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## TAX NOTES

### Fair Market Valuation Issues For Yield Restricted Investments of Bond Proceeds Part I - Economic Basis, Yield Burning and SLGS

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Recently, the issue of whether the price paid for securities purchased with proceeds of tax-exempt bonds is at fair market value has been the focus of media scrutiny and government investigations. On June 15, 1995, *The Bond Buyer* reported that the SEC was investigating whether Lazard Freres & Co. overcharged the Los Angeles County Metropolitan Transportation Authority for government securities purchased with tax-exempt bond proceeds. The Dow Jones News Service has reported that the U.S. Justice Department's Antitrust Division is investigating Municipal Government Investment Associates Inc. in connection with price fixing in the sale of guaranteed investment contracts to governmental entities that purchased such contracts with tax-exempt bond proceeds. Finally, in the Tax-Exempt Bond Action Plan released by the IRS on January 10, 1994, the Internal Revenue Service (IRS) has indicated that, among other things, "open market purchases of Treasury obligations for advance refunding escrows and purchases of long-term guaranteed investment contracts" will be the focus of their bond examination program.

This month's column will discuss reasons for these concerns and the use of State and Local Government Series (SLGS) as an investment alternative. Next month's column will discuss procedures currently being used to assure that investments of bond proceeds in open market securities are at fair market value.

#### **"Legal" Yield Burning and "Illegal" Yield Burning**

In the case of proceeds of tax-exempt obligations subject to arbitrage yield restriction or to rebate, the economic motivation to maximize aggregate investment yield generally ceases once bond yield, in the aggregate, is attained. In a positive arbitrage environment, this creates an

opportunity for the diversion of arbitrage to the sellers of investments. The practice of selecting investments with yields at or below bond yield or overcharging for investments to bring the investment yield down to bond yield is often referred to as “yield burning”. Section 1.148-5(d) of the Treasury Regulations (Regulations) generally requires that tax-exempt bond proceeds be invested at their fair market value. Technically, Section 1.148-5(d) attributes a fair market value purchase price to an investment for arbitrage yield restriction and rebate purposes regardless of what was actually paid for the investment. (A purchase price at above fair market value will therefore be ignored and the fair market value of the investment will be treated as its purchase price).

Fair market value is defined in Section 1.148-5(d)(6) as “the price at which a willing buyer would purchase the investment from a willing seller in a bona fide, arm’s-length transaction”. The fair market value rule does not require that the investment purchased with bond proceeds be the highest yielding or most appropriate investment under the circumstances. All that is required is that the purchase price of any investment purchased be at fair market value. For example, assume an issuer issues bonds bearing interest at 5 percent per annum and seeks to invest the bond proceeds for a 3-year temporary period while it constructs its project. The issuer may invest in investment X that earns 5 percent per annum, is highly rated, is extremely well collateralized, and is very liquid or in investment Y that earns 6 percent per annum, is not as highly rated, not as well collateralized and not as liquid as Investment X. The issuer chooses investment X because the extra benefits of X are basically free since all of the excess earnings above bond yield on investment Y must be rebated to the federal government. Although investment Y may have been a more appropriate investment, as long as the purchase price paid for investment X was an arm’s-length market price, the issuer has complied with the fair market value requirements. This is “legal yield burning”.

The other type of yield burning often referred to is “illegal yield burning” which is simply the sale and purchase of investments at greater than their fair market value. It is interesting to note that the Treasury regulation’s requirement of valuation at fair market value applies to investments purchased *below* fair market value as well as to investments purchased above fair

market value. In most circumstances, the recharacterization of a below-market purchase price to a higher fair market value should not pose an arbitrage yield restriction or rebate problem because the effect of the adjustment will be to decrease the yield of the investment.

Unfortunately, the Treasury regulations do not require intent in order to apply the fair market value rules. Although an investor may have thought it was purchasing investments at fair market value and was innocent of any intent to violate the fair market value rules, if the IRS determines (and, presumably a court agrees if it gets that far) that the purchase price was not fair market value, the investment's fair market value will be treated as its purchase price and not the price actually paid by the issuer. Under these circumstances, is it fair to penalize an investing issuer for the fraud or misrepresentation of an investment provider? A strong argument can be made that, in cases of illegal yield burning where the investing issuer acted in good faith and had no knowledge of the price tampering by the investment provider, the purchase price of the investments should be accepted as fair market value for arbitrage yield restriction and rebate purposes. Penalties against the investment provider should be applied by government regulators under relevant civil and criminal authority.

### **A Simple Solution to Most Yield Burning Problems**

One obvious solution to discourage the practices of legal and illegal yield burning is for Congress to amend the Internal Revenue Code (Code) to permit issuers to retain all of the arbitrage that they earn. However, based on its actions in the Tax Reform Act of 1986, it appears that Congress is not likely to repeal rebate and yield restriction requirements in the foreseeable future.

Another proposal that may be more palatable to Congress (and one which would probably not lose revenue), would be to amend the Code to permit issuers to earn and retain a meaningful portion (e.g., at least 25 percent) of investment earnings in excess of bond yield. This simple change would provide a sufficient economic incentive to issuers to insure that all investments of bond proceeds are at fair market value and that, to the extent appropriate under the relevant circumstances, the highest yielding investments are purchased. Because the current system discourages investment above bond yield, this change would produce rebatable arbitrage

earnings where no such earnings existed when legal yield burning was engaged in. Therefore, this amendment could actually increase rebate revenues for the federal government.

### **SLGS as an Investment Alternative**

Circumstances under which the issue of yield and the purchase price of investments become most pronounced are the investment of bond proceeds in advance refunding escrows. Proceeds of advance refunding bonds placed in an advance refunding escrow may not be invested at a yield in excess of the yield of the refunding bonds. Because investments appropriate for refunding escrows frequently yield more than refunding bonds, there is a real potential for illegal yield burning. In the case of refunding escrows, a simple method for avoiding any fair market value headaches is to invest the bond proceeds in United States Treasury Securities SLGS .

SLGS may be ordered to mature on exactly the day they are needed, and very efficient escrows can usually be created with them. SLGS can be ordered to bear a specific interest rate up to the maximum rate available on that particular maturity and the purchase price is deemed to be fair market value regardless of the interest rate paid. So why doesn't everyone just invest in SLGS and avoid any fair market value issues? Like most things in life, this solution is not that simple.

### **Problems with SLGS**

While an excellent solution to fair market value problems, SLGS are not necessarily always the best investment for advance refunding escrows. From October 18, 1995, through March 29, 1996, the Treasury Department was not selling SLGS because of the failure by Congress to increase the Treasury's borrowing authority. This is not the first time that the "SLGS window" has been closed nor will it most likely be the last time. So SLGS are not all that dependable.

Another problem with SLGS is that they bear interest at 1/8 of 1 percent less than comparable current issue Treasury securities determined on the basis of "on the run" pricing, meaning the Treasuries most recently issued are used as the basis for determining the current yield offerings on SLGS. Evidently, older Treasuries trading on the secondary market trade at slightly higher rates than recent issue Treasuries of similar maturities. Therefore, not only do SLGS take a 1/8 of 1 percent haircut over Treasuries, that haircut is not applied on the basis of the highest yielding available Treasuries.

SLGS have some pesky and annoying requirements and restrictions. For example, there is the “all or nothing” rule which requires that all bond proceeds subject to yield restriction be invested in SLGS, meaning that refunding bond proceeds cannot fund an escrow with a mixture of SLGS and open markets. In addition, only yield restricted bond proceeds may be invested in SLGS, SLGS must be ordered at least 15 days prior to delivery, the minimum maturity of SLGS is 30 days, minimum principal increments are \$100, the investor must declare under penalties of perjury that it is following the SLGS rules, and it is sometimes difficult and expensive to redeem SLGS prior to their maturity. Finally, some financial advisors maintain that investment in SLGS may reduce an issuer's flexibility at a future date in a restructuring of its advance refunding escrow.

### **Proposals to Improve SLGS**

Over the years, the Treasury Department has been periodically asked to improve and simplify the SLGS program. On January 12, 1996, a group of municipal issuers, investment bankers, investment providers and bond lawyers submitted a letter to the Treasury, outlining seven specific changes that would improve the SLGS program. The seven changes requested are as follows:

1. Make SLGS pricing more consistent with open market Treasury pricing by reducing the 1/8% yield differential between SLGS and other Treasuries and not using "on the run" pricing.
2. Delete the "all or nothing" rule allowing SLGS to be purchased and owned simultaneously with open markets.
3. Shorten the order period for SLGS from 15 days to 7 days, provide minimum maturities of 15 days and allow minimum principal amount increments of less than \$100.
4. Allow SLGS to be purchased with funds subject to rebate as well as arbitrage yield restriction.
5. Facilitate the sale or redemption of SLGS by making SLGS fully transferable or revising the method used in computing redemption penalties on early redemption of SLGS.

6. Delete the following issuer certifications and prohibitions: (i) the prohibition against using proceeds of redeemed SLGS to purchase new SLGS', (ii) the prohibition against using sale proceeds of open markets to buy higher yielding SLGS', and (iii) the prohibition against investing yield restricted bond proceeds in SLGS with a maturity longer than the yield restriction period.

7. Delete the current demand deposit SLGS program and allow all SLGS subscriptions to be made on a single form.

On April 26, 1996, the Bureau of Public Debt of the Treasury Department, released an Advance Notice of Proposed Rulemaking (31 CFR Part 34, Dept. of the Treasury Circular, Public Debt Series No. 3-72) expressing an "intention to issue regulations designed to make the SLGS securities program more attractive and flexible to investors while still achieving policy and cost objectives of the Department." The advance notice indicates that the text of the notice is on the Internet at <http://www.ustreas.gov:803treasury/bureaus/pubdebt.html>. The proposals in the advance notice are basically the same as the seven suggested changes listed above except that "on the run" pricing, transferability of SLGS, the prohibitions against using SLGS proceeds to buy higher yielding open markets, and longer maturities, are not mentioned. In addition, the advance notice suggests that the demand deposit SLGS program be revised and not eliminated. These proposals by the Bureau of Public Debt are a very positive development and final implementation of the proposed changes should be encouraged.

#### **Should SLGS Be Mandatory?**

Some bond counsel have suggested that, whenever SLGS are available, that they should be required to be used in a yield restricted escrow. A refinement of this suggestion is that SLGS should be mandatory whenever they are available and their use would not result in negative arbitrage in the escrow. Currently, there is no requirement in the Code or in the Treasury regulations that SLGS be used instead of open markets, even when SLGS result in no negative arbitrage in the escrow. When SLGS do not result in negative arbitrage, is the use of open markets justified? The answer to this question is that the use of open markets does not have to be "justified", open markets are permitted so long as they are purchased at their fair market value

regardless of the ability of the issuer to use SLGS. Currently, the decision to use SLGS (when they are available) versus open markets is controlled by economic factors and is not controlled by the Code. The only question for an issuer is whether using open markets in lieu of SLGS presents significant fair market valuation risks that outweigh any additional benefits of the open markets.