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Client Alert

Current Issues Relevant to Our Clients

September 16, 2013

New Proposed Arbitrage Regulations

Today the IRS published, in the Federal Register, proposed arbitrage regulations that are applicable to tax-exempt bonds (for purposes of this Client Alert, a bond includes notes, warrants, leases and other obligations) and other tax-advantaged bonds (such as certain tax credit bonds, including qualified zone academy bonds). Among other things, the proposed regulations would:

- **Issue Price:** revise the definition of the issue price of a bond, which is important in calculating bond yield and applying a number of other tax rules--this could affect advance refunding transactions as described below;
- **Working Capital:** revise the rules relating to working capital financings, specifically the issuance of long-term working capital financings and certain rules relating to a working capital reserve;
- **Hedges:** revise some rather technical accounting rules for qualified hedges (*e.g.*, swaps) and require a certification of the hedge counterparty regarding, among other things, the bona fide, arm's length nature of the pricing of the hedge;
- **Definition of an Issue:** revise the definition of an "issue" as it relates to taxable bonds, including taxable tax-advantaged bonds, to clarify that taxable tax-advantaged bonds and other taxable bonds are treated as part of different issues and different types of tax-advantaged bonds are treated as parts of different issues; and
- **Grants:** revise the definition and treatment of a grant to clarify that the character and nature of a grantee's use of proceeds generally is taken into account in determining whether non-arbitrage tax requirements are met (such as determining the amount of private business use).

Effective Date

The proposed regulations are proposed to apply prospectively to bonds that are sold, or hedges entered into, on or after the date that is 90 days from the publication of the final regulations in the Federal Register. However, except for specialized rules relating to hedges, issuers may apply and rely upon the proposed regulations, in whole or in part, with respect to bonds that are sold, or hedges entered into, on or after September 16, 2013 and before the date that is 90 days after publication of the final regulations in the Federal Register.

Issue Price

The definition of issue price under the proposed regulations is significantly different from the existing definition. This would affect not just arbitrage bond yield calculations, but also other tax rules, such as measuring the $10,000,000 limit for bank qualified bonds and, in the context of private activity bonds, volume cap, the amount of allowable private business use and the two percent costs of issuance limitation. Under the proposed regulations, the underwriter's reasonable expectations and the initial offering price to the public can no longer be used to determine the issue price of each maturity of a bond issue. Instead, issue price would be based on the first price at which a substantial amount of each maturity of a bond issue is **actually sold** to the public. In addition, 25 percent (not the current ten percent) would be a substantial amount. This means that issue price might not be known on the issue date of the bonds if 25 percent of a maturity of a bond issue has not yet been sold to the public.

Treasury acknowledges that this could cause problems for structuring escrows in advance refundings (because issuers would not know their bond yield until bonds are actually sold). Accordingly, the proposed regulations provide that issuers can make yield reduction payments (a payment to the U.S. Treasury) to deal with a lower than expected bond yield caused by the difference between the actual issue price of an issue and the issuer's reasonable expectations of issue price on the sale date.

Working Capital Financings

If a bond issue remains outstanding longer than necessary, so-called "replacement proceeds" are created. Replacement proceeds are treated as proceeds of a bond issue and complicate compliance with the rules necessary to maintain tax exemption of interest on a bond issue.

Generally, under the proposed regulations, working capital financings with a maturity of 13 months or less would not create replacement proceeds. The proposed regulations would also provide a framework for the issuance of long term (more than 13-month) tax-exempt working capital financings. Under the proposed regulations, a long term tax-exempt financing would not create replacement proceeds as a result of being outstanding longer than necessary so long as the issuer estimated the anticipated cash flow deficits and agreed to monitor actual deficits (or the existence of available amounts). The issuer must begin this monitoring for the first fiscal year in which it reasonably expects to have available amounts (but it must in any event begin testing no later than five years after the issue date). If there are actual available amounts, those amounts must, within 90 days of the start of each year, be invested in non-AMT tax-exempt bonds or used to redeem and cancel bonds.

The proposed regulations eliminate the existing rules dealing with the creation of replacement proceeds for working capital financings that are deemed to directly or indirectly finance a working capital reserve. It is these rules that currently require bond counsel to go through fairly complex calculations of the "average maintained reserve" for issuers that are not eligible for the small issuer exception from rebate.

For More Information

To discuss any topic covered in this alert, please contact an attorney in our Public Finance Group or visit us online at Chapman.com.