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IRS Increasing Scrutiny of Underwriter's Reoffering Price Certifications

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Background

Bond underwriters take note. A recent academic study,¹ determining that municipal bonds are sometimes underpriced when issued, has caught the attention of the Internal Revenue Service (the "Service"). Bond underwriters are generally asked by Bond Counsel to certify as to the reoffering price of publicly offered bond issues. The certification is used to establish bond yield for federal tax purposes. If less than ten percent (10%) of each maturity of a bond issue is actually sold to the public at the certified reoffering price, and bonds are subsequently sold at a price higher than the certified reoffering price, the actual bond yield may be lower than that used by Bond Counsel for federal tax purposes. This could affect whether the bonds meet the spread limitations of general arbitrage requirements, whether a private activity bond had enough volume cap and the calculation of rebate liability to the United States Treasury. As a result, the IRS is adding to its audit checklist compliance by bond underwriters with the reoffering price rule described immediately below.²

Reoffering Price Rule

Treasury Regulations provide that the reoffering price of bonds that are publicly offered is the first price at which a substantial amount of the bonds is sold to the public. Ten percent (10%) is a substantial amount. The public does not include bond houses, brokers, or similar persons or organizations acting in the capacity of bond underwriters or wholesalers.³ Basically, when making a reoffering price certification, a bond underwriter is representing it has sold 10% of each maturity of the bonds to the public at the reoffering price prior to the closing date.

The Study

Historically, the accuracy of reoffering price certifications has been difficult to establish. As pointed out in the Study, reoffering price data has been costly to obtain and has not, until recently, been recorded with a central source. That is starting to change. The Study made use of data from the Municipal Securities Rulemaking Board and Primuni.com. These two sources are making it easier for the Service to check the accuracy of reoffering price certifications. In addition, the Service's Tax Exempt

¹ RICHARD C. GREEN, BURTON HOLLIFIELD AND NORMAN SCHÜRHOFF, DEALER INTERMEDIATION AND PRICE BEHAVIOR IN THE AFTERMARKET FOR NEW BOND ISSUES (2005) (the "Study").

² The Bond Buyer, October 14, 2005, at 1, col. 2.

³ Definition of "Issue Price," 26 C.F.R. § 1.148-1 (2002).

Bond Office is developing a form to send to bond underwriters which is intended to allow the Service to determine the accuracy of reoffering price certifications. The form is expected to be ready by the end of this year.⁴

The Study, having tracked 1,048 municipal bond issues with 13,987 individual maturities originally issued between February 15, 2000 and May 1, 2003, found that municipal bonds are often underpriced when issued and that average prices rise slowly over a period of days after issuance. Specifically, for 27% of the bond maturities examined, the Study found no sales to customers at the certified reoffering price over the first 60 days, and for 16% of these maturities, there were no sales at all at or below the certified reoffering price.

Impact

As is generally understood, in connection with initial bond underwritings, bonds can remain in inventory or be sold to bond resellers. Neither practice violates the reoffering price rule so long as 10% of each maturity is sold to the public at the certified reoffering price. However, the Study cites evidence suggesting this is not always the case. Should the Service find noncompliance with the reoffering price rule, and determine that in fact the certified reoffering price should have been higher, the Service may claim that the bonds are taxable if a lower yield implies a “premium” issue price for which no volume cap was obtained, if the issuer had used all of what it thought was a permissible arbitrage “spread” or if the amount of rebate paid was less than required. This could expose a bond underwriter to significant liability as well as public embarrassment.

Conclusion

It is clear that primary responsibility for making reoffering price certifications will generally fall upon bond underwriters. In light of these developments, bond underwriters will be well advised to discuss the reoffering price rule and the sale of Bonds with their trading desks. Also, if there is any question as to whether the facts in a particular case allow the certification to be made, the certification, and the basis for it, should be discussed with bond counsel and bond underwriter’s counsel.

The foregoing summary of the rule is very general in nature. Our clients are encouraged to contact us for specific guidance if they have any questions on these developments.

⁴ The Bond Buyer, October 25, 2005, at 3, col. 1.