26 CFR 601.202: Closing agreements.
(Also Part I, §§ 103, 148, 7121.)

Rev. Proc. 96–41

SECTION 1. PURPOSE

This revenue procedure applies to an issuer of state or local bonds that has used the proceeds of state or local bonds sold prior to July 19, 1996, to pay more than fair market value for nonpurpose investments deposited into an advance refunding escrow. It provides a program under which an issuer may request a closing agreement pursuant to which the purchase of those investments alone will not be sufficient to cause §§ 103(b)(2) and 148 of the Internal Revenue Code to apply to those bonds.

SECTION 2. BACKGROUND

.01 Section 103(a) provides, in general, that gross income does not include interest on any state or local bond. Section 103(b)(2) provides, however, that this exclusion from gross income does not apply to arbitrage bonds.

.02 Section 148(a)(1) provides, in general, that bonds of an issue are arbitrage bonds if any portion of the proceeds of the issue is "reasonably expected" on the issue date of the issue to be used directly or indirectly to acquire higher yielding investments.

.03 Section 1.148–1(b) of the Income Tax Regulations provides 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. Section 1.148–1(b) also provides that factors relevant to a determination of reasonableness include the level of inquiry by the issuer into factual matters.

.04 Section 148(f) provides, in general, that bonds of an issue are arbitrage bonds unless the earnings from the investment of bond proceeds in excess of the yield on the issue are rebated to the United States. The rebate requirement of § 148(f) is generally not based on reasonable expectations.

.05 Section 1.148–6(c) provides that gross proceeds of an issue of bonds are not allocated to a payment for a nonpurpose investment in an amount greater than the fair market value of that investment on the purchase date. For this purpose only, the fair market value of a nonpurpose investment is adjusted to take into account qualified administrative costs allocable to that investment.

.06 Section 1.148–5(d)(6)(i) generally defines fair market value 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 generally is determined on the date on which a contract to purchase the nonpurpose investment becomes binding (that is, the trade date rather than the settlement date).

.07 Section 1.148–5(d)(6)(iii) provides that the purchase price of a guaranteed investment contract is treated as its fair market value on the purchase date if the issuer makes a bona fide solicitation for a guaranteed investment contract that meets the requirements of that section. The definition of guaranteed investment contract in § 1.148–1(b) generally does not include the purchase of investments for an escrow for an advance refunding transaction.

.08 Section 1.148–2(d)(2)(ii) defines "materially higher yield" for investments in an advance refunding escrow as 0.001 percent higher than the yield on the issue.

.09 An issuer cannot avoid the application of § 148 by giving away the prohibited arbitrage profit. *See* 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II–746 (1986), 1986–3 (Vol. 4) C.B. 746. The deflection of arbitrage through the purchase of investments at other than fair market value is prohibited. H.R. Rep. No. 426, 99th Cong., 1st Sess. 556 (1985), 1986–3 (Vol. 2) C.B. 556.

.10 Issuers of advance refunding bonds commonly enter into an agreement to purchase United States Treasury securities that are to be deposited into an escrow to pay the refunded prior issue of bonds. In most cases, an issuer enters into this investment purchase agreement on the same date it enters into an agreement to sell its advance refunding bonds. That date (the "sale date") is often several weeks before the issue date of the issue of bonds.

.11 In a typical tax-exempt advance refunding transaction, the obligation to purchase the Treasury securities is contingent on the issuance and sale of the advance refunding bonds, which in turn are commonly subject to contingencies that are standard in the municipal bond industry (such as the ability of bond counsel to render an unqualified opinion on the validity of the bonds).

.12 In general, a valuation method must take into account all pertinent information. A valuation method that singles out one economic factor and disregards other significant economic factors is erroneous. *See, e.g., Powers v. Commissioner*, 312 U.S. 259, 260 (1941), 1941–1 C.B. 448; *Guggenheim v. Rasquin*, 312 U.S. 254 (1941), 1941–1 C.B. 445; *Commissioner v. McCann*, 146 F.2d 385 (2d Cir. 1944).

.13 Certain state and local government issuers, and certain sellers of Treasury securities to state and local government issuers, of advance refunding bonds have used a valuation method that results in prices for those Treasury securities that exceed the fair market value of the securities. It has been asserted that the risk of nonsettlement justifies the inclusion of the cost of a hedge (such as a put option on Treasury securities) in the fair market value of the

Treasury securities to protect the seller against any increase in interest rates between the sale date (trade date) and the issue date (settlement date).

.14 In these transactions, a substantial mark-up of the price of Treasury securities for the risk of nonsettlement is inappropriate for two reasons. First, the risk of nonsettlement is remote. In addition, the seller of the Treasury securities is in a position to benefit if interest rates fall. This potential for benefit should reduce the weight given to the potential for loss if rates should rise. In general, nonsettlement is not more likely when interest rates rise than when they fall.

.15 In other cases, issuers have entered into agreements to purchase open market Treasury securities to be deposited into an escrow to pay the refunded prior issue of bonds. On the same date, issuers have subscribed to purchase United States Treasury securities—State and Local Government Series (“SLGS”) from the United States Department of the Treasury, Bureau of Public Debt to pay the same refunded prior issue of bonds. In effect, this arrangement provides a call option on the open market Treasury securities to the seller of those securities.

.16 In the case of simultaneous SLGS subscription and forward purchase contracts, the issuer and the seller of the open market Treasury securities agree on the sale date that, if the advance refunding bonds are issued and if interest rates decline between the sale date and the issue date of the advance refunding bonds so that the value of the nonpurpose investments increases, the issuer will purchase the SLGS. In this case, the seller will not be obligated to deliver the open market Treasury securities to the issuer. Alternatively, if the advance refunding bonds are issued and if interest rates remain the same or increase between the sale date and the issue date so that the value of the nonpurpose investments remains the same or decreases, the issuer will be obligated to purchase the open market Treasury securities. In this case, the seller will be obligated to deliver the open market Treasury securities to the issuer for deposit into the advance refunding escrow. In addition, the issuer will not purchase the SLGS. In such a case, by subscribing for the SLGS, the issuer in effect provides a call option on the open market Treasury securities to the seller of the open market Treasury securities. For purposes of the arbitrage rules, the fair market value of the open market Treasury securities under the agreement with the seller must accordingly be reduced by the value of this call option.

.17 Even if the issuer obtains certifications that the purchase price being paid for nonpurpose investments does not exceed the fair market value of those investments, an issue may nevertheless fail to meet the reasonable expectations standard of § 148(a). Further, in general, an agreement between unrelated persons about price does not presumptively establish fair market value in a situation where one party to the agreement lacks financial incentive to obtain the best price. *See Raymond v. Commissioner*, 114 F.2d 140 (7th Cir.), *cert. denied*, 311 U.S. 710 (1940).

.18 All the facts and circumstances are considered in the determination of whether the proceeds of the issue are to be invested at a materially higher yield. Factors strongly tending to establish that an issuer does not reasonably expect the proceeds of the issue to be invested at a materially higher yield are (1) the use of a bona fide bidding procedure to reasonably probe the market for the fair market value of nonpurpose investments and (2) reasonable due diligence by the issuer to review the method used to determine the fair market value of Treasury securities. One important factor tending to establish that a bidding procedure is bona fide is that it is conducted by a person that does not have a material financial interest in the transaction (for example, as the seller of Treasury securities to the issuer).

.19 Some issuers have obtained Treasury securities for an advance refunding escrow by using procedures that generally are designed to conform to the safe harbor for guaranteed investments contracts in § 1.148–5(d)(6)(iii). Although that safe harbor does not expressly apply to the purchase of Treasury securities for an advance refunding escrow, the Internal Revenue Service will apply the principles underlying that safe harbor to the purchase of those nonpurpose investments. Absent extraordinary circumstances, a bona fide bidding procedure consistent with the principles of the safe harbor for guaranteed investments contracts is rebuttably presumed to establish fair market value for transactions to which this revenue procedure is applicable, even in cases where the forward price paid for Treasury securities is greater than the spot price of those Treasury securities. Other procedures may also establish fair market value.

.20 If promulgated as a final regulation, § 1.148–5(d)(6)(v) of the proposed Income Tax Regulations, published in the Federal Register on June 27, 1996 (61 Fed. Reg. 33405), would provide a rebuttable presumption for establishing fair market value for Treasury securities purchased other than directly from the United States Treasury for those transactions described in the regulation.

SECTION 3. DESCRIPTION OF THE CLOSING AGREEMENT PROGRAM FOR ADVANCE REFUNDING ESCROWS

.01 Under the program established by this revenue procedure, the Service will enter into closing agreements with the issuers of bonds. These closing agreements will resolve the effect of the payment of more than fair market value for the nonpurpose investments for yield restriction and rebate purposes under § 148. The closing agreements will not resolve any other matters.

.02 The closing agreements will provide that, for purposes of § 148, the amount paid by the issuer for the Treasury securities deposited into an advance refunding escrow will be treated as the fair market value for those nonpurpose investments. For purposes of computing rebate under § 148(f), the closing agreement amount will not be treated as a rebate payment.

.03 This program is a compliance program but is not based upon an examination of an issue of bonds by the Service.

.04 Because this program does not arise out of an examination, consideration under this program does not preclude or impede an examination of the issuer, the bondholders, or the issue of bonds by the Service with respect to matters not addressed in the closing agreement.

.05 The intent underlying this program is to treat expeditiously all requests for closing agreements which are submitted in accordance with sections 5 and 6 of this revenue procedure. Accordingly, negotiations with the issuers on the basis of mitigating circumstances of individual cases will not be entertained under the terms of this revenue procedure.

SECTION 4. SCOPE

.01 This revenue procedure applies to any issue of advance refunding bonds which was sold prior to July 19, 1996, and issued prior to August 19, 1996, and the proceeds of which were used to purchase nonpurpose investments pursuant to an agreement that is substantially similar to an agreement to purchase described in sections 2.13 or 2.15 of this revenue procedure.

.02 An issue of bonds that is under an examination by the Service is not eligible for the program. An issue of bonds is under examination if the issuer of the bonds has been contacted in any manner by the Service for the purpose of scheduling any type of examination of that issue of bonds. For issuers that do not avail themselves of a closing agreement under this revenue procedure, the Service will treat the purchase of nonpurpose investments with the proceeds of an issue of bonds as being subject to the usual procedures governing tax consequences. The result upon any examination by the Service of the issue of bonds could be different from the terms of this revenue procedure, depending on the merits of the issuer's position.

.03 For purposes of this revenue procedure, ''issuer'' means only the entity that actually issues the bonds and not a conduit borrower of the issue.

SECTION 5. PROCEDURE

.01 The issuer seeking relief must request a closing agreement within 1 year from July 19, 1996, following the procedures in this revenue procedure.

.02 The issuer must request a closing agreement using Form 10001, which is shown as an exhibit at the end of this revenue procedure.

.03 The closing agreement will be prepared by the Service and, in general, will be in substantially the same form as the model closing agreement set forth in Announcement 95–61, Exhibit (7)(10)-(15)0–6, 1995–32 I.R.B. 54, 74, or any successor of Announcement 95–61.

.04 As a condition to executing a closing agreement under this procedure, the issuer must agree to pay, simultaneously with the execution by the issuer of the closing agreement, the closing agreement amount computed under section 6 of this revenue procedure.

.05 The Service will not challenge whether an issuer paid more than fair market value for Treasury securities that are purchased other than directly from the United States Treasury and deposited into an advance refunding escrow in a transaction described in section 2.13 of this revenue procedure if:

(1) The amount paid for the Treasury securities does not exceed the spot price as described in section 6.02 of this revenue procedure;

(2) The period between the sale date and the issue date of the issue of bonds was not greater than 1 month; and

(3) The Treasury securities are purchased prior to July 19, 1996.

SECTION 6. CLOSING AGREEMENT AMOUNT

.01 The closing agreement amount is equal to:

(1) The excess of the amount paid by the issuer for the nonpurpose investments deposited in the advance refunding escrow over the spot price (as described in section 6.02 of this revenue procedure) of those nonpurpose investments (this excess is referred to as the ''differential amount''); plus

(2) Interest on the differential amount from the issue date of the bonds to the date of payment at an interest rate equal to the yield on the issue of bonds.

.02 The spot price is the noncontingent price on the trade date of a nonpurpose investment for delivery on the next business day after the trade date.

.03 In the case of an agreement to purchase Treasury securities described in section 2.15 of this revenue procedure, the differential amount must include the value of a call option on an equivalent portfolio of Treasury securities for the period from the sale date to the issue date of the advance refunding bonds at a strike price for the portfolio equal to the price established in the agreement.

.04 Use of the spot price as the basis for the settlement amount under this revenue procedure is for the administrative convenience of state and local government issuers and the Service and does not reflect a view by the Service that the spot price closely reflects the fair market value in all cases of a contingent forward price for the portfolio. For example, in many cases, use of the noncontingent forward price for Treasury securities may be a more accurate basis for determining the fair market value of the contingent forward price.

.05 Use of the spot price of the nonpurpose investments is not permitted if the period between the sale date and the issue date of the issue of bonds was greater than 1 month.

SECTION 7. INQUIRIES

Inquiries in regard to this revenue procedure should be directed to:

Internal Revenue Service
CP:E:EO:T:4 Room 6236
1111 Constitution Ave. NW
Washington, D.C. 20224

SECTION 8. EFFECTIVE DATE

This revenue procedure is effective July 19, 1996, and applies to state or local bonds described in section 4.01 of this revenue procedure.

DRAFTING INFORMATION

The principal author of this revenue procedure is Loretta J. Finger of the Office of Assistant Chief Counsel (Financial Institutions and Products). For further information regarding this revenue procedure contact Loretta J. Finger on (202) 622–3980 (not a toll-free call).

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26 CFR 601.602: Forms and instructions.
(Also Part I, Sections 408, 6041, 6041A, 6042, 6043, 6044, 6045, 6047, 6049, 6050A, 6050B, 6050D, 6050E, 6050H, 6050J, 6050N, 6050P; 1.408–5, 1.408–7, 1.6041–1, 7.6041–1, 1.6042–2, 1.6042–4, 1.6044–2, 1.6044–5, 1.6045–1, 5f.6045–1, 1.6045–2, 1.6045–4, 1.6047–1, 1.6049–4, 1.6049–6, 1.6049–7, 1.6050A–1, 1.6050B–1, 1.6050D–1, 1.6050E–1, 1.6050H–1, 1.6050H–2, 1.6050J–1T, 1.6050N–1, 1.6050P–1)