

**THE SLGS COMPLIANCE INITIATIVE:  
A CORRESPONDENCE EXAMINATION INITIATIVE OF  
ADVANCE REFUNDING BONDS**

**By  
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1. Introduction

For the past several years, the Tax Exempt Bonds (TEB) office of the Internal Revenue Service has been engaged in an on-going effort to identify and resolve possible violations of the yield restriction and arbitrage rebate requirements under section 148 of the Code. As part of this effort, TEB launched a compliance initiative examining the use of United States Treasury State and Local Government Series (SLGS) securities in the funding of escrows established in connection with the issuance of tax-exempt advance refunding bonds as well as their general effect on the escrows' overall compliance with the tax law requirements of section 148. Thus far, the Initiative has been conducted through correspondence examinations.

2. Purpose of the Initiative

The purpose of the SLGS Initiative is to test whether refunding escrows that are initially fully funded with SLGS securities are significantly less likely to violate the yield restriction rules of section 148 than refunding escrows that are initially funded with open market securities.

3. The Yield Restriction Rules

The tax-exempt status of every municipal bond begins with section 103(a), which states that, except as provided in subsection (b), gross income does not include interest on any State or local bond. Subsection (b)(2) provides that a municipal bond will not be entitled to the economic benefits provided under subsection (a) if it is an arbitrage bond within the meaning of section 148. Section 148(a) defines an arbitrage bond as follows:

For purposes of section 103, the term "arbitrage bond" means any bond issued as part of an issue any portion of the proceeds of which are reasonably expected (at the time of issuance of the bonds) to be used directly or indirectly – (1) to acquire higher yielding investments, or (2) to replace funds which were used directly or indirectly to acquire higher yielding investments.

The term “higher yielding investments” is defined generally in section 148(b)(1) as any investment property which produces a yield over the term of the issue which is materially higher than the yield on the issue. Treas. Reg. section 1.148-2(d)(1) provides in part that:

The yield on investments is materially higher than the yield on the issue to which the investments are allocated if the yield on the investments over the term of the issue exceeds the yield on the issue by an amount in excess of the applicable definition of materially higher set forth in paragraph (d)(2) of this section.

Section 1.148-2(d)(2)(ii) provides that, with respect to refunding escrows, the term materially higher means one-thousandth of one percentage point. Thus, with respect to a refunding escrow, the yield restriction rules of section 148 generally require that the proceeds of an issue cannot be invested, directly or indirectly, into investments earning a yield more than one-thousandth of one percentage point greater than the yield on the issue. Noncompliance with these rules may result in the bonds being declared arbitrage bonds, which in turn, jeopardizes their tax-exempt status under section 103(a).

This basic regulatory framework for restricting the yield of investments acquired with the proceeds of tax-exempt bonds, combined with the arbitrage rebate requirements, serves to limit the Treasury’s overall loss of revenue by mitigating the incentive of issuers to invest, in whole or in part, the proceeds of bonds issued at tax-exempt interest rates in securities earning yields at taxable interest rates.

#### 4. SLGS Securities

The United States Treasury established the State and Local Government Series (SLGS) securities program in 1972 within the Bureau of the Public Debt in order to facilitate the overall compliance of state and local government issuers with the yield restriction and arbitrage rebate rules of section 148. This purpose is illustrated in 31 CFR Sec. 344.0(a) which generally provides that SLGS securities are offered:

In order to provide issuers of tax-exempt securities with investments from any amounts that constitute gross proceeds of an issue or any other amounts which assist an issuer of tax-exempt bonds in complying with applicable provisions of the Internal Revenue Code relating to such tax exemption.

SLGS securities, which are issued in book-entry form and are non-marketable, are generally offered for sale to issuers of tax-exempt bonds at interest rates and maturities specified by the issuer. With respect to time deposit securities, 31 CFR Sec. 344.2(b) provides in part that each security shall bear such rate of interest the government issuer designates, but the rate shall not exceed the maximum interest rate. Maximum interest rates for specified lengths of maturity are set at five basis points below the then current estimated Treasury borrowing rate for a Treasury security of comparable maturity. These interest rate caps are published by 10:00 AM EST each business day by the Bureau of Public Debt and can be obtained on-line from the Bureau's website. Time deposit SLGS securities are also offered at zero interest.

The flexibility of the SLGS securities program provides issuers with an opportunity to structure their advance refunding escrows to achieve maximum efficiency while ensuring that investments acquired with bond proceeds do not earn a materially higher yield. In other words, SLGS can be used to ensure that the advance refunding bonds do not run afoul of the yield restriction rules of section 148 and, consequently, result in being declared arbitrage bonds. This can be accomplished either through fully funding the refunding escrow with SLGS earning yields at a level permissible under the yield restriction rules or through blending down the escrow's yield by rolling open market securities into zero interest SLGS.

##### 5. Assumptions Prompting the SLGS Initiative

The SLGS Initiative was developed based upon a set of assumptions with respect to the tax law requirements under section 148, industry practices in structuring advance refunding escrows identified through TEB examination efforts, and the parameters of the SLGS securities program. These assumptions are set forth as follows.

- First, section 148 requires that the yield on investments held in a refunding escrow cannot exceed the yield on the advance refunding bond issue, over the term of the issue, by more than one-thousandth of one percentage point.
- Second, refunding escrows are often funded, at least initially, in taxable open market Treasury securities earning yields higher than the yield of the tax-exempt advance refunding bond issue.
- Third, maintenance of the one-thousandth of one percentage point spread permissible under Treas. Reg. section 1.148-2(d)(2)(ii) for refunding escrows generally requires rolling all or part of the open market securities

held in the escrow into zero interest SLGS securities in order to blend down its yield.

- Fourth, trustees can often fail to timely roll over the open market securities as required in the Indenture.
- Fifth, given the changing interest rate environment, tax-exempt advance refunding bonds issued during certain periods of time are more likely to require rollovers into zero interest SLGS.
- Sixth, refunding escrows that are initially fully funded with SLGS will not violate the yield restriction rules of section 148.

## 6. Methodology

The methodology used to conduct the SLGS Initiative was developed consistent with the use of correspondence examinations. The sample of advance refunding bond issues used for the study was created following an analysis of the interest rate trends of open market securities. Through this research, it was determined that refunding escrows of tax-exempt advance refunding bonds issued during calendar years 1989 and 1990, as well as from June 1993 through July 1994, would most likely require rollovers into zero interest SLGS to maintain compliance with the requirements of section 148. For the purposes of the Initiative, calendar years 1989 and 1990 were selected for study.

By accessing the IRS Return Inventory Classification System (RICS), listings of tax-exempt advance refunding bonds issued during 1989 and 1990 were secured. From these lists, advance refunding bond issues that refunded more than \$1,000,000 in bonds prior to 2001 were identified. From this universe, 51 Form 8038-Gs filed by issuers throughout the nation were selected for inclusion in the SLGS Initiative.

Initial letters were sent to the issuers of the selected forms advising them that the identified bond issue was selected for examination. The letter described the project, explained the examination process, and requested copies of various documents including the Form 8038-G, official statement, escrow agreement, and verification report. Information was also requested regarding any purchases of zero interest SLGS securities, escrow restructuring, and redemption of the refunded bonds. The revised version of the initial letter expanded the information request to include verification of all purchases of securities acquired to fund the refunding escrow (e.g. open market securities, interest bearing SLGS, and zero interest SLGS). A sample of this letter follows this article.

## 7. Findings

Of the fifty-one advance refunding bond issues selected for study under the Initiative, forty-four of the refunding escrows (86%) were fully funded with SLGS securities, either all interest bearing or a combination of zero interest and interest bearing SLGS. Of these, a couple of the escrows even required that the earnings from the interest bearing SLGS be invested into zero interest SLGS. A few of these forty-four exams remain open pending verification of SLGS purchases.

The refunding escrows of the remaining seven advance refunding bond issues (14%) were invested in open market securities. Of these seven, several incidents of yield burning involving different escrow providers occurred. The following describes some of these findings:

- Multiple bond issues were part of either the Global Yield Burning Settlement or a separate court settlement with respect to yield burning practices. The refunding escrows of these issues were either restructured using SLGS or the investments therein were rolled over into zero SLGS in order to blend down the escrows' respective yields.
- With respect to the bond issues not included in the Global Yield Burning Settlement, tentative determinations have been made that the refunding escrows were funded with open market securities priced with mark-ups ranging from de minimis amounts up to approximately 100 basis points. These initial findings are based upon Wall Street Journal quotations and purchase confirmation slips.

## 8. Early Conclusions from the Initiative

The findings of the Initiative are consistent with the assumption that refunding escrows fully funded with SLGS securities have a very low probability of violating the yield restriction rules under section 148. Moreover, the findings have shown that a significantly high percentage of refunding escrows are fully funded with SLGS. Thus, the Initiative suggests that it would not be an effective use of resources to include advance refunding bond issues with escrows funded with SLGS securities in future examination efforts focused on compliance with the requirements of section 148. Excluding such issues from future examination samples would also be consistent with TEB's goal of minimizing the burden placed upon issuers of bond issues under examination to the greatest extent possible without compromising the exam's effectiveness.

Additional findings of the Initiative support TEB's concern that the structuring of refunding escrows with open market securities has a significant

chance of resulting in the advance refunding bond issue's noncompliance with the requirements of section 148. While such noncompliance could result from either excessive mark-ups on the sales of open market securities or the failure, inadvertent or otherwise, of a trustee to roll open market securities into zero interest SLGS, there is currently insufficient data to reach any final conclusions. However, it is apparent from the Initiative that this area warrants continued study through future examination efforts.

#### 9. Future Direction of the Initiative

The results of the SLGS Initiative suggest that the most effective way to continue this effort is to limit examinations of advance refunding bond issues to those with escrows invested in open market securities. Thus, in selecting examination samples of future compliance initiatives in this area, TEB will strive to identify and exclude issues with refunding escrows fully funded with SLGS securities.

To achieve this aim, Outreach, Planning & Review (OPR) staff will continue to partner with the Division of Special Investments at the Bureau of Public Debt to identify SLGS subscriptions placed by issuers that closely match the issue price of tax-exempt advance refunding bonds. This will allow the methodology of future compliance initiatives in this area to include the elimination of advance refunding issues with escrows fully funded with SLGS from the lists of advance refunding bond issues developed through RICS. TEB will also eliminate those issues that are identified as having been included in yield burning related closing agreements.

#### 10. Conclusion

Through the SLGS Initiative, TEB has been able to largely confirm its assumption that the escrows of advance refunding bond issues that are initially fully funded with SLGS securities have a low probability of violating the yield restriction and arbitrage rebate requirements of section 148 of the Code. However, while further study is needed, it is apparent that those escrows funded, in whole or in part, with open market securities do indeed pose a significant probability of noncompliance with applicable tax law requirements. Thus, while slugs themselves may not be the most attractive of creatures, SLGS can be a very attractive investment for issuers of tax-exempt advance refunding bonds looking to ensure their continued compliance with section 148 of the Code.



TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

Date:

Person to Contact:

**(SLGS Initiative)**  
**(Sample Initial Contact and Information Request Letter)**

Badge No.  
Contact Address:  
Internal Revenue Service  
TEB 722X

Contact Telephone No.:  
(000) 000-0000  
FAX No.  
(000) 000-0000

EIN: 00-0000000 Form 8038-G

Re: \$  
Report No.: , Date of Issue: , CUSIP No.:

Dear Sir or Madame:

We have selected the debt issuance named above for examination. The IRS routinely examines municipal debt issuances to determine compliance with Federal tax requirements. Your debt issuance was selected for examination as part of a project initiative involving advance refunding bonds. The primary purpose of this examination will be to ascertain the compliance of your debt issuance with the Federal tax requirements applicable to advance refunding bonds. At this time, we have no reason to believe that your debt issuance fails to comply with any of the applicable tax requirements.

The focus of our project is to measure compliance with the restrictions placed on refunding escrows of advance refunding issues. The yield on refunding escrow investments cannot be more than one-thousandth (.001) of one percentage point higher than the yield on the refunding issue.

Certain advance refunding bond issues may require that their escrow funds earn no interest for a specified period to insure that the spread between the escrow fund yield and the bond yield stays within the limits required by law. This is generally accomplished by investing the escrow account in zero-interest United States Treasury Securities - State and Local Government Series (SLGS).

The examination will be conducted through correspondence. A correspondence examination is generally limited in scope and is the recommended technique when the information required to resolve the apparent issues on a return can be readily furnished by mail and when it appears that the organization can effectively communicate by mail.

In the event the issues under examination cannot be resolved by the correspondence technique, the examination may be converted to a field examination and conducted at your office.

As always, we reserve the right to expand this examination to any aspect of your debt issuance.

If you decide to appoint a representative to act on your behalf, a power of attorney must be filed with the Service in order for the Service to discuss or provide your representative with confidential information. A Form 2848, Power of Attorney and Declaration of Representative, or any other properly written power of attorney or authorization may be used for this purpose. Copies of Form 2848 may be obtained from any Internal Revenue Service Office.

Please provide the following documents and information related to the above named bond issue within 30 days from the date of this letter.

1. A copy of the Form 8038-G;
2. A copy of the Official Statement;
3. A copy of the Escrow Agreement;
4. A copy of the Verification Report;
5. Copies of all documents related to the purchase of the Refunding Escrow Securities;

A. In the event Open Market Securities were purchased:

Copies of dealer confirmation slips, (buy slips), for all Escrow Securities sold to you, showing the prices you paid.

B. In the event United States Treasury, State and Local Government Series (SLGS) Securities were purchased for the Refunding Escrow, investment of earned interest, or rollover of Open Market Securities:

Copies of all subscription forms and related documents.

C. Verification of SLGS Securities' purchase, e.g.:

1. Copies of SLGS Securities Subscriptions showing Federal Reserve Bank received stamps;
2. Copies of Bureau of Public Debt Statement of Account, State and Local Govt. Book Entry Securities Maintained by the Dept of the Treasury; or,
3. Copies of Statements of the Trustee Bank such as, Schedules of Transactions showing the purchase of US Treasury SLGS or Schedules of Principal Assets showing the US Treasury SLGS held, etc.

D. An explanation in the event an intended purchase of SLGS did not take place.



6. Verification of the date the refunded bonds were redeemed or an explanation why the bonds were not called in accordance with information shown on Form 8038-G; and,
7. If the Refunding Escrow Fund was subsequently restructured, please provide a full explanation and the relevant information requested above in A, B, C & D.

Send all correspondence and requested information to:

**Internal Revenue Service  
TEB Group No. & Mail Code  
Street Address.  
City, State & Zip Code**

If more than 30 days are required to prepare and submit your responses please call me at (000) 000-0000 so that we may discuss an extension of the time for submitting the requested information and documents.

Thank you for your cooperation in this matter and please feel free to call or write if you have any questions or concerns about this matter.

Sincerely yours,

Internal Revenue Agent

Enclosure: Publication 1