

VALUATION OF GOVERNMENT SECURITIES - YIELD BURNING

by
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1. Introduction

State and local governments commonly issue tax-exempt advance refunding bonds the proceeds of which are used to redeem a prior bond issue more than 90 days after the issue date of the advance refunding bonds. The proceeds of the refunding bonds are typically placed in an escrow fund and invested until used to redeem the refunded bonds. Usually, the escrow fund consists of a variety of investments (i) United States Treasury securities purchased in the open market (referred to herein as “Treasury securities”), (ii) the State and Local Government Series (SLGS) issued by the United States Treasury and (iii) other eligible investments.

This article addresses the valuation of the Treasury securities purchased for an advance refunding escrow and the effect an improper valuation may have on the tax-exempt status of the advance refunding issue.

2. Yield Restriction Requirement for the Advance Refunding Escrow

A. Arbitrage Bonds

In order for a municipal obligation to qualify as a tax-exempt debt instrument, it must not be an arbitrage bond, as defined under section 148 of the Internal Revenue Code (the “Code”).

Pursuant to section 148(a), an arbitrage bond is defined, in part, as a bond, any portion of the proceeds of which are reasonably expected to be used to acquire higher yielding investments. Additionally, a bond is an arbitrage bond if the issuer intentionally uses any portion of the proceeds of the issue to acquire higher yielding investments or to replace funds used to acquire higher yielding investments. The prohibited acquisition of higher yielding investments is not applicable during the initial temporary period of 30 days after the issue date of the refunding bonds.

B. Reasonable Expectations

The regulations state that an issuer's expectations or actions are reasonable only if a prudent person in the same circumstances as the issuer would have those same expectations or take those same actions based on all the objective facts and

circumstances. Treas. Reg. section 1.148-1(b) provides factors relevant to a determination of reasonableness, including the level of inquiry by the issuer into factual matters.

An issuer typically certifies in the "arbitrage certificate" (a document prepared as a part of almost all tax-exempt bond financings) the factual basis for the issuer's determination that it reasonably expects to comply with the arbitrage rules. However, under current regulations, the arbitrage certificate has no special evidentiary significance.

C. Higher Yielding Investments

The definition of an arbitrage bond also uses the term "higher yielding investments". A higher yielding investment is any investment property that produces a yield over the term of the issue that is materially higher than the yield on the issue. In the case of an advance refunding escrow, the yield on the escrow is materially higher than the yield on the advance refunding issue if it is more than one percentage point (0.001) higher than the yield on the issue. See section 1.148-2(d)(ii).

Investment property includes any security, obligation, annuity contract, and "investment-type property" (as further defined under section 1.148-1(b)). Section 148(b)(3) provides that tax-exempt bonds are not investment property unless the interest on such bonds is subject to alternative minimum tax. The interest on private activity bonds that are not qualified 501(c)(3) bonds is subject to the alternative minimum tax.

Investments are classified as either "purpose investments" or "non-purpose investments", each having their own set of rules under the regulations. Investments in an advance refunding escrow are yield-restricted non-purpose investments.

All investments allocable to the advance refunding escrow are treated as a single investment having a single yield. Therefore, if the yield on the entire advance refunding escrow is greater than one-thousandth of one percentage point above the yield on the refunding bond, the refunding bond is an arbitrage bond. See section 1.148-5(b)(iv).

D. Rebate

In addition to yield restriction rules, most bond issues are also subject to rebate requirements. Failure to timely pay the rebate amount can also cause a bond to be an arbitrage bond.

Other than for the initial temporary period of 30 days, the yield on the investments in an advance refunding escrow cannot be materially higher than the yield on the advance refunding issue. As stated above, yield on the escrow that is in excess of .001% above the yield on the advance refunding issue is materially higher. Because such an escrow violates the yield restriction requirements under section 1.148-2(d)(ii), rebate payment of the excess earnings in the escrow will not cure the fact that the bonds are arbitrage bonds. Further, yield reduction payment to the Treasury - a mechanism for reducing the yield on most yield restricted investments - is not available to advance refunding escrows.

E. Fair Market Value

Under section 1.148-6(c), gross proceeds of an issue are not allocated to the payment of a nonpurpose investment to the extent that the purchase price of the investment exceeds its fair market value on the purchase date.

Fair market value is defined in section 1.148-6(i) as the price at which a willing buyer would purchase from a willing seller in a bona fide, arm's length transaction. Fair market value is generally determined on the date on which a contract to purchase the nonpurpose investment becomes binding (the trade date of the investment rather than its settlement date).

For bonds issued on or after December 30, 1998, the 1998 Regulations contain a safe harbor under section 1.148-5(d)(6)(iii). This provision generally provides criteria establishing that guaranteed investment contracts and Treasury securities purchased on the open market are purchased at fair market value if an issuer makes a bona fide solicitation (as defined under that section).

F. Use of State and Local Government Series (SLGS) Treasury Securities

The ability to purchase Treasury securities for an advance refunding escrow that comply with the yield restriction requirements and provide sufficient amounts on a timely basis to pay debt service on the refunded bonds can be challenging for an issuer. Additionally, an issuer cannot always structure an advance refunding escrow that meets its specific needs regarding payment on the refunded bonds.

To address such concerns, the United States Department of Treasury sells State and Local Government Series (SLGS) Treasury securities. These are federal securities that can be purchased to match the yield on the refunding bonds as well as the payment schedule on the refunded bonds. This allows issuers to more easily

comply with the advance refunding escrow's yield restriction requirement and alleviates concerns about compliance.

There are three types of SLGS: (1) certificates of indebtedness, which have maturity periods from 30 days up to and including 1 year, (2) notes, which have maturity periods from 1 year and 1 day up to and including 10 years, and (3) bonds, which have maturity periods from 10 years and 1 day up to and including 30 years.

Advance refunding escrows may consist entirely of SLGS or SLGS may be used in conjunction with Treasury securities. SLGs may be purchased by the issuer on the same date that it purchases the Treasury securities or the issuer may purchase SLGS at the end of the life of the escrow with moneys received from maturing investments. If the yield on the Treasury securities (or other investments) in the escrow is materially higher than the yield on the advance refunding bonds, the issuer can also include SLGs in the escrow that have a yield below the yield on the advance refunding bonds and thus blend down the yield on the Treasury securities so that the cumulative yield of the escrow is not materially higher than the yield on the refunding bonds.

The issuer must subscribe for the SLGs with the Bureau of Public Debt. The issuer provides the amount, maturity date, and the interest rate for the SLGs that will result in the escrow's compliance with the yield restriction rules. The SLGS can bear interest at 0% or any other specified rate necessary to meet the issuer's need.

3. Improper Valuation of Advance Refunding Escrow Investments

A. Yield Burning

As stated above, the allowable yield on the investments in an advance refunding escrow is limited. Depending upon the differences in taxable and tax-exempt interest rates, the yield on an escrow funded solely with Treasury securities could result in the escrow having a yield that is materially higher than the yield on the refunding bonds. However, if the same Treasury securities are sold to the issuer at a price that is in excess of their fair market value, the yield to the issuer would be lower. In an attempt to earn additional profits and/or give the appearance of compliance with the arbitrage regulations, the seller of the Treasury securities can thus mark up the price of such securities and thus structure an escrow that purportedly meets the yield restriction requirements. Accordingly, by selling the investments above their fair market value, the seller (referred to herein as the "escrow provider") artificially lowers the yield on the investments. This practice is commonly referred to as "yield burning".

Example:

An issuer issues advance refunding bonds with a yield of 4.9%. It contracts with the escrow provider to purchase investments for the escrow. The escrow provider purchases a Treasury security at a purchase price of \$100,000. At that price, the security has a yield of 5%. It is assumed that \$100,000 is the fair market value for that Treasury security.

On the same date, the escrow provider sells the same Treasury security to the issuer at a price of \$105,000. At this purchase price, the yield on the security is 4.762%.

If the Treasury security had been sold to the issuer at its fair market value (\$100,000), the yield on the escrow would have been 5%. This is more than 0.001% above the yield on the advance refunding bonds (4.9%). As a result, the bonds would be arbitrage bonds. By marking up the security to a price of \$105,000, the yield on the escrow is 4.762% and is not materially higher than the yield on the advance refunding bonds. Additionally, the escrow provider has made a profit of \$5,000.

B. Escrow Churning

Generally, the sale date of the Treasury securities to the issuer is two to three weeks before the issue date of the advance refunding bonds. The escrow provider does not deliver the Treasury securities to the issuer until the date the advance refunding bonds are issued. This is because the issuer uses the proceeds of the bonds to purchase the Treasury securities. The Service is aware of situations where the escrow provider sold the initial Treasury securities and purchased different Treasury securities or other eligible investments between the sale date and the issue date of the advance refunding bonds. Amounts received as a result of such sale and repurchase of Treasury securities were not included in the computation of the yield on the escrow.

Since the initial purchase of the Treasury securities has a direct nexus to the advance refunding bonds, the earnings from the trades of these securities prior to their delivery to the issuer must be included in computing the yield on the investments in the escrow. By excluding the earnings of these trades, the yield on the escrow is lower. Therefore, escrow churning is another form of yield burning.

4. The History of Yield Burning

During the mid-1990's, the practice of yield burning by securities brokerage firms came to the attention of various regulatory authorities including the Internal Revenue Service, the Securities and Exchange Commission and the Department of Justice.

In 1996, the Service issued Rev. Proc. 96-41, 1996-32 I.R.B. 9, to provide issuers the opportunity to resolve potential yield burning issues regarding their advance refunding bonds. Under Rev. Proc. 96-41, issuers that paid more than fair market value for the Treasury securities acquired with proceeds of advance refunding bonds could enter into a closing agreement with the Service pursuant to which the Service would agree that, as a result of the payment made by the issuer, the Service would not challenge whether the issuer paid more than fair market value for the Treasury securities.

The regulatory authorities' investigations and the issuance of Rev. Proc. 96-41 had the effect of putting the industry on notice that the overpricing of Treasury securities could jeopardize the tax-exempt status of the bonds. These actions reduced but did not eliminate yield burning.

The Service's initiative to address this complex compliance matter pursuant to Rev. Proc. 96-41 was not successful in resolving the potential taxability of the bonds. Investment banking firms routinely argued that use of the "spot price" in Rev. Proc. 96-41 to value the Treasury securities did not properly reflect the risk borne by the escrow providers.

In a typical transaction, the escrow provider purchases the Treasury securities in advance of the closing date of the bonds (usually two to three weeks before the bonds are issued). In the event there is a failure to issue the bonds, the issuer is not obligated to purchase the Treasury securities from the escrow provider. Therefore, the escrow provider bears the market risk associated with the purchase of the Treasury securities in the event the bonds are not issued. The industry asserted this risk as justification for the inflated prices charged for the Treasury securities.

History proved that the actual risk associated with the failure to issue bonds subsequent to the purchase of the Treasury securities was minimal. However, in an effort to resolve the potential taxability of numerous bond issues, the Service and other regulatory agencies acknowledged some element of risk associated with the provision of the Treasury securities and entered into agreements with various investment banking firms that acted as escrow providers. Because the agreement with an escrow provider addressed all the advance refunding issues (within a

certain period) for which it provided Treasury securities, the agreement is commonly referred to as the "global settlement agreement " .

Pursuant to the terms of the global settlement agreements, participating firms were allowed certain amount of mark-ups on the Treasury securities. The mark-ups are stated in terms of basis points. The allowable basis points varied according to the year the advance refunding bonds were issued. The agreements addressed bonds issued during the years 1990 through 1996.

The allowable mark-ups were as follows:

<u>Year of Bond Issue</u>	<u>Basis Point Allowance</u>
1990	45
1991	45
1992	40
1993	35
1994	35
1995	35
1996	35

The Service does not view the basis point allowance used in the global settlement agreements to be a fair market value determination of Treasury securities, but rather, the result of extended negotiations between the regulatory authorities and the escrow providers.

Firms who marked up securities beyond that allowed under the terms of the global settlement agreements were required to pay the excess profits (plus additional amounts). The excess profits were paid to the U. S. Treasury, the issuer, or both as determined respectively by the positive, negative, or "straddled" arbitrage of the escrow.

The opportunity to resolve the taxability of bond issues resulting from yield burning was available to all escrow providers and issuers.

As part of its continuing effort to address yield burning, the Service is now engaged in a series of examinations with a number of escrow providers.

5. The Role of the Examiner

Although escrow providers and issuers were encouraged to enter into a global settlement agreement with the Service, not all took advantage of this

opportunity. Therefore, the Service continues to address the fair market value of Treasury securities purchased in connection with advance refunding bonds.

Generally, at the time the advance refunding bonds are issued, the issuer typically certifies that the Treasury securities are purchased at fair market value. The fact that certification of the issuer was provided on the date of issue of the advance refunding bonds does not necessarily mean that the issuer made an independent determination regarding the fair market value of the Treasury securities. Issuers generally rely on certification provided to them by the escrow provider or some other financial advisor.

Accordingly, an examiner must look beyond any certification provided by the issuer and independently verify that the investments in the advance refunding escrow were purchased at fair market value.

A. Verifying Fair Market Value

As indicated above, the escrow provider generally purchases the Treasury securities prior to the issuance of the advance refunding bonds. In many instances, the escrow provider purchases the Treasury securities in the open market from a third party for resale to the issuer on the same trade date (the date used to determine fair market value). In such a case, the price paid by the escrow provider is the best indicator of the fair market value of the securities.

As an alternative to purchasing Treasury securities on the open market, the escrow provider may sell securities from its own inventory. In certain cases, the Service has found that the escrow provider purchased Treasury securities intended for an issuer's escrow on a certain date but did not resell them to the escrow on that same date. In these situations, the trade date of the Treasury security when purchased by the provider is different from the trade date on which the security is sold to the issuer. In these instances, an examiner may use financial publications, such as the Wall Street Journal, to generally determine the fair market value of the Treasury securities.

Such financial publications may also be useful even in situations where the trade dates of the escrow provider and the issuer are the same. Keep in mind, the usefulness of similar trade dates is the assumption that the escrow provider is purchasing the Treasury securities at fair market value and then reselling the same to the issuer. Any increase in the price over that paid by the escrow provider clearly represents a mark-up.

The fact that the purchase price of each of the Treasury securities paid by the escrow provider and the issuer is the same does not always mean that the

issuer paid fair market value for such securities. Suppose the escrow provider and the underwriter with regard to the issuance and sale of the advance refunding bonds are two different firms. The escrow provider purchases Treasury securities above fair market value from the underwriter and then resells these securities to the issuer at the same price. On its face, and without further inquiry, it would seem that the issuer paid fair market value for the Treasury securities. If the examiner were to assume that the escrow provider purchased the securities at fair market value and limit the fair market value analysis to the purchase/sale price of the escrow provider, one would conclude that the securities were sold to the issuer at fair market value. By referring to a financial publication, the examiner can generally obtain the price at which a Treasury security was selling on a particular date. If after reviewing the market prices it appears that such security was sold to the issuer at a price that was greater than fair market value, albeit the same as that paid by the escrow provider, the examiner should inquire further. In such instances, an agreement may exist between the escrow provider and the underwriter (or any other parties involved in the provision of securities) whereby the parties share the excess profits stemming from the sale of the Treasury securities from the underwriter to the escrow provider. *Thus, when examining an advance refunding issue, the examiner must always make an independent determination of the fair market value of the Treasury securities.*

If the examiner comes across a situation described above, the examiner will need to question the escrow provider, under penalties of perjury, regarding the existence of arrangements with third parties. The above example also indicates that it is important for the examiner to check from whom did the escrow provider purchase the Treasury securities. If they were purchased from a party that was involved in the issuance and sale of the advance refunding bonds, the examiner should make additional inquiry as to any side agreements. The ability to determine the existence of such circumstances can aid the examiner in determining whether the issuer paid more than fair market value and whether some sort of collusion existed between certain parties to engage in yield burning

As previously indicated in this article, the 1998 Regulations contain a safe harbor provision that generally deems investments purchased at fair market value if all requirements of the regulation are met. One requirement is that the issuer must solicit at least three bids from reasonably competitive providers (commonly referred to as the "three bid rule"). While the Service can generally conclude that if an issuer can demonstrate compliance with the safe harbor provision the investments were purchased at fair market value, the agent however should be cognizant that, although rare, the possibility of collusion either among the bidders or between a bidder and the issuer remains.

For example, as a courtesy between bidders, one firm might agree to submit a bid for the provision of securities at a price resulting in a yield that is lower than the intended bid of another firm. (The issuer must accept the bid that results in the highest yield). One reason the accommodating firm might agree to such bidding is that it recognizes the issuer to be a continuing client of the accommodated firm and expects the latter to reciprocate.

Therefore, while the safe harbor provisions are designed to provide issuers with a set of rules on which they can rely to show that the Treasury securities were purchased at fair market value, the examiner should be aware that the “three bid rule” is not foolproof and is susceptible to abuse. An issuer's ability to demonstrate that it has complied with the form of the safe harbor provision is not enough. While the burden of proof may be higher for the Service, the examiner must verify that there was substantive compliance with the safe harbor rules.

B. Examining the Transaction

1) Cases Previously Resolved Pursuant to the Global Settlement Agreements

In light of the fact that the Service has previously settled the potential taxability of numerous bond issues resulting from yield burning, the examiner should determine whether the particular bond issue to be examined was included as part of the global settlement agreement between the Service and the escrow provider. The Tax Exempt Bond Division's Outreach, Planning and Review staff can provide information necessary to make this determination.

2) Determination and Analysis of the Necessary Documents

After confirming that the bond issue assigned was not resolved under the global settlement agreement, the examiner should obtain records that will be necessary to determine the fair market value of the Treasury securities.

Prior to requesting any additional records from parties to the transaction, an examiner may be able to ascertain the fair market value of the Treasury securities in the escrow by reviewing documents normally contained in the bond transcript. Often, the confirmation statements (or tickets) associated with the sale of the Treasury securities to the advance refunding escrow are included in the bond transcript. Confirmation statements include descriptive data regarding the sold securities, including the price and trade date of the security. Using the data from the confirmation statement, the examiner will generally be able to identify the securities in financial publications. Once the securities are identified, by using the trade date the examiner should compare the price at which the securities were

selling on the open market to the price at which the same securities were sold to the issuer. This initial analysis alone may indicate whether the securities were sold to the issuer at fair market value.

a) Interpreting Confirmation Statements and Financial Publication Data

It is important to understand how to properly compare data on the confirmation statement to data in a financial publication. For purposes of this article, we will discuss the form of the data as presented in the Wall Street Journal (WSJ).

Typically, the cost of a Treasury security is computed using the quantity and unit price reflected on the confirmation statement. Therefore, assume that the confirmation statements provide that an issuer purchased 79,649,000 units of an interest strip (a type of Treasury security) at a price of 69.54600 (representing a percentage) per unit. The cost of the Treasury security to the issuer is \$55,392,693.54 determined by multiplying the quantity by the price ($79,649,000 \times 69.54600\% = \$55,392,693.54$).

The selling price of many different types of Treasury securities is reported daily in the WSJ. To compare the selling price of the Treasury securities bought by the issuer to the selling price as reported in the WSJ, the particular securities sold must be first identified in the WSJ.

The escrow may consist of notes, bills, strips, a combination or other types of securities. The WSJ contains a legend to identify a particular security type. The maturity date of the Treasury security can be used to identify the particular security of that security type.

Once the Treasury security has been identified in the WSJ, the price associated with the security must be determined. The WSJ reports two prices for any particular security, a "bid" price and an "ask" price. The bid price is most useful because it reflects the actual price buyers were willing to pay for a security on the specified date.

WSJ prices are quoted in 32nds. To compare like data, the WSJ's price must be converted to a percentage as reported on the confirmation statement. A security with a WSJ price of 68.13 is restated as 68.40625 ($13/32$ equals .40625).

Now that the prices from the WSJ and the confirmation statements are similarly stated, a comparison can be made to determine whether the Treasury

security was sold to the escrow at a price higher than that being paid by buyers on the open market.

b) Requesting Additional Information

To determine whether the Treasury securities were sold at greater than fair market value, it is useful to have information in addition to the confirmation statements associated with the sale of the securities to the escrow. The examiner should also obtain the confirmation statements associated with the escrow provider's purchase of the Treasury securities. As indicated previously in this article, when trade dates are the same, a comparison of the price at which the escrow provider purchased and subsequently sold the securities can be the best evidence of inflated prices.

When determining the amount of profit an escrow provider earned in connection with the provision of the Treasury securities, it is necessary to determine the amount of any "accretion" associated with the particular securities. Accretion is the amount by which a security increases in value due to the accrual of interest. During the period beginning with the escrow provider's settlement date and ending with the issuer's settlement date, the security has increased in value to the benefit of the escrow provider. This will be the case in the instances where the settlement date of the escrow provider is earlier than the settlement date of the issuer. If the settlement dates are the same, there is no accretion.

For example, assume an escrow provider purchases a Treasury security on March 1 at a price of \$1,000 and settles the transaction on March 2. Also on March 1, the escrow provider sells the Treasury security to the issuer at a price of \$1,100 and the issuer's settlement date is March 22, 20 days after the escrow provider's settlement date. By March 22, the security accretes to a value of \$1,025.

Using the example above, the escrow provider typically asserts that the mark-up of the Treasury security is \$75, the difference between the selling price to the issuer of \$1,100 and the \$1,025 accreted value of the security on the sale date.

As was the case in the global settlement agreements, the Service treats the \$25 accretion earned by the escrow provider as additional mark-up. By simply holding the Treasury securities the escrow provider is not permitted to earn and keep the additional profits from the sale of the advance refunding escrow.

Generally, the escrow provider does not use its own funds to purchase the Treasury securities that are to be delivered to the issuer on the issue date of the advance refunding bonds. The escrow provider borrows funds (generally at the

federal fund rate) to purchase the Treasury securities. Even if the escrow provider uses its own moneys it incurs costs associated with carrying the Treasury securities between the date it purchases the securities and the settlement date with the issuer.

Usually, the escrow provider has records necessary to determine the amount of accretion earned between the sale date to the issuer and the issue date of the advance refunding bonds. Also, the escrow provider typically has records to determine the "carrying costs" incurred by the provider during the period of accretion. The Service's position is that while accretion should be included as part of the mark-up of Treasury securities, the escrow provider should be allowed to deduct carrying costs associated with carrying the Treasury securities prior to settlement date with the issuer.

Using the above example, the escrow provider was required to pay for the securities on March 2, however, the issuer did not pay the escrow provider until 20 days later on March 22. Assume during the 20-day carry period, the provider borrowed funds from a bank and paid \$20 in interest to the bank. The \$20 is the "carrying cost" for the Treasury securities. Thus the mark-up for the Treasury securities is as follows:

Price paid by escrow provider on March 2	\$1,000
Price paid by issuer on March 22	1,100
Accreted value of the security on March 22	1,025
Accretion on the security between 3/2 and 3/22	25
Cost of carrying to escrow provider	20

Total mark up to escrow provider is \$1,100 less \$1,000 less \$20 = \$80

In addition to requesting documentation necessary to determine any mark-ups on escrow securities, an examiner should request information regarding the environment surrounding the time the bonds were issued. As indicated previously in this article, issuers and/or escrow providers typically argue that Treasury securities are marked-up to account for the risk associated with providing such securities, such as the potential failure of the bonds to be issued. Therefore, as a part of the examination, evidence of the existence of any unusual circumstances existing at the time the bonds were issued should be requested. This information could be useful in determining an appropriate mark-up for the particular circumstance.

c) Determining Excessive Mark-Ups on Securities

Basis point mark-ups allowed under a global settlement agreement depend

upon the date the bonds were issued (see schedule of allowable mark-ups previously listed in this article) and range from 35 to 45 basis points. To determine whether mark-up is excessive, the basis point mark-up of the transaction under examination must be determined. One basis point is expressed as .0001. Ten basis points are expressed as .001, and so on.

To compute the number of basis points by which a Treasury security was marked-up, divide the mark-up expressed in terms of dollars by the escrow provider's total cost of the security.

Example:

Selling Price of the Security to the Escrow	\$ 55,600,000
Escrow Provider's Purchase Price	55,000,000
Accredited Value of Security	55,250,000
Cost of Carry	200,000

Mark-up expressed in Dollars	\$ 400,000*
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Mark-Up expressed in Dollars	\$ 400,000

Escrow Provider's Total Cost of the Security \$ 55,000,000 = .007272, or about 73 basis points.

* \$55,600,000 minus (\$55,000,000 + 200,000). The accretion on the Treasury securities (\$250,000) is not included in the computation.

d) Interpreting the Results of the Analysis

Once the necessary records have been analyzed and the existence of yield burning identified, the examiner must determine whether the mark-up is significantly large enough to jeopardize the tax-exempt status of the bonds. In the absence of any credible evidence of unusual risk associated with a particular bond transaction, any mark-up beyond that allowed under the terms of the global settlement agreements will be deemed excessive.

Suppose the Treasury security shown in the example above is the sole investment of the escrow. From the example, it can be determined that the escrow provider marked up the security 73 basis points. Also, assume the escrow provider paid fair market value for the Treasury security, therefore, as a result of the mark-up, the issuer paid greater than fair market value, thereby burning down the yield on the escrow. Further assume that if the provider had not marked up the

security, the yield on the escrow would have been greater than one-thousandth of one percent above the yield on the refunding bonds.

In this example, when using the fair market value of the Treasury security to determine the yield on the escrow, the result is that the escrow's yield violates the yield restriction rules. Based on these assumptions, the refunding bond, for which this escrow is a part, is an arbitrage bond.

e) Resolving Yield Burning Cases

In the event the examiner determines that the issuer paid more than fair market value for the Treasury securities, the issuer can resolve the potential taxability of the bond issue pursuant to a closing agreement. Typically, the Service offers settlement terms that are substantially the same as the global settlement agreements.

In the case of an examination of a particular bond issue, a closing agreement may be negotiated with the issuer (although the issuer may expect any payments due under the closing agreement to be paid by the escrow provider). In other instances, the examination may involve a particular escrow provider. In the latter case, the firm must identify all bonds for which it provided securities in connection with an advance refunding escrow.

6. Conclusion

Although the practice of yield burning has been substantially curtailed, the Service continues to identify the presence of this abuse in a number of advance refunding issues. An agent examining an advance refunding issue, even if issued after 1996, should always make an independent determination that the Treasury securities (if purchased by the issuer) were purchased by the issuer at fair market value. Since the issuance of the “three-bid rule” in 1998, issuers will generally take advantage of the safe harbor. The examiner should nevertheless scrutinize the bid requests and the bids carefully to determine that the bids were bonafide.