

Treasury Department Releases Final Issue Price Regulations

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Following the issuance of proposed and re-proposed regulations in 2013 and 2015, the Treasury Department and the Internal Revenue Service published final regulations (the “Final Regulations”) on December 9, 2016, to alter the rules for determining the issue price of tax-exempt and other tax-advantaged bonds. The issue price of a bond is important because the issue price establishes arbitrage limitations for investing bond proceeds and is a baseline for measuring compliance with other statutory and regulatory rules.

Under the Final Regulations, the issue price of bonds is determined either according to the general “actual sales” rule or according to one of two special “reasonable expectation” rules. These rules and certain related definitions differ in several respects from the existing arbitrage regulations (the “Existing Regulations”) concerning issue price.

General Rule: Actual Sales Approach

The general rule of the Final Regulations is, like that of the Existing Regulations, based solely on actual sales. In addition, the rule provides additional clarification concerning private placements and expands existing definitions.

Under the general rule, the issue price of bonds sold to the “public” is the first price at which ten percent of the bonds is sold to the public. Further, the issue price of bonds that are not sold to the public but are sold in a private placement to a single buyer is the price paid by that buyer. The issue price of bonds may not be reduced by any issuance costs.

The Final Regulations define “public” to mean any person other than an underwriter or a related party. The Final Regulations define “underwriter” to mean any person that agrees pursuant to a written contract with the issuer (or with the lead underwriter to form an underwriting syndicate) to participate in the initial sale of the bonds to the public. An “underwriter” can also be a person that enters into an agreement with another underwriter to participate in the initial sale of the bonds to the public under, for example, a retail distribution agreement.

Special Rules: Reasonable Expectations Approach

For practical reasons, an issuer must conclude that bonds qualify as tax-exempt bonds as soon as the bonds are sold to underwriters. Under the general rule, however, this determination would be impossible where actual sales of bonds to the public have not passed the ten percent threshold. In the Final Regulations, the Treasury Department and the Internal Revenue Service recognize this dilemma and provide for two special rules based on reasonable expectations.

Special Rule for Negotiated Sales to the Public

The first of the two special rules is available for negotiated sales of bonds to the public. Under this rule, the issuer may treat the initial offering price as the issue price of the bonds but only if two requirements are satisfied. First, the underwriter (or the lead underwriter in the underwriting syndicate or selling group) must certify that the underwriter offered the bonds to the public for purchase at the specified initial offering price on or before the sale date. The underwriter must provide reasonable supporting documentation, such as a copy of the pricing wire. Second, each underwriter must agree in writing that it will neither offer nor sell the bonds to any person at a price that is higher than such initial offering price during the period starting on the sale date and ending on the earlier of (1) the close of the fifth business day after the sale date or (2) the date on which the underwriters have sold ten percent of the bonds to the public at a price that is no higher than the initial offering price to the public. This second requirement is referred to as a “hold-the-offering-price” requirement.

Special Rule for Competitive Sales

The second of the two special rules is available for competitive sales. Under this rule, the issue price of bonds sold in a competitive sale is the reasonably expected initial offering price to the public as of the sale date as long as the winning bidder certifies as to such expectation.

The Final Regulations define a “competitive sale” to mean a sale of bonds to an underwriter that is the winning bidder in a bidding process in which the issuer offers the bonds for sale to underwriters at specified written terms, but only if the process meets the following requirements: (1) the issuer disseminates the notice of sale to potential underwriters in a manner that is reasonably designed to reach potential underwriters; (2) all bidders must have an equal opportunity to bid; (3) the issuer receives bids from at least three underwriters; and (4) the issuer awards the sale to the bidder who submits a firm offer to purchase the bonds at the highest price (or lowest interest cost).

Separate Determination of Issue Price and Selection of Method

As under the Existing Regulations, the issue price of bonds with different credit terms or payment terms is to be determined separately under the Final Regulations. The Final Regulations clarify that an issuer does not need to apply the same rule for each such separate determination of issue price.

Where more than one rule for determining issue price is available, the issuer may determine its selected rule at any time on or before the issue date of the bonds in its books and records maintained for the

bonds. This allows an issuer to use the general rule even if the issuer initially determines to use the special expectations-based rule for determining issue price of bonds.

Applicability Date and Compliance

The Final Regulations apply to bonds that are sold on and after June 7, 2017. Compliance with the Final Regulations will require some changes in current market practices. We expect that interpretation of the Final Regulations and necessary adjustment to market practices and related documentation will be part of an ongoing dialogue among market participants in the months to come.

Kutak Rock LLP

- The Final Regulations referred to in this notice are available online at <https://goo.gl/OzbgnK>
- The Proposed Regulations for 2015 are available online at <https://goo.gl/dJyTn1>
- The Proposed Regulations for 2013 are available online at <https://goo.gl/bmK39n>

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