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IRS Announces a New Voluntary Closing Agreement Program

On Thursday, August 30, 2007, the IRS continued to expand its enforcement efforts regarding tax-exempt bond issuers. The IRS announced a new voluntary closing agreement program to address "yield burning" that the IRS believes exists in connection with escrow float agreements for refunding escrows. Our Alert summarizes the IRS announcement. We have included a link to the IRS announcement as well.

> "Issuers who entered into escrow float agreements on a negotiated basis should review those contracts to determine if a payment would be owed under the IRS's methodology…"

Background

In connection with the funding of an escrow to advance refund tax-exempt bonds, unless the escrow is funded with (SLGS), it is likely that there will be periods in which funds are uninvested (for example, from the dates that Treasury securities in the escrow mature until those amounts are used to pay debt service on the refunded bonds). To reduce this inefficiency in the escrow, issuers often enter into tailored investment agreements under which the investment provider makes an upfront payment to the issuer and, in return, is permitted to invest the idle cash in the escrow (an "escrow float agreement"). Due to changes in the IRS regulations, escrow float agreements acquired since June 2002 have generally been acquired through a competitive bidding process. Before that time, the agreements were acquired through negotiation or a competitive bidding process.

Yield-burning

The IRS has long been concerned with the potential for otherwise impermissible arbitrage to be deflected to an investment provider through the issuer paying more than fair market value for an investment. In the late 1990s, the IRS found yield-burning to be prevalent in the acquisition of open-market securities for advance refunding escrows. The IRS believes that the underpayment by a provider of an escrow float agreement also results in yield-burning.

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If an issuer has "burned yield," it is the issuer's bonds that can be declared taxable, even if it received no benefit from or had no knowledge of the yield-burning.

IRS announcement

The IRS believes that escrow float agreements that were not competitively bid in accordance with the IRS safe harbors may have resulted in yield-burning. The IRS is, therefore, offering issuers the opportunity to maintain the tax-exempt status of advance refunding bonds even if an escrow float agreement was improperly priced. To obtain this relief, an issuer would enter into a voluntary closing agreement with the IRS under which it may be required to make a payment to the IRS based on a formula set out in the IRS announcement. This formula is intended to result in the IRS recouping the impermissible arbitrage resulting from the escrow float agreement (that is, the underpayment to the issuer).

Formula

The formula established by the IRS is based on certain assumptions. First, the IRS believes that the return on an escrow float agreement should relate, in part, to the average of the interest rates on Treasury securities for the period from acquisition of the contract until (1) the first date on which cash is available for the provider to invest and (2) the last date on which cash is available for the provider to invest. The IRS's interest rate approach is based on the theory that long-term interest rates reflect expected future short-term interest rates. For example, if the three-year Treasury rate is 6 percent on the date that an issuer enters into an escrow float agreement under which the first investment will occur in three years, the IRS formula will produce a rate on the float agreement in excess of 6 percent (even if the amounts in the escrow will only be invested for a very short time). Second, the IRS believes that the rate on an escrow float agreement should be higher than the rate on the corresponding Treasury securities. The IRS announcement uses these factors to provide for the determination of "implied forward rates."

These implied forward rates are then used to determine the upfront payment that the issuer should have received (net of a 20-percent reduction for dealer costs and profits). If the amount so determined, when factored into the escrow yield calculation, causes the yield on the escrow to exceed the yield on the bonds, a payment to the IRS of the amount needed to reduce the escrow yield to the bond yield would be required as part of the closing agreement. An example of this determination is included in the attached IRS announcement.

The IRS announcement indicates that the IRS recognizes that its methodology is not perfect. The IRS invites issuers who believe that the specified method is not appropriate to their situation to make a submission, which the IRS will analyze to determine if deviation from its method is appropriate.

Conclusion

Issuers who entered into escrow float agreements on a negotiated basis should review those contracts to determine if a payment would be owed under the IRS's methodology. Because of changes to the regulations to strongly encourage escrow float agreements to be bid since June 2002, the bonds likely to be affected by the IRS announcement are those issued before that time. If no payment would be owed, the related bond issue does not have a yield-burning issue and there is no need to seek a closing agreement from the IRS. If a payment is owed, the issuer should consider whether to enter into a voluntary closing agreement with the IRS. It is clear that the IRS is implying that issuers who do not enter into closing agreements by March 1, 2008, may find themselves audited and subject to the IRS seeking a greater penalty to protect the tax-exempt status of the bonds.

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