IRS Publishes Final "Issue Price" Regulations for Tax-Exempt Bonds

The Existing Regulations – Reasonable Expectations Standard

The existing regulations that have been in place since 1993 provide that the issue price of bonds is the first price at which substantial amounts of the bonds (10%) are sold. A "reasonable expectations" standard in the existing regulations is frequently utilized by issuers and underwriters to establish, as of the sale date of the bonds, the issue price of bonds that are sold in a bona fide public offering. Under the existing regulations, in a bona fide public offering, the issue price of each bond with different payment and credit terms (generally, this means each stated maturity in a bond issue) can be assumed to be the initial offering prices of those bonds to the public, provided that the underwriter reasonably expected on the sale date that at least 10% of each of the maturities would be sold at or below the initial public offering prices. So long as the underwriter's expectations were reasonable, this rule applied even if the bonds were actually sold at prices that exceeded the initial offering prices.

Using this method, the issuer typically obtains a certificate from the underwriter verifying that the bonds were offered to the public on or before the sale date, at specified offering prices and that, as of the sale date (the date the bond purchase agreement or its equivalent was signed), the underwriter reasonably expected that at least 10% of each maturity of those bonds would be sold at prices no higher than those offering prices. Except for certain public sales of bonds, the final regulations depart from this standard and instead look at the actual prices at which bonds are sold to establish issue price of the bonds for arbitrage purposes.

The General Rule Under the Final Regulations – Actual Sales Standard

As a general rule, the final regulations provide that the issue price of publicly offered bonds is the first price at which a substantial amount (still defined as 10%) is sold to the public. This general rule is based on actual sales of bonds, and (except for certain public sales) issue price may no longer be established based on the reasonable expectations of the underwriter.

Alternative #1 to the General Rule – Hold-the-Offering-Price Alternative

As an alternative to the general rule discussed above, an issuer may elect to establish the issue price by having the underwriter certify (1) it offered the bonds at the initial offering prices on or before the sale date, along with documents that support the certification (e.g. the pricing wire); and (2) that it did not offer nor sell the bonds to any person at a price higher than the initial offering prices for a specified period of time after the sale date. This "hold-the-offering-price period" begins on the sale date and ends on the earlier of (1) the close of the 5th business day after the sale date; or (2) the date on which 10% of the bonds are sold to the public at or below the initial offering prices. It is worth noting that the underwriter can sell bonds for less than the offering price during this period of time, but in order for an issuer to use this alternative, the underwriter cannot sell bonds at prices that are higher than the initial offering prices – even if those sales are to other underwriters.

Alternative #2 to the General Rule – Competitive Sale Alternative

Another special alternative to the general issue price rule is available for eligible public (competitive) sales of bonds. A public sale will be eligible to employ this issue price method if (1) the issuer distributes the notice of sale in a way designed to reach prospective underwriters; (2) all bidders have an equal opportunity to bid; (3) at least three bids are received from underwriters with established industry reputations for underwriting municipal bonds; and (4) the issuer awards the sale to the bidder who offers the highest price/lowest interest cost. If an issuer satisfies these requirements, it may establish the issue price of its bonds on the sale date by receiving a certification from the winning bidder regarding the reasonably expected initial offering price upon which the winning bid was based. The preamble to the final regulations stated that the reasoning for this special rule was that "competitive sales favor competition and price transparency that may result in better pricing for issuers."

Choice of Rules, Private Placements, and Definitions

If more than one of the issue price alternatives discussed above is available for an issue of bonds, the issuer may choose which rule it will apply. This choice must be made on or before the issue date of the bonds and must be identified in the books and records maintained for the bonds (e.g., in an arbitrage or tax certificate).

There was some ambiguity remaining from the 2015 proposed regulations with respect to the appropriate method of determining the issue price of bonds that were sold in a private placement. The final regulations clarify that the issue price of bonds sold for money in a private placement to a single buyer is the price paid by the buyer. The buyer cannot be an underwriter or a party related to an underwriter. As a general matter, if a buyer and an underwriter have more than 50% common ownership or control, the parties will be related for this purpose (*see* Treas. Reg. Section 1.150-1(b)).

In the final regulations, an underwriter is defined as (1) any legal entity that agrees in a written contract with the issuer (or with the lead underwriter to form an underwriting syndicate) to sell the bonds to the public; and (2) any legal entity that enters into a written contract with a person described in (1) above to participate in the initial sale of the bonds to the public. In addition, the term "public" is defined as any person other than the underwriter or a related party to an underwriter.

Effective Date

The final regulations must be used to determine the issue price of bonds sold on or after June 7, 2017. The final regulations do not provide any special exception that would permit issuers to apply them to bonds sold prior to this date. A copy of the final regulations can be found here.