 148(f)(4)(D) and 265(b)(3).

Treasury and the IRS felt equally free to raise the threshold to 25 percent.

In addition to these specific substantive concerns, the proposed regulations note that the issue price proposals are intended to ''provide greater certainty.'' They will certainly do so in a metaphysical sense by tying issue price to actual facts instead of reasonable expectations, but it is far from clear whether this added certainty will be offset by the widespread practical uncertainty that the issue price proposals, if finalized, would create.

Broader 'Anti-Abuse' Powers for IRS

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

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.[6] If implemented, this rule would 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 in some sense are arguably inconsistent with the objectives of the arbitrage rules.

The turmoil over the proposals regarding the definition of issue price and, to a lesser extent, the expanded anti-abuse powers, has masked some very beneficial provisions in the proposed regulations.

OK, exhale as we move on to more pleasant topics. The turmoil over the proposals regarding the definition of issue price and, to a lesser extent, the expanded anti-abuse powers, has masked some very beneficial provisions in the proposed regulations, which are discussed below. Issuers can apply these beneficial provisions immediately and without also committing to the issue price proposals.

Rules Eased for Working Capital Financings

The proposed regulations generally liberalize and simplify the rules on working capital financings.

The Internal Revenue Code and Treasury Regulations sharply restrict the use of tax-advantaged bond proceeds for working capital expenditures (i.e., expenditures other than capital expenditures for federal income tax purposes). Except for certain limited exceptions, an issuer cannot finance working capital expenditures unless the issuer has no other ''available amounts'' to pay those expenditures (referred to as the ''proceeds-spent-last'' rule).[7]

Under the current regulations, an issuer is allowed to treat a reasonable working capital reserve as ''unavailable'' for this purpose.[8] The proposed regulations liberalize and simplify the calculation of the reserve by establishing the limit on the reserve as generally 5 percent of the issuer's working capital expenditures for the previous year. The proposed regulations would eliminate the current restriction based on the extent to which the issuer has previously maintained such a reserve or cash balances.

This change is very helpful in that it eliminates a confusing rule that had the unintended and irrational effect of penalizing the most needy issuers that couldn't afford to maintain prior cash balances.

In addition to the above proceeds-spent-last rule, the current regulations severely limit the term of a working capital financing. The safe harbor maximum term of a working capital financing under the current regulations is two years.[9] The IRS purported to further reduce this safe harbor term to 13 months by the issuance of a revenue procedure in 2002.[10]

Treasury acknowledges in its preamble to the proposed regulations the questionable status (maybe more accurately, the potential invalidity) of a revenue procedure intended to override a regulation, and in one of the few unfavorable provisions of the proposed regulations' working capital rules, a general safe harbor term of only 13 months would be available.

In addition to this general safe harbor term restriction, however, the proposed regulations also establish the first set of rules addressing long-term working capital financings, according to the following procedure. Upon issuance, the issuer must determine the first year in which it expects to have ''available amounts'' to pay working capital expenditures. Then, beginning with the earlier of the first year in which the issuer expects to have these available amounts or five years after issuance, the issuer must determine, as of the first day of that fiscal year, its available amounts. Within 90 days after that day, the issuer must use the available amounts either to redeem bonds or to invest in tax-exempt investments that aren't subject to the alternative minimum tax (generally, governmental purpose tax-exempt bonds and 501(c)(3) bonds).

While these rules have a number of technical problems, such as mandating an arbitrary annual date to test for available amounts and requiring that the resulting available amounts be used to redeem bonds or be invested in non-AMT tax-exempt investments regardless of the issuer's future needs for these amounts, the regulations represent a good start toward a long-term working capital financing regime, and helpful comments on these regulations are currently being prepared by practitioners.

Under the current regulations, some ''extraordinary'' working capital expenditures, such as certain legal judgments, can be financed without application of the proceeds-spent-last rule[11]; however, no guidance is provided as to the permitted term of such financings. The

[6] Treas. Reg. Section 1.148-10(a).

[7] Treas. Reg. Section 1.148-6(d)(3)(i).

[8] Treas. Reg. Section 1.148-6(d)(3)(iii)(B).

[9] Treas. Reg. Section 1.148-1(c)(4)(i)(B)(1).

[10] Rev. Proc. 2002-31.

[11] Treas. Reg. 1.148-6(d)(3)(ii)(B)

   ISSN 0092-6884

proposed regulations take a step in the direction of providing such guidance by recognizing in the arbitrage anti-abuse rules the possible need for a maturity beyond 13 months for a financing of extraordinary working capital expenditures.

Simpler Rules Regarding Hedges

The proposed regulations would simplify and liberalize several rules regarding hedges (such as swaps).

Under the current regulations, an issuer can ''integrate'' a hedge with an associated issue of bonds and thus take payments and receipts under the hedge into account in computing the bond yield if the hedge is a ''qualified hedge.''[12] This treatment generally benefits the issuer by frequently increasing the yield on the bonds, which increases the issuer's permitted investment yield on the bond proceeds, and in any event causing the bond yield more closely to reflect the issuer's actual borrowing cost.

Under the current regulations, one of the many requirements for qualified hedge status is that the issuer must identify the hedge within three calendar days after the issuer and hedge provider enter into the hedge agreement.[13] This exceptionally short period, especially given that it is based on actual days rather than just business days, has often been a trap for less-informed issuers. The proposed regulations would liberalize this requirement by extending the identification period from three days to 15 days.

The proposed regulations would unfortunately continue the current requirement that the governmental issuer of the bonds, rather than a conduit borrower of the bond proceeds, identify the hedge.

The proposed regulations would unfortunately continue the current requirement that the governmental issuer of the bonds, rather than a conduit borrower of the bond proceeds, identify the hedge. The proposed regulations would also add further complication by mandating that the hedge provider certify various characteristics of the hedge. Although obtaining these certifications from the hedge provider is generally a recommended practice under the current regulations, it isn't presently a requirement for the hedge to be integrated with tax-advantaged bonds so its failure doesn't necessarily preclude integration as it would under the proposed regulations.

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/reacquisition produces 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'' disregarding the ''off-market'' nature of the hedge, then no such termination and reacquisition is deemed to occur. 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 wouldn't apply in this context.

Treatment of Bond-Financed Grants Clarified

The proposed regulations would clarify the treatment of bond-financed grants for many tax purposes.

Currently, bond proceeds are treated as spent when they are granted to an unrelated party.[14] Thus, for example, the grantee can 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 purposes.

For example, what ''temporary period'' is available to the issuer prior to granting bond proceeds? What is the useful life of a grant? 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 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, don't change the favorable current rule that proceeds are treated as spent when they are used to make a grant.

Tax Credit, Build America Bonds Treated as Separate Issue

The proposed regulations clarify that tax credit bonds and Build America Bonds are, per se, a separate issue from an issue of tax-exempt bonds.

The proposed regulations clarify that different types of bonds, e.g., tax-exempt bonds, Build America Bonds and various other types of tax credit bonds, would generally be treated as separate issues, an issuer-friendly rule. In doing so, the regulations use the new term ''tax-advantaged bonds,'' which has been used by the public finance community to refer to tax-exempt bonds and all current and future types of tax credit bonds.

Favorable Valuation of Investments From Proceeds on Refunding

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 another issuer-favorable change, the proposed regulations permit an issuer to value investments allo-

[12] Treas. Reg. Sections 1.148-4(b), 1.148-4(c)(2).
[13] Treas. Reg. Section 1.148-4(h)(2)(viii).
[14] Treas. Reg. Section 1.148-6(d)(4).

cable 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.[15]

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, and thus potentially subject to rebate. This proposed change therefore seeks to put taxable and tax-exempt refundings of tax-exempt bonds on equal footing in terms of the potential rebate consequences with respect to the investments acquired with proceeds of the tax-exempt refunded bonds.

Conclusion

The proposed regulations on issue price are intended to correct a number of perceived abuses that the IRS has observed in the market and to provide greater certainty. It is unclear whether the proposed regulations would correct those perceived abuses, and it is quite clear that they will result in less certainty, not more.

Further undermining the certainty provided by the current regulations, the proposed regulations would 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. Fortunately, these rules would apply only to bonds sold, or hedges created or modified, 90 days or more after Treasury publishes the proposed regulations as final, unless the issuer elects current application.

Issuers can choose to apply the proposed regulations in whole or in part now. So, issuers can immediately take advantage of more favorable rules regarding working capital financings, hedges, grants and other matters.

Treasury and the IRS have repeatedly requested specific comments on these proposed regulations. Readers are encouraged to offer their suggestions to Treasury or to one of the industry groups that likely will be submitting comments—the National Association of Bond Lawyers and the American Bar Association Section of Taxation Subcommittee on Tax-Exempt Financing are two obvious choices. While the prospect of dealing with the issue price regulations in particular may seem daunting, personnel from Treasury and the IRS seem genuinely interested in receiving and responding to suggestions for improving the proposed regulations before they are finalized.

[15] Treas. Reg. Section 1.148-5(d)(2)-(3).

   ISSN 0092-6884