

The following article written by David A. Walton appeared in the Public Finance Advisor, Volume I, Issue 6 (September, 1996). Mr. Walton is a member of the Editorial Board of the Public Finance Advisor.

TAX NOTES

Investments of Bond Proceeds: Recent IRS and Treasury Pronouncements Regarding Fair Market Value

By David A. Walton
David A. Walton is a partner at Jones Hall, A Professional Law Corporation, in San Francisco

Two previous columns (May and June, 1996) have already addressed the issue of fair market value of investments of bond proceeds. This issue, however, merits further discussion because of the recent release of proposed regulations regarding U.S. Treasury Obligations State and Local Government Series (SLGS) by the U.S. Treasury Department Bureau of Public Debt (Proposed SLGS Regulations), and the release of proposed fair market value regulations (Proposed Fair Market Value Regulations) and Revenue Procedure 96-41 by the U.S. Treasury and the IRS. There is good news and bad news in these recent pronouncements. The good news is the Proposed SLGS Regulations and the bad news is the Fair Market Value Regulations and Revenue Procedure 96-41.

The Proposed SLGS Regulations

In an Advance Notice of Proposed Rulemaking (Advance Notice) issued by the U.S. Treasury Bureau of Public Debt on April 26, 1996, the Bureau expressed 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." On July 24, 1996, the Bureau of Public Debt released the Proposed SLGS Regulations (31 CFR Part 344, Dept. of the Treasury Circular, Public Debt Series No. 3-72) setting forth in detail the general proposals in the Advance Notice. (*See the Bureau of Public Debt's home page at*

<http://www.ustreas.gov/treasury/bureaus/pubdebt/pubdebt.html> (do not use the e-mail address published in the preamble to the Proposed SLGS Regulations, it contains a typographical error). The Proposed SLGS Regulations will not become effective until final regulations are issued.

Overview of Specific Provisions in the Proposed SLGS Regulations

The proposals contained in the Proposed SLGS Regulations would make the SLGS program much more flexible. This flexibility will be beneficial to bond issuers because it will provide more options for funding advance refunding escrows resulting in more efficient and cost effective escrows and more alternatives for dealing with arbitrage and rebate requirements. The two most significant changes proposed are: (i) reducing the current 12.5 basis point yield differential between SLGS and other Treasuries to 5 basis points; and (ii) deleting the "all or nothing" rule allowing SLGS to be purchased and owned simultaneously with open markets Treasury securities.

Other significant proposed changes include providing a \$1,000 order minimum for all SLGS with minimum \$1.00 increments for time deposit SLGS and no minimum increment for demand SLGS (the current minimum increment is \$100). In addition, the regulations propose reducing the minimum maturity for SLGS certificates (maturities of 1 year or less) to 15 days for non-interest bearing certificates. This change will be of significant benefit in circumstances where zero percent SLGS are used to blend down the yield of an escrow (a request for maturities of less than 15 days was denied due to "operational constraints"). Another helpful proposed change is to reduce the minimum subscription period from the current 15 days to 5 days before the date of issue for orders of \$10 million or less and 7 days for orders in excess of \$10 million.

The Proposed SLGS Regulations would allow SLGS to be purchased with any "gross proceeds" of the issue. This would be a very expansive change permitting issuers to invest funds subject to rebate as well as arbitrage yield restriction in SLGS.

Another simplification proposed is the deletion of all of the currently required issuer certifications and the current prohibitions against: (i) using proceeds of redeemed SLGS to purchase new SLGS; (ii) using sale proceeds of open markets to buy higher yielding SLGS; and (iii) investing yield restricted bond proceeds in SLGS with a maturity longer than the yield restriction period.

The Proposed SLGS Regulations would modify the current demand deposit SLGS program by removing the \$35 million cap, reducing the Treasury's administrative costs in the interest rate formula, and requiring 7 days notice for SLGS in excess of \$10 million and 5 days notice for SLGS \$10 million or less. With respect to early redemption of SLGS, the regulations propose: (i) allowing a premium upon early redemption; (ii) changing the irrevocability of an early redemption notice to a penalty prohibiting the issuer from subscribing for SLGS for 6 months; (iii) reducing the minimum holding period for time deposit notes and bonds before allowing early redemption from one year to 30 days; (iv) allowing zero percent time deposit SLGS to be redeemed early at par; and (v) permitting the purchase of SLGS with proceeds of previously redeemed SLGS or open market Treasuries.

The Proposed Fair Market Value Regulations

On June 27, 1996, the Treasury Department published in the Federal Register a Notice of Proposed Rulemaking announcing the Proposed Fair Market Value Regulations under Section 148 of the Internal Revenue Code of 1986. These would amend Section 1.148-5 of the final arbitrage regulations to provide a "rebuttable presumption" for establishing the fair market value of U.S. Treasury obligations purchased on the secondary market when using a bidding procedure and for determining that a solicitation for bids on a guaranteed investment contract (GIC) was bona fide.

Specific Bidding Procedures for Open Market Treasuries

The Proposed Fair Market Value Regulations provide that the purchase price of U.S. Treasuries are rebuttably presumed to be at fair market value if each of the following requirements are met:

1. The issuer conducts a good faith solicitation for the Treasuries in which: (i) the agent conducting the bidding does not bid; (ii) all bidders have equal opportunity to bid (no “last looks”); and (iii) all bidders are reasonably competitive providers of that type of security. Three bona fide bids from providers with no material financial interest in the issue must be received (underwriters and financial advisors have a material financial interest). In most circumstances, the underwriter to a transaction is the most logical choice to be the bidding agent and to bid on the securities, but this would be prohibited under the proposal.

2. The issuer purchases the highest-yielding Treasury for which a “qualifying bid” was made. Under this provision, it is unclear that when 3 other bids from parties with no material financial interest are received, whether the underwriter who was not acting as the bidding agent could be the winning bidder. Because only “Treasuries with qualified bids” can be purchased, can an underwriter, as an interested party, make a qualified bid?

3. The yield on the Treasuries purchased is not significantly less than the yield then available from the provider on reasonably comparable Treasuries offered to other purchasers not purchasing with tax-exempt bond proceeds. Recognizing that escrow securities are priced for forward delivery, the proposed regulations provide that if comparable forward prices are not offered to such other purchasers, implied forward prices for Treasuries based on “standard financial formulas” should be used as a comparison, and the bidding agent should certify as to these comparisons. Although a bidding agent is declared to be optional under these rules, the requirement of forward price comparisons and the reference to a bidding agent making certifications essentially makes a bidding agent mandatory. Since an

underwriter that wishes to bid on the securities may not be a bidding agent (*see 2. above*), an issuer may be forced to incur additional costs in hiring a bidding agent.

4. The yield on the Treasuries cannot be less than the highest yielding SLGS with the same maturity.

5. The terms of the agreement to purchase the Treasuries must be reasonable.

6. The issuer retains the following items with the bond documents: (i) the purchase agreement or confirmations and a statement detailing any oral and other terms of the agreement; (ii) a receipt for the amount actually paid setting out any commissions or fees paid to or by the seller; (iii) each bid received with a date stamp showing date of receipt and a description of the bidding procedure; and (iv) a statement from the issuer, dated as of the issue date, under penalty of perjury that (A) if the issuer used a bidding agent, the agent did not bid, (B) all bidders had equal opportunity to bid (how is an issuer supposed to know this if it did not conduct the bidding?), (C) all bidders are reasonably competitive sellers of Treasuries (how is an issuer supposed to know this?), and (D) the issuer received at least 3 bona fide bids from providers with no material financial interest in the transaction. Note that issuer means the actual governmental issuer and not a conduit borrower.

Finally, the Proposed Fair Market Value Regulations provide that a fee paid to a bidding agent is a qualified administrative cost (*i.e.*, not treated as “additional yield” on the investment) if it is separately stated and does not exceed .02 percent of the amount invested in the Treasuries. In addition, the fee must be comparable to fees charged for similar investments made from sources other than tax-exempt bonds. When comparable transactions are not available, the bidding fees must be compared to bidding fees generally paid for forward delivery contracts for Treasuries.

Two very important aspects of these proposed regulations are the scope of its application and its characterization as a rebuttable presumption. The rules as proposed would apply to all investments of bond proceeds in open market

Treasuries. Specifically these rules would apply to the investment of construction funds and reserve funds by trustees in Treasuries after the date of issuance (the fact that the fund may be exempt from rebate and yield restriction requirements is irrelevant). Query, since the requisite issuer's statement set forth in 6. above must be dated "as of the issue date", how can an issuer comply for post-issuance investments? Finally, a rebuttable presumption is not nearly as useful as a safe harbor for the following reasons. If the requirements for a safe harbor are met, the issue of fair market value is not subject to challenge. If the requirements of a rebuttable presumption are met, the IRS may still successfully challenge the investment as not being at fair market value by overcoming a presumption that the investment is at fair market value.

The Proposed Fair Market Value Regulations are proposed to be effective 60 days after adoption of final regulations.

Revenue Procedure 96-41

Revenue Procedure 96-41, issued on July 19, 1996, establishes a means whereby issuers may enter into closing agreements with the IRS "which will resolve the effect of the payment of more than fair market value" for Treasuries purchased with bond proceeds for advance refunding escrows. To qualify for this closing agreement offer, an issuer must pay to the IRS the difference between the actual purchase price paid for the Treasuries and the "spot price" of those Treasuries as of the trade date (date of sale not date of delivery) of the Treasuries, plus interest on the difference at the bond yield from the trade date to the date of this payment. This payment must be made during the one year period beginning July 19, 1996, and ending July 19, 1997. Issuers are warned that if they do not avail themselves of this offer during the 1-year period and they are subsequently audited, any closing agreement offer made by the IRS may contain terms "different from the terms" of the Revenue Procedure. Upon receipt of a payment made in compliance with

Revenue Procedure 96-41, the IRS “will not challenge whether an issuer paid more than fair market value for Treasury securities.”

The Revenue Procedure defines spot price as the “noncontingent price on the trade date of a nonpurpose investment for delivery on the next business day”. Securities traders use “screens”, which are part of electronic data bases, to price Treasuries. The spot price is the price on the screen at the time of day when the security was traded. The only historical records available for these screen prices are records of end-of-the-day prices which do not reflect price fluctuations during the day. Also, the screen prices reflect prices for 3-day delivery, not next day delivery and do not reflect mark-ups for brokerage commissions or carrying costs. The Revenue Procedure specifically disallows price mark-ups for risk of nonsettlement even though this was a common mark-up in the securities industry for the last 25 plus years. Based on this pricing methodology, some market professionals have estimated that issuers would owe the IRS over a billion dollars.

Revenue Procedure 96-41 applies to any issue of advance refunding bonds sold prior to July 19, 1996 and issued prior to August 19, 1996, the proceeds of which were used to purchase Treasuries for advance refunding escrows. Theoretically, this could apply to all tax-exempt advance refunding bonds with open market escrows issued after 1968, the year when the arbitrage rules were first introduced. Issuers that purchased escrow Treasuries using a 3-bid procedure similar to the guaranteed investment contract (GIC) 3-bid safe harbor currently contained in Section 1.148-5(d) of the Treasury Regulations, will be “rebuttably presumed to establish fair market value” for those securities. The Revenue Procedure also provides that “other procedures may also establish fair market value” but specifically states that “even if the issuer obtains certifications that the purchase price” is fair market value, “an issue may nevertheless fail to meet the reasonable expectations standard” and violate the fair market value rules. Revenue Procedure 96-41 specifically states that the 3-bid GIC rules do not on their face apply to investments in advance refunding

escrows. Evidently, prior to the release of this Revenue Procedure, issuers were supposed to have guessed that they should have used the inapplicable 3-bid GIC safe harbor and should not have relied on certifications regarding fair market value. Interestingly, in the preamble to the proposed arbitrage regulations published on November 4, 1992, comments were requested regarding “whether to provide specific rules for establishing that an open market refunding escrow is acquired at fair market value”. In the final arbitrage regulations published on August 18, 1993, no “specific rules” for open market refunding escrows were promulgated. Now, Revenue Procedure 96-41 appears to be applying “specific rules” regarding fair market value of open market Treasuries retroactively.

The initial reaction to this Revenue Procedure by municipal issuers and professionals can be characterized as one of shock and anger. Some have characterized this as a tax-amnesty program. Others have complained about the inappropriate standard of spot pricing and the coercive nature of the program. Because of this criticism, on July 25, 1996, Treasury Secretary, Robert Rubin, referring to Revenue Procedure 96-41, announced that the IRS will work with the municipal bond industry on a final yield-burning policy. Perhaps this Revenue Procedure will be modified to more accurately reflect reality or, even better, be revoked.