Public Finance 2016 in Review and the Outlook for 2017

Federal Tax Laws

2016 Developments

Despite an increase in the federal funds rate by the Federal Open Market Committee in December, municipal bond interest rates throughout 2016 were (and still are) extremely low when compared to historic rates. As a result, the volume of municipal bond issues reached an all-time high in 2016.

As discussed below, the Treasury Department released a number of highly anticipated and significant proposed and final regulations during 2016. In addition, to accommodate public-private partnerships, Treasury issued Revenue Procedure 2016-44, which allows issuers to enter into longer-term management contracts without resulting in private business use.

Final Issue Price Regulations Address Some (But Not All) Concerns with Proposed Issue Price Regulations

On December 9, 2016, Treasury published final issue price regulations (Final Issue Price Regulations) that largely follow the proposed regulations issued on June 24, 2015 (Proposed Issue Price Regulations) with a few notable exceptions.

Under the Final Issue Price Regulations, issuers can no longer rely on reasonable expectations regarding the initial public offering price to establish issue price. Instead, the issue price of bonds issued for money is the first price at which a "substantial amount" of the bonds is sold to the public. Fortunately, a "substantial amount" remains at 10% as opposed to the 25% threshold that was suggested by Treasury in regulations proposed in 2013. The Final Issue Price Regulations also provide that, for a bond issued for money in a private placement to a single buyer that is not an underwriter or a related party to an underwriter, the issue price of the bond is the price paid by that buyer. This seemingly tidy rule is muddied somewhat by the absence of a definition of "private placement." The preamble to the Final Issue Price Regulations indicates that a bank loan is an example of a private placement, but there is little additional elucidation of what qualifies as a private placement.

For bonds offered to the public, where the issuer sells less than 10% of a maturity, issue price may instead be determined based on a certification from the underwriter that states the price at which the bonds were initially offered to the public. The regulations include a "hold-the-offering-price" requirement that requires underwriters to hold the price for offering and selling the remaining bonds at a price that is no greater than the initial offering price to the public. The underwriter(s) must hold the offering price for a time period that ends on the earlier of (1) the close of the day that is the fifth business day after the sale date of the bonds or (2) the day on which the underwriter(s) have sold a substantial amount of the bonds to the public at a price that does not exceed the initial offering price ("Hold Period"). In a deviation from the Proposed Issue Price Regulations, an underwriter cannot sell a bond at a price in excess of the initial offering price during the Hold Period even if the underwriter is willing to certify that the increased price is in response to a market change.

Despite the potential flexibility that was afforded underwriters under this market change rule in the Proposed Issue Price Regulations, commenters objected to the rule, claiming it was unworkable because of the absence of meaningful benchmarks for municipal bond prices. Pursuant to the Final Issue Price Regulations, under no circumstances can a bond now be sold at a price higher than the initial offering price during the Hold Period if the issuer wants to use the hold-the-offering-price rule to set the issue price of that bond.

The Final Issue Price Regulations apply to bonds sold on or after June 7, 2017.

For more information, visit our summary on the *Public Finance Tax Blog*.

Highly Controversial Proposed Political Subdivision Regulations

You may recall from our year-end report last year that unsubstantiated rumors were circulating in late 2015 that Treasury would soon release regulations setting forth requirements for an entity to qualify as a political subdivision. Those rumors turned out to be true. On February 23, 2016, Treasury promulgated proposed regulations regarding the definition of "political subdivision" ("Proposed Political Subdivision Regulations").

Under the Proposed Political Subdivision Regulations, if finalized, an entity would need to meet three requirements to qualify as a political subdivision. First, the entity must possess sovereign powers. Second, the entity must serve a governmental purpose. Third, a state or local government must exercise control over the entity. The "governmental purpose" and "governmental control" requirements are new requirements in determining whether an entity is a political subdivision and their introduction has caused significant consternation within the public finance community. Fortunately, at various public appearances, officials from the IRS and Treasury have seemed open to comments and suggestions, leaving public finance practitioners hopeful that the Proposed Political Subdivision Regulations will undergo significant revisions prior to being finalized.

For more information, visit our summary on the *Public Finance Tax Blog*.

General Arbitrage (Non-Issue Price) Regulations – Helpful Though Not Groundbreaking

In July 2016, Treasury published final regulations governing a variety of arbitrage provisions other than issue price ("Final Non-Issue Price Regulations"). The Final Non-Issue Price Regulations, which generally apply to bonds sold on or after October 17, 2016, contain a variety of arbitrage provisions including, most notably:

- The yield calculation for issues with callable high-premium bonds is modified so that the callable high-premium bonds are treated as called on the redemption date that results in the lowest yield of the particular *bond*, rather than the date that results in the lowest yield of the entire *issue*.
- The window of time during which a hedge (e.g., a swap) may be identified and still be a qualified hedge is extended from three days to 15 days.

- A deemed termination will no longer occur for a qualified hedge that is materially modified (or the underlying debt is refunded), provided the hedge continues to meet the requirements of a qualified hedge and without regard to whether any portion of the hedge is off-market as of the date of the material modification or refunding.
- Consistent with regulations previously proposed, where bond proceeds are used to make a grant, the character and nature of a grantee's use of tax-exempt bond proceeds is taken into account in determining whether arbitrage and other applicable tax law requirements are met.

For more information, visit our summary on the *Public Finance Tax Blog*.

Taxpayer-Friendly Revenue Procedure Governing Management Contracts

Since guidelines were first introduced to determine whether a management contract qualifies for a safe harbor against private business use, that determination has been based primarily on the term of the contract and the form of compensation paid to the manager. Under Revenue Procedure 97-13, as amended by IRS Notice 2014-67, the safe harbor term of a management contract was limited to five years if the service provider's compensation was not almost entirely a fixed amount. Revenue Procedure 2016-44 substantially extends the safe harbor term of a management contract to the lesser of 30 years or 80% of the weighted average reasonably expected economic life of the property to which the management contract relates. Under the new revenue procedure, a service provider's compensation may be calculated in any manner provided the compensation (i) is "reasonable," (ii) does not give the service provider a share of net profits and (iii) does not impose on the service provider the burden of sharing any of the net losses from the operation of the managed property.

There remains some uncertainty regarding the application of certain additional requirements that Revenue Procedure 2016-44 now imposes for a management contract to qualify for the safe harbor. For example, to qualify for the new safe harbor, a service provider must agree not to take a tax position that is inconsistent with being a service provider. It is unclear whether this requirement is met absent an explicit statement in the management contract to that effect. Similarly, the "qualified user" (depending on the project, this is either a governmental person or a 501(c)(3) organization) must exercise a "significant degree of control" over the managed property. This provision appears to be intended to prevent a management contract that is, in substance, a lease from qualifying for the safe harbor from private business use. However, the indicia of control referenced in Revenue Procedure 2016-44 are often absent and, as a result, the status of some management contracts without these provisions is unclear.

Nonetheless, a degree of uncertainty always accompanies new guidance from Treasury or the IRS, and Revenue Procedure 2016-44 should be considered a very favorable development.

For more information, visit our summary on the *Public Finance Tax Blog*.

What to Look For in 2017

Tax Reform

In last year's year-end report, we accurately predicted that comprehensive tax reform was unlikely to occur during 2016. Tax reform is far more likely in 2017. With Republicans now in control of Congress and the White House, the GOP is poised to move forward with comprehensive tax reform. These efforts, which could take shape as legislation in the first half of 2017, will build on the principles set forth in the House Republicans' "A Better Way" proposal, which its proponents intend to serve as a blueprint for a "21st Century tax code that is built for growth and that puts America first." Although the blueprint does not reference municipal bonds, it does mention repealing unnamed "special-interest" provisions, a statement that could be interpreted as calling into question the tax exemption for interest on municipal bonds. (For more information, visit the *Public Finance Tax Blog*.) Such an ambitious proposal, however, faces many hurdles, as Republicans and Democrats remain sharply divided on the myriad issues addressed or alluded to in the blueprint (including the interest exemption for state and local bonds). Nonetheless, comprehensive tax reform is more likely with a unified government than it would have been had Secretary Clinton won the election and confronted a Republican Congress.

For more information, read our 2016 Post-election Analysis - A New Administration and a New Congress: What to Expect.

Tax Regulation

Somewhat uncharacteristically, many of the tax-exempt bond projects included in Treasury's 2016-17 Priority Guidance Plan (2016-17 Guidance Plan) have already been completed. The Proposed Political Subdivision Regulations, guidance on management contracts that was issued in the form of Revenue Procedure 2016-44, the Final Non-Issue Price Regulations and the Final Issue Price Regulations were all included in the 2016-17 Guidance Plan released by the Treasury Department on August 15, 2016. Certain items on the 2016-17 Guidance Plan remain, including final regulations on the public approval requirement for private activity bonds and regulations on what constitutes a "reissuance" of a tax-advantaged bond. At the 2016 Tax and Securities Law Institute, hosted by the National Association of Bond Lawyers, a senior Treasury official indicated that the reissuance regulations are "next in line." However, both items have been well represented in prior annual guidance plans, so it remains to be seen whether 2017 is the year when we can stop referring to the oddly-numbered and fairly ancient section 5f.103-2 of the Treasury Regulations for the rules on public approval of private activity bonds.

For more information, visit our summary on the *Public Finance Tax Blog*.