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New IRS Proposed Regulations—major impact on tax-exempt bonds

On September 13, 2013, the IRS released two sets of proposed regulations (the "Proposed Regulations") that would make a number of significant changes to the arbitrage restrictions applicable to tax-exempt bonds. Most importantly, the Proposed Regulations would modify the long-standing rules for determining issue price by increasing the percentage of bonds that must be sold to establish the issue price from 10 percent to 25 percent, and by eliminating an issuer's ability to rely on its reasonable expectations regarding the issue price. This change may also have significant implications for the application of other tax-exempt bond rules. Other important aspects of the Proposed Regulations are changes to the rules for swaps and other "qualified hedges," and changes to the rules related to financing of working capital expenditures. A summary of the proposed rules on issue price and other provisions of the Proposed Regulations is provided below. The Proposed Regulations are generally not effective until 90 days after adopted in final form.

Determination of a bond's issue price

The Proposed Regulations would significantly modify the definition and standards for determining the "issue price" of a bond issue. The current rules have been in place for over 20 years. The issue price of a bond issue is key to the determination of the "yield" on a bond issue, which in turn is important to the application of the arbitrage yield restriction and rebate requirements, as well as the determination of the amount of federal subsidy payments or tax credits for "tax-advantaged bonds," such as Build America Bonds. The issue price of a bond issue also impacts other rules that are applied based on a bond's issue price, including rules that limit the size of a reserve fund, limit the amount of costs of issuance that may be funded with bond proceeds, and determine the amount of volume cap that must obtained.

Existing regulations provide that the issue price of publicly-offered bonds is determined based on the first price at which a "substantial amount" of the bonds is sold to the public, with substantial amount defined as 10 percent. The existing regulations further provide that the issue price of publicly-offered bonds is determined as of the date the bonds are offered for sale based on the prices at which bonds are reasonably expected to be sold. Over the past several years, the IRS has indicated its concern that the existing regulations may not result in a "representative issue price." As an example, the preamble

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to the Proposed Regulations describes circumstances where an underwriter sells the first 10 percent of each maturity at one yield and then sells the remaining bonds at lower yields. The IRS further states that pricing data from the Municipal Securities Rulemaking Board's Electronic Municipal Market Access (EMMA) platform has sometimes shown "actual sales to the public at prices that differed significantly from the issue price used by the issuer." Lastly, the IRS expressed concern that sales to underwriters and securities dealers may have been treated as sales to the public in determining issue price.

In light of the concerns of the IRS, the Proposed Regulations provide that the issue price is the first price at which a "substantial amount" of the bonds is sold to the public. The Proposed Regulations, however, replace the definition of substantial amount as 10 percent with a safe harbor pursuant to which the first price at which a minimum of 25 percent of each maturity of bonds is sold to the public may be treated as the issue price. This safe harbor only applies if all orders received from the public within the offering period at that price are filled (to the extent that public orders at such price do not exceed the amount of bonds sold). If the safe harbor is not met, it is unclear how much constitutes a "substantial amount," or whether issue price must be determined based on the actual sale prices of all of the bonds.

The Proposed Regulations further eliminate the ability to determine issue price based on the reasonably expected sale prices of the bonds on the sale date, and instead require that issue price be determined based on actual sale prices. In order to address the fact that it may not be possible to determine the issue price on the sale date—or even by the issue date—the Proposed Regulations would permit issuers to make yield reduction payments to the IRS if the issue prices are later determined to be higher, and the yield lower, than estimated. In that event, the issuer will bear the cost of sales of the bonds at higher prices after the sale date of the bonds, even though they would receive no corresponding benefit. The Proposed Regulations do not address the impact of these changes on other tax law requirements, such as the debt service reserve fund sizing limitation applicable to all bonds with reserve funds, and the 2 percent costs of issuance and volume cap limitations applicable to private activity bonds. For example, if a bond is sold at its expected issue price, but the initial purchaser resells the bond at a higher price, this additional amount may count as additional costs of issuance, or may require an additional allocation of volume cap.

In providing that a bond's issue price is based on sales to the "public," the Proposed Regulations define "public" to mean any person other than an underwriter. "Underwriter" is defined, in turn, as any person that purchases bonds for the purpose of effecting, directly or indirectly, the original distribution of the bonds. An underwriter includes a lead underwriter and all members of a selling syndicate. Importantly, the term also includes all securities dealers (even if not part of the selling syndicate and even if they do not purchase bonds from the issuer) that purchase bonds for the purpose of effecting the original distribution of the bonds. In addition, an underwriter includes any related party to an underwriter. A person that buys and holds bonds for investment is not an underwriter, although no guidance is provided on the requirements for bonds to be treated as being held for investment.

The proposed changes to the determination of "issue price" have the potential to significantly impact the manner in which bonds are priced and sold and the structuring of yield-sensitive transactions, such as advance refundings. The Proposed Regulations also raise a number of questions. For

example, no special rules are provided for competitive bond sales. Moreover, although important to the establishment of the issue price under these rules, no guidance is provided regarding the meaning of "offering period," or when a purchaser will be deemed to be purchasing bonds for "the purpose of effecting the original distribution of the bonds." If the rules are finalized in their present form, issuers and underwriters may seek to alter their contractual agreements to address risks related to the determination of issue price, and the rules may impact retail sales of bonds and the willingness of underwriters to purchase unsold bonds. Further, one potential effect could be increased borrowing costs to issuers due to attempts to generate sufficient sales to ensure that the safe harbor is satisfied.

Interest rate swaps and other "qualified hedges"

The arbitrage regulations have long provided that an interest rate swap, or other hedging contract that meets certain requirements, may be "integrated" with a bond issue and treated as a "qualified hedge," which results in the payments and receipts on that hedge being included in the arbitrage bond yield computation for that issue. Under these rules, for example, a variable rate bond and an integrated interest rate swap under which the issuer makes fixed payments and receives variable payments can result in a fixed rate bond for arbitrage purposes. The Proposed Regulations include four significant proposals to change the rules for hedges. In addition, they propose to extend the deadline for identification of the hedge for tax purposes by the issuer to 15 calendar days (from 3).

One of the more complex rules under the existing regulations is accounting for a qualified hedge that is terminated or deemed terminated (e.g., when the hedged bond is refunded or modifications are made to an existing hedge). Under the existing rules, the termination or deemed termination of a qualified hedge results in the issuer being treated as having made or received a termination payment based on the mark-to-market value of the hedge, and the issuer is then permitted to "re-integrate" that hedge with a bond issue (e.g., refunding bonds) on a going-forward basis at that mark-to-market rate. The existing regulations permit any termination payment resulting from a deemed termination to be included in the bond yield computation for the bonds to which the hedge is reintegrated. The Proposed Regulations would simplify these rules by providing that a qualified hedge will only be deemed terminated upon an actual modification, acquisition of another hedge, or an assignment of the hedge, but only if the resulting modifications are "material." Importantly, even if a modification is material, there is no deemed termination if the hedge remains a qualified hedge when tested at the time of the modification. The idea behind these changes was to eliminate the unnecessary complexity of the existing regulations, while at the same time producing economically similar results.

Similarly, the existing regulations provide that a qualified hedge is deemed terminated if the hedged bond is refunded, even if the refunding bond is also hedged by the same qualified hedge. Though the yield treatment under the existing regulations in such circumstances is complicated, these rules effectively continue to treat the hedge as a qualified hedge reflected in the yield of the refunding bonds. The Proposed Regulations would simply allow the hedge to continue to be a qualified hedge with respect to the refunding bonds without requiring the complicated allocation arithmetic that is required under the current rules. This may also enhance the ability of an issuer to finance a greater portion of a future swap termination payment than would be allowed under the existing regulations.

Third, the Proposed Regulations clarify the determination of the amount paid for an interest rate swap that is terminated or deemed terminated. In the case of a deemed termination, the termination

payment is equal to the fair market value of the qualified hedge on the termination date. In the case of an actual termination, there is a distinction between hedges terminated "out of the money" for the issuer versus "in the money." If the issuer makes a payment to terminate a qualified hedge, it is proposed that the amount that may be treated as a termination payment cannot exceed fair market value. On the other hand, if the termination payment is paid to the issuer, the amount that may be treated as a termination payment must at least equal the fair market value.

Finally, the Proposed Regulations would require that certain certifications be received from the hedge provider at the time the hedge is acquired as a new condition to treatment as a qualified hedge. The hedge provider would have to certify that (a) the terms of the hedge were agreed to in a bona fide, arms-length transaction, (b) the rate payable by the issuer was comparable to the rate they would quote for a similar hedge in a non-tax-exempt bond transaction, and (c) except as specifically identified in the hedge documents, no payments were made to third parties in connection with the hedge, and no payments under the hedge are reasonably allocable to anything other than to the modification of interest rate changes or to the hedge provider's overhead.

Working capital financings

The existing regulations contain a number of special rules and restrictions on the financing of operating expenses and other working capital costs, including that bond proceeds to be used for these types of expenses are only treated as "spent" (and thus no longer subject to the arbitrage rules) after all of the issuer's other available amounts are expended. This approach is tempered by the definition of "available amounts," which permits an issuer to disregard a certain amount of cash on hand (the "working capital reserve"). The existing regulations define a permitted working capital reserve as up to 5 percent of the issuer's prior year working capital expenditures but further provide that an issuer must demonstrate that this reserve does not exceed the issuer's average monthly cash balance for at least the prior year. This rule was intended to permit issuers to finance their working capital deficits but generally not permit the financing of a working capital reserve. The Proposed Regulations would eliminate this prohibition on financing a working capital reserve and, as a result, under these rules an issuer may finance both its deficit and, apparently, an amount equal to the permitted working capital reserve.

Another IRS concern, with respect to working capital financings, is that this type of financing should not have an unnecessarily long maturity. The Proposed Regulations would reduce the existing permitted maturity safe harbor for working capital financings from 24 months to 13 months. In the case of a working capital financing with a term longer than 13 months, the regulations could result in other funds of the issuer (e.g., taxes or other revenues) being treated as so-called "replacement proceeds" that are subject to the arbitrage restrictions.

The Proposed Regulations provide a new safe harbor against the creation of replacement proceeds for longer-term working capital financings. Under this safe harbor, beginning in the first year in which the issuer expects to have available amounts for working capital expenses, the issuer must annually monitor its fund balances and use any available amounts to retire tax-exempt bonds or invest in tax-exempt bonds. One difficulty with this rule is that an issuer must measure its available amounts on the first day of its fiscal year, and that amount must be used within 90 days to retire or invest in tax-exempt bonds. Depending on when an issuer receives revenues and when its deficits are

expected to occur, this could result in funds being treated as available amounts at the beginning of the year when the issuer does not have any additional funds beyond what is necessary to meet its obligations for that fiscal year. This could result in the need to issue additional bonds or additional costs being imposed on issuers that are already fiscally distressed.

Other proposed changes

The Proposed Regulations provide for a number of other, more technical changes to the existing arbitrage regulations. One helpful rule would clarify that tax credit bonds, Build America Bonds, and other "tax advantaged bonds" (e.g., Qualified School Construction Bonds, Clean Renewable Energy Bonds) would be treated as separate issues from tax-exempt bonds and that each type of tax-advantaged bond would be a separate issue from other types of tax-advantaged bonds. This is a helpful change that should simplify tax structuring and compliance issues.

Another useful change would, in the context of a taxable refunding of a tax-exempt bond, generally eliminate the need to mark-to-market any remaining investments acquired with the proceeds of tax-exempt bonds at the time those bonds are refunded by the taxable bonds. Under the existing regulations, this mark-to-market requirement can add a significant cost to taxable refundings and certain other transactions and can add considerable uncertainty in transactions where the mark-to-market valuation will occur in the future.

Finally, the Proposed Regulations would make limited procedural changes to the rules for seeking refunds of arbitrage rebate overpayments.

Effective dates and comments

The Proposed Regulations are proposed to be effective for bonds sold (or qualified hedges entered into) 90 days or more after the finalization of these regulations. Issuers can, however, choose to apply the provisions related to qualified hedges in whole to hedges entered into or modified, or to qualified hedges for bonds that are refunded on or after September 16, 2013. The remainder of the Proposed Regulations can be applied in whole or in part to bonds sold on or after September 16, 2013. The IRS is accepting comments on the Proposed Regulations until December 16, 2013, and will hold a public hearing on February 5, 2014. Please click here to view the the Proposed Regulations.

If you have any questions about the Proposed Regulations or this alert, please contact Travis Gibbs, Jeffrey Piemont, Mitchell Rapaport, or Bruce Serchuk, whose contact information is set forth below, or any other member of the Nixon Peabody Public Finance group.

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