Client Alert

Current Issues Relevant to Our Clients

June 30, 2015

Memorandum Concerning the 2015 Proposed Issue Price Regulations

On June 24, 2015, Prop. Treas. Reg. §1.148-1(f) (the "Proposed Regulation") addressing the definition of "Issue Price" was published in the Federal Register. The Internal Revenue Service is accepting comments on the Proposed Regulation through September 22, 2015. A public hearing is scheduled for October 28, 2015. While the Proposed Regulation is not now automatically applicable, the preamble to the Proposed Regulation specifically permits issuers to apply the Proposed Regulation to bonds sold on or after June 24, 2015 and before the day 90 days after the publication of final regulations on this matter. Regulations on the same subject matter were proposed in 2013 and withdrawn in 2015.

Issue Price is a fundamental concept of tax-exempt bond law. Yield on a bond issue is determined based on Issue Price. A lower Issue Price would result in a higher bond yield and would potentially lower payments of arbitrage rebate. Where federal tax law imposes limits on amounts of bonds or amounts of proceeds that may be used for various purposes, Issue Price is often used to measure the amount of such bonds or proceeds.

A similar concept is used to determine the amount of "original issue discount" on debt instruments. Issue Price for tax-exempt bond provisions is clearly modeled on the long established definition for original issue discount purposes, but has been modified in part to allow issuers to determine Issue Price as of first date on which there is a binding contract in writing for the sale or exchange of the bonds (the *"Sale Date"*). Under the current final regulations (adopted in 1993) issuers are able to determine Issue Price as of the Sale Date by using "reasonable expectations." For this reason, underwriters of bonds have historically been asked to provide their expectations as to the price that bonds not sold to the public at the time that the underwriter buys them would eventually be sold to investors.

Generally the Proposed Regulation moves away from the concept of reasonable expectations. When the Proposed Regulation is applied, it is not necessary to ask the underwriter for its reasonable expectations concerning the sale of the bonds. Also, the current regulations include a provision limiting the Issue Price to the fair market value of the bonds. That is not part of the Proposed Regulation and, accordingly, certifications about the fair market value of the bonds are not required or useful when the Proposed Regulation is applied.

Under both current regulations and under the Proposed Regulation, Issue Price is determined based on the selling price or offering price of bonds "to the Public." However the definition of "Public" is changed significantly in the Proposed Regulation.

Under the current regulations "Public" is defined to exclude bondhouses, brokers and similar persons or organizations acting in the capacity of underwriters or wholesalers. That definition is not operative under the Proposed Regulation. Rather, the Public is defined in the Proposed Regulation as including anyone who is not an "Underwriter" of the bonds or a party related to an Underwriter of the bonds. An Underwriter is defined to include any person that contractually agrees with the bond issuer to participate in the initial sale of the bonds to the Public. The brokerage firm that executes a bond purchase agreement or wins a competitive bid to purchase the bonds will generally be an Underwriter, as will any other firm that enters into an "arrangement" with such an Underwriter to sell bonds, including a member of an underwriting syndicate.

A person is an Underwriter if (a) it has a contract with the issuer to participate in the initial sale of the bonds, (b) it contracts with a lead underwriter to join an underwriting syndicate or (c) it has an arrangement with another Underwriter to sell bonds entered into on or before the Sale Date.

Generally investors that are not bond sellers (and have not contracted with the issuer to participate in the initial sale) are part of the Public. However, under the Proposed Regulation (but not the current final regulations), the Public also includes brokerage houses and others who purchase with intent to resell the bonds so long as those brokerage houses do not have arrangements with the issuer or any Underwriter to sell the bonds.

Under the Proposed Regulation, as under the current final regulations, Issue Price is determined separately for each group of substantially identical bonds (that is bonds with the same credit and payment terms). There are two ways to establish the Issue Price of bonds under the Proposed Regulation.

Under the general method, an issuer may use as the Issue Price the first price at which at least 10% of the bonds of that maturity (or other group of substantially identical bonds) is sold to the Public. For example, if at least 10% of a group of substantially identical bonds is actually sold to the Public (anyone not related to an Underwriter) before the closing date at a single price before any bonds are sold at a different price, then that sale price is the Issue Price. For many bonds it will be possible to determine the Issue Price simply, often on the Sale Date. This first sale price may be used even if the bonds are sold by the Underwriter at that price to a broker that meets the definition of Public and that is expected to mark up and resell the bonds to other members of the Public, provided that there is no arrangement between such broker and an Underwriter or the issuer.

An alternative method allows the Issue Price to be the initial offering price of the bonds to the Public. This alternative method may only be used if:

1. The Underwriter has (or Underwriters have, if more than one) not received orders placed by the Public on or before the Sale Date for at least 10% of the bonds.

2. The Underwriter fills all orders at the initial offering price placed by the Public and received on or before the Sale Date (up to the amount of the bonds).

3. The Underwriter does not fill any orders placed by the Public on or before the Sale Date to sell bonds at a price higher than the initial offering price.

4. The Underwriter agrees not to fill an order placed by the Public and received after the Sale Date and before the issue date at a price higher than the initial offering price unless the higher price is a result of a market change (such as a decline in interest rates) for those bonds that occurs after the Sale Date.

5. The Underwriter (or lead Underwriter, if more than one) provides certifications and supporting documentation for these matters.

6. The issuer does not know or have reason to know after exercising due diligence that any certification of the Underwriter on this matter is not correct.

We will be developing forms of underwriter certificates and other documentation that may be used to implement the Proposed Regulation. Please contact us if you wish to apply the Proposed Regulation to any current or proposed financing.

For More Information

To discuss any of the topics covered in this Client Alert, please contact a member of our Public Finance Group or visit us online at chapman.com.

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