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TAX NOTES

Fair Market Valuation Issues For Yield Restricted Investments of Bond Proceeds Part II - Bidding and Non-Interested Party Certifications

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This is the second and final column addressing the issue of investment of bond proceeds and whether the purchase price paid is fair market value. In the first column, the economic reasons for the fair market value problems, “legal” and “illegal” yield burning, and the use of SLGS were discussed. This month’s column discusses the bidding and certification procedures currently being used to assure that investments of bond proceeds are at fair market value.

On September 13, 1995, the Arbitrage and Rebate Committee of the National Association of Bond Lawyers (“NABL”), delivered a letter to IRS and Treasury officials commenting on establishing fair market value for open market escrow investments. In this letter, NABL requested that the government address illegal yield burning by instituting enforcement actions against those misrepresenting the market value of investments and those selling investments to issuers in excess of their fair market value. NABL urged the government not to react by promulgating onerous restrictions, and requested that, if the government decided to provide more guidance on this issue, the following safe harbors be established: (1) a qualified professional certifies that the purchase price is fair market value, (2) three bids from non-interested parties are obtained and the investments are purchased at the lowest price or the highest yield offered, or (3) the yield on the investments is significantly below the relevant bond yield. Under these proposed safe harbors, if the

investments were actually purchased at a price other than fair market value, and if the safe harbor was met, the purchase price for arbitrage and rebate purposes would be the actual purchase price paid.

On March 1, 1996, the IRS and Treasury issued their annual Joint Statement setting the "1996 Priorities For Tax Regulations and Other Administrative Guidance" commonly referred to as the "business plan". One of the items in the business plan is "[g]uidance regarding certain open market escrows." Presumably, this refers to illegal yield burning with respect to purchases of open market securities for refunding escrows and indicates an intent by the IRS to publish guidance on this subject in the near future.

Certifications as Assurance of Fair Market Value

A common practice among issuers investing bond proceeds in refunding escrows for many years was to rely on a certification from a qualified investment professional (usually an underwriter or financial advisor) to the effect that the investment was purchased at its fair market value. These certifications were usually only for escrow investments and were not customarily required by bond counsel for other investments of bond proceeds. Because of the recent media attention and investigations regarding fair market value, the practice of relying solely on the certification of the provider of the investment or of an investment expert with a material financial interest in the transaction is not as common as it once was. The concern is that, if the party making the representation has a material financial interest in the transaction, that party is akin to the proverbial "fox in the hen house" because it has an incentive to engage in illegal yield burning and, therefore, its certifications may not be entirely truthful. Regardless of the certifier's incentive, why should an issuer be forced to doubt the certifier's honesty and integrity? If the certifier is lying in its certification, the certifier can be penalized under civil and criminal actions. It should not be the issuer's responsibility to be a lie detector.

One alternative currently in use has been to rely on the certification of an investment professional with no material financial interest in the transaction. If the certifier is truly independent and receives no benefit from the transaction, other than compensation for its work in providing the certification, the certifier should have no economic motivation to misrepresent the fair market value of the investment. Apparently, one of the concerns that the IRS has with fair market value certifications is that they generally do not contain pricing information providing an “audit trail” to which an examining agent may refer. Evidently, the IRS would like some type of objective evidence readily available to someone examining the bonds setting forth the basis upon which the determination of fair market value was made.

With respect to certification, NABL, in its letter, recommended a safe harbor providing that when a party knowledgeable about similar investments certifies to the issuer that the purchase price of the investments is the fair market value thereof and such party agrees to maintain objective evidence of the methodology and data used in arriving at such conclusion and to provide it to the IRS in the event such information is requested, the certified price is treated as the fair market value of the investment. This safe harbor does not require that the certifier have no material financial interest in the transaction because many times the person in the best position to determine the fair market value of escrow securities is the underwriter or financial advisor to the transaction. The requirement that the certifier maintain evidence of how it determined fair market value should operate to keep the certifier honest and should satisfy the government’s desire for an audit trail. Currently, there is no direct provision in the Internal Revenue Code (Code) or the Treasury Regulations providing a safe harbor for the type of certification suggested by NABL or for certifications by non-interested parties. The closest regulatory provision is Section 1.148-2(b) of the Treasury Regulations which requires that an issuer certify

its reasonable expectations regarding “the amount and use of the gross proceeds of the issue” as of the date of issue of the bonds.

Bidding and Significant Negative Arbitrage as Assurance of Fair Market Value

In response to the furor over fair market value, many open market escrow securities are being purchased via a competitive bidding process. Section 1.148-5(d)(6)(ii) of the Treasury Regulations provides a safe harbor that treats the purchase price of guaranteed investment contracts as the contract’s fair market value if three bona fide bids from providers with no material financial interest in the bonds are received and the contract with the highest yield is purchased. This rule has been applied by analogy to the purchase of open market escrow securities although the guaranteed investment contract safe harbor does not technically apply to most of these types of investments. Section 1.148-1(b) of the Treasury Regulations defines a guaranteed investment contract as “any nonpurpose investment that has specifically negotiated withdrawal or reinvestment provisions and a specifically negotiated interest rate, and also includes any agreement to supply investments on two or more future dates (e.g., a forward supply contract)”. A typical forward delivery agreement for open market treasuries provides for future delivery on only one date (the issue date) and, therefore, does not fit within the definition of a guaranteed investment contract.

NABL, in its 1995 letter, proposes a three-bid safe harbor under which investments are deemed purchased at fair market value if (i) a bona fide solicitation for specified securities is made, (ii) of the bids received, at least three are bona fide bids from sellers that have no material involvement in the pricing of the issue; and (iii) the securities are purchased from the bidder which made the highest yielding bid and such securities have a yield at least as high as such bid. It should be noted that, unlike the guaranteed investment contract safe harbor in the current regulations, under the NABL proposal, parties with a material financial interest in

the bonds (such as underwriters) could bid on and provide the escrow securities if at least three bids from parties with no material financial interest were received.

Using three bids to establish fair market value is not always simple, and prices in excess of fair market value can still occur. A three-bid procedure can also be difficult to accomplish when maturing open markets are reinvested in 0 percent SLGS. A common practice when funding an escrow with open market treasuries with yields in excess of the refunding bond yield is to buy treasuries that mature prior to the final payment date of the escrow and reinvest the maturing proceeds in 0 percent SLGS for a period long enough to blend the aggregate yield of the escrow down to bond yield. If the investor does not know the yield of the treasuries going into the escrow, the investor does not know what maximum treasury maturities to request in the solicitation for bids. If the result of the bidding produces treasuries with a yield that cannot be blended down to bond yield because there is not enough time remaining in the escrow for sufficient 0 percent SLGS reinvestments, then the escrow must be re-bid with shorter treasury maturities. One method of bidding in these circumstances is to request multiple bids with decreasing treasury maturities (e.g., ask the bidders to bid on treasuries maturing 7/15/2000, 6/15/2000 and 5/15/2000) and then select the longest bid with the best yield that still provides an adequate 0 percent SLGS reinvestment period.

Also, difficult questions such as whether a "last look" arrangement qualifies as a bona fide bidding procedure plague the three-bid method. A "last look" means that, after all the bids are received, some entity (either one of the bidders or someone else) has a right to beat the highest yielding bid. Finally, bidding may add an additional expense to a transaction. If the necessary escrow securities are not readily available, a public bidding process may actually increase the cost of the securities because disclosure of the issuer's need for those scarce securities may drive the price up. Despite its difficulties, bidding appears to have become very popular and is the

method of choice in many cases for establishing fair market value of escrow investments.

The third safe harbor proposed by NABL would presume that any escrow investment is purchased at fair market value if either the aggregate yield to maturity of the investment is less than the yield of the bonds by at least .25 percent or the expected cash flow from the investments is at least \$200,000 less than if such investments had been invested at the bond yield. The philosophy behind this safe harbor is that, when there is significant negative arbitrage on an investment, it should be presumed that there is no illegal yield burning. Although there is no comparable rule in the Code or in the current Treasury Regulations, Section 1.148-4(c)(4)(ii)(C) of the final Treasury Regulations promulgated in May, 1992 (T.D. 8418), which were replaced by the current Section 1.148 regulations, provided that guaranteed investment contracts with a yield of more than .25 percent below the yield on the issue were not required to comply with the 3-bid requirement then contained in said regulations. This provision was dropped in the guaranteed investment contract safe harbor of Section 1.148-5(d)(16)(ii) of the current Treasury Regulations.

Summary of Options

Because it appears that the economic forces that make legal and illegal yield burning attractive will not go away anytime soon, there will continue to be a cloud of doubt over open market escrow securities when a positive arbitrage environment exists. Issuers who diligently employ one of the methods described above for assuring that open market escrow investments are purchased at fair market value will certainly be in a better position when government investigators come knocking on their door than those who ignore this issue. Investment in SLGS is clearly the simplest and surest method to avoid any fair market valuation problems. It is not clear which of the other methods (certificates or bids) will provide the greatest assurance that investments are purchased at fair market value, but either method, if

applied diligently, should afford at least some protection. It should be noted, however, that, under the Code, the ultimate responsibility for purchasing investments at their fair market value rests with the issuer.