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

OFFICE OF
CHIEF COUNSEL

August 14, 2001

Number: **200209003**
Release Date: 3/1/2002
CC:TEGE:EOEG:TEB/TL-N-878-01
UILC: 148.00-00, 148.12-02

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR AREA COUNSEL (NORTHEAST & MIDATLANTIC AREA)

FROM: Rebecca L. Harrigal
Branch Chief, CC:TEGE:EOEG:TEB

SUBJECT: Arbitrage on Advance Refunding Tax-Exempt Bonds

This Chief Counsel Advice responds to your memorandum dated May 11, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Authority =

Escrow Agent =

Financial Advisor =

Provider A =

Provider B =

Series A Bonds =

Series B Bonds =

Series C Bonds =

Refunded Series A Bonds =

Refunded Series C Bonds =

Date 1 =

Date 2 =

Date 3 =

Date 4	=
Date 5	=
Date 6	=
Year 1	=
Year 2	=
G%	=
$H	=
$J	=
$K	=
$L	=
$M	=
$N	=
$P	=
$Q	=
$R	=
$S	=
$T	=
$U	=
$V	=
$W	=
$X	=
$Y	=
$Z	=

ISSUES

1. Whether payments to Provider A may be taken into account when calculating the yield on the yield restricted defeasance escrows.

2. Whether the Authority paid Provider B more than fair market value for the investments it purchased for the yield restricted defeasance escrows.

CONCLUSIONS

The Authority took the payments it made to Provider A into account in computing yield either because it treated the rights it acquired through those payments as options married to the escrow securities or because it treated the agreements which funded the escrows as guaranteed investment contracts ("GICs"). First, we have doubts about whether the rights acquired with the payment to Provider A should be treated as options. Second, we have doubts about whether the agreements to purchase Treasury securities for deposit to the yield restricted defeasance escrow are GICs. Alternatively, the Authority might argue that the payments to Provider A acquired investments, in themselves. Based on the facts provided, we cannot opine whether those "investments" were acquired at fair market value, and whether the payments and receipts for those "investments" were properly taken into account in determining the yield on the escrows. Further development is needed before we can provide an opinion on the second issue.

FACTS

The Authority issued the Series A, Series B, and Series C Bonds (collectively, the "New Bonds") on Date 1. The New Bonds have a yield of G%. The Series A and B Bonds (collectively, the " Refunding Bonds") have a final maturity date in Year 2 and are subject to optional redemption after Date 2.

The Series A Bonds were issued in the amount of $H, and the proceeds (minus certain issuance costs) were placed in an escrow account ("Escrow A"), the stated purpose of which is to defease the Refunded Series A Bonds. The Series C Bonds were issued in the amount of $J, and the proceeds (minus certain issuance costs) were placed in a separate escrow account ("Escrow C"), the stated purpose of which is to defease the Refunded Series C Bonds. The amounts needed to pay debt service on the Refunded Series A and the Refunded Series C Bonds (collectively, the "Prior Bonds") are the Escrow A Requirements and the Escrow C Requirements, respectively.

The official statement for the New Bonds provides that the proceeds of the Series A Bonds and the Series C Bonds will be deposited in an escrow for each prior bond issue with the Escrow Agent and will be used to acquire obligations of the U.S. Treasury sufficient to pay debt service on each prior bond issue and, on Date 3, to call each prior bond issue. The money in each escrow was invested as described below.

Bid Solicitation and Acceptance

On Date 4, ten days prior to Date 1, the Financial Advisor sent out a single bid solicitation to six prospective providers for bids for investments for each escrow account. Bids were due by a specified time on Date 5, one week prior to Date 1.

The bid solicitation contained a model contract. The bid solicitation was to result in two separate contracts, one for each escrow account. The amounts to be paid for the contracts were fixed. The bid solicitation for Escrow A provided that the Authority would pay $K (an amount equal to the sum of the Escrow A Requirements as of Date 1) to the winning bidder for the Escrow A contract, and the winning bidder would pay to the Authority the difference between $K and the present value of $K, using a present value factor of G%. Similarly, the bid solicitation for Escrow C provided that the Authority would pay $L (the sum of the Escrow C Requirements as of Date 1) to the winning bidder for the Escrow C contract, and the winning bidder would pay to the Authority the difference between $L and the present value of $L, using the same present value factor. Also, each winning bidder was required to pay the Financial Advisor $M per contract. The documents do not indicate whether these fees paid for more than brokerage services.

The bid solicitation provides that each contract would be awarded to the bidder with the earliest Effective Date for that contract. The Effective Date is the earliest date upon which the Authority may sell a portion of the escrow securities. This right is described in greater detail below. The bid solicitation provides that the Authority would select the securities to be sold if it exercises this right.

The Financial Advisor received four bids for each contract, and Provider A was awarded both contracts. The time stamp from the fax machine suggests that Provider A's bid may have been received after the time the bids were due. None of the other bid forms indicate what time they may have been received.

Provider A had the second earliest Effective Dates, Date 6. The bids with the earliest Effective Dates were rejected because the bidder wanted to add additional terms. One of the other bidders (with Effective Dates later than those of Provider A) also changed terms on the bid form.

The bid solicitation also provides that the winning bidder will be entitled to any excess amounts in the escrows. This provision is not in the model contract.

Escrow A

The Authority established Escrow A by entering into an escrow agreement with the Escrow Agent on Date 1. The escrow was established for the benefit of the holders of the Refunded Series A Bonds, and any excess funds after all payments of principal and interest on those bonds will be transferred to the trustee of the Series A Bonds to be applied to debt service on the Series A Bonds.[1]

On Date 1, the Authority and the Escrow Agent entered into a "Forward Supply Agreement" with Provider A and another party, Provider B. Provider A split its rights and obligations under the contracts with Provider B because Provider A did not have a bankruptcy proof subsidiary that could serve as the provider of the securities. We do not have any documents that show how the amount paid to each Provider was determined.

Pursuant to the Forward Supply Agreement, Provider B provided a portfolio of United States government obligations (the "Escrow A Securities") on Date 1. This portfolio was structured to provide payments in such amounts and at such times sufficient to satisfy the Escrow A Requirements. While labeled a Forward Supply Agreement, it appears that the agreement did not require any securities to be provided in the future.

Some of the Escrow A Securities will pay principal and/or interest before the date that debt service payments on the Refunded Series A Bonds are required to be paid. The Forward Supply Agreement provides that Provider B has the right to replace securities in the escrow with other securities maturing up to the day before the debt service payment dates (the "Escrow A Float") provided that the securities pay at a time and in an amount sufficient to meet the debt service requirements.

The Forward Supply Agreement also permits the Authority, after Date 6 (the Effective Date), to sell a portion of the Escrow A Securities (the "Sale Right"). The Authority may exercise this right if it has eliminated the Escrow A Requirements that were to be met with the securities to be sold. The Authority may use the Sale Right to sell the securities otherwise needed for up to 50% of the Escrow A Requirements (as of Date 1). The Forward Supply Agreement describes this right as an "option." The particular securities to be sold will be chosen by Provider A.

If the Authority exercises the Sale Right, the Escrow Agent will solicit bids for the Escrow A Securities to be sold from at least three dealers (one of whom must be either a particular affiliate of Provider A or someone chosen by Provider A) and sell the securities to the highest bidder. If the Escrow Agent receives less than the Guaranteed Amount for the securities, Provider A must pay the Escrow Agent the difference between the Guaranteed Amount and the amount received. If the Escrow Agent receives more than the Guaranteed Amount for the securities, the Escrow Agent must pay Provider A the excess. The Guaranteed Amount is the present value of the debt service on the Refunded Series A Bonds no longer required to be serviced by Escrow A, using a discount factor of G%.

---

[1]This provision appears to be inconsistent with the bid solicitation which stated that excess funds in the escrow would go to the winning bidder.

The escrow agreement provides that any amounts received from the Escrow A Securities that are not needed at the time of receipt for payments on the Refunded Series A Bonds shall remain in trust for the owners of the Refunded Series A Bonds, and pending application of the payment of principal or interest on the Refunded Series A Bonds, shall be (i) invested in U.S. Treasury obligations having a yield not in excess of 0%, (ii) held uninvested, or (iii) reinvested pursuant to the terms of the Forward Supply Agreement.

The purchase price for the Escrow A Securities was $K. Provider B paid a provider fee of $N for the right to engage in this transaction. Thus, the net amount paid to Provider B was $P. Provider A received $Q for the Sale Right. The Authority calculated the yield on the Escrow A to be G%.

On the day the bids for the Forward Supply Agreements were accepted (Date 5), the aggregate price of the Escrow A Securities, according to the closing prices in the following day's Wall Street Journal, was $R. The difference between the net amount paid to Provider B and the value of the Escrow A Securities on Date 5 according to the Wall Street Journal is $S.

Escrow A Yield Calculation

An independent accountant prepared a report that verifies the yield on the Escrow A investments is equal to the yield on the New Bonds, G% (the "Escrow A Verification Report"). The Escrow A Verification Report assumes that the cost of the investments was $T, an amount equal to the net amount paid to Provider B, plus the amount paid to Provider A (these amounts include the Financial Advisor fee), plus the small amount of cash remaining in Escrow A at the end of Date 1. This report used the dates and amounts of the Escrow A Requirements to be paid out of Escrow A as the receipts from the investments for the purpose of calculating the yield.

Escrow C

Escrow C is structured similarly to Escrow A. The Authority established Escrow C by entering into an escrow agreement with the Escrow Agent on Date 1. The Authority and the Escrow Agent also entered into a "Forward Supply Agreement" with Provider A and Provider B for investments for Escrow C. This agreement is similar to the Forward Supply Agreement for Escrow A.

The purchase price for the Escrow C Securities was $L. Provider B paid a provider fee of $U for the right to engage in this transaction. Thus, the net amount paid to Provider B was $V. Provider A received $W. The Authority computed the yield on the Escrow C to be G%.

On the day the bids for the Forward Supply Agreements were accepted (Date 5), the aggregate price of the Escrow C Securities, according to the Wall Street Journal, was $X, which is $Y less than the net amount paid to Provider B.

Escrow C Yield Calculation

The same independent accountant prepared a report that verified the yield on the Escrow C investments is equal to the yield on the New Bonds, G% (the “Escrow C Verification Report”). The Escrow C Verification Report assumes that the cost of the investments was $Z, an amount equal to the net amount paid to Provider B, plus the amount paid to Provider A (these amounts include the Financial Advisor fee), plus the small amount of cash remaining in Escrow C at the end of Date 1. In a manner similar to the Escrow A Verification Report, it appears that the Escrow C Verification Report used the dates and amounts of the Escrow C Requirements to be paid out of Escrow C as the receipts from the investments.

LAW

Generally, under § 103(a), gross income does not include interest on any state or local bond. Interest on a state or local bond is not excluded from gross income if the bond is an arbitrage bond within the meaning of § 148.

Under § 148(a), an arbitrage bond is 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 bond) to be used directly or indirectly to acquire higher yielding investments, or to replace funds which were used directly or indirectly to acquire higher yielding investments. Section 148(a) also provides that a bond is an arbitrage bond if the issuer intentionally uses any portion of the proceeds to directly or indirectly acquire higher yielding investments or to replace funds used in such manner.

Proceeds subject to the arbitrage rules include any sale proceeds, investment proceeds, and transferred proceeds of an issue. § 1.148-1(b). Amounts cease to be treated as proceeds under § 148 when they are allocated to an expenditure for a governmental purpose. § 1.148-6(b)(1).

Section 148(b)(1) provides that a “higher yielding investment” is “any investment property which produces a yield over the term of the issue which is materially higher than the yield on the issue.” Section 1.148-2(d)(2)(ii) provides that for investments in a refunding escrow, materially higher means one-thousandth of one percentage point.

Section 1.148-1(b) defines refunding escrow to mean one or more funds established as part of a single transaction or a series of related transactions, containing proceeds of a refunding issue and any other amounts to provide for payment of principal or interest on one or more prior bonds.

Section 1.148-5(b)(2)(iv) provides that for all purposes of § 148, in computing the yield on yield restricted investments allocable to proceeds of a refunding issue that are held in one or more refunding escrows, the individual investments are treated as a single investment, having a single yield, whether or not held concurrently.

Section 1.148-5 provides the rules for calculating yield and valuing investments. Section 1.148-5(b)(1) provides that the yield on a fixed rate investment is equal to the discount rate that produces a present value of all unconditionally payable receipts on the investment equal to the present value of all unconditionally payable payments for the investment. For this purpose, payments means amounts to be actually or constructively paid to acquire the investment, and receipts means amounts to be actually or constructively received from the investment, such as earnings and return of principal. Section 1.148-5(b)(1) also provides that the yield on a variable rate investment is determined in a manner comparable to the determination of the yield on a variable rate issue. Section 1.148-4(c) describes how to calculate the yield on a variable rate issue.

Section 1.148-6(c) provides that gross proceeds are not allocated to a payment for a nonpurpose investment to the extent that the payment exceeds the fair market value of the investment as of the purchase date. For this purpose, the fair market value of a nonpurpose investment is adjusted to take into account qualified administrative costs allocable to the investment.

Section 1.148-5(d)(6)(i) provides that, in general, the fair market value of an investment is the price at which a willing buyer would purchase the investment from a willing seller in a bona fide, arm’s length transaction. This regulation further provides that generally, an investment that is not of a type traded on an established securities market is rebuttably presumed to be purchased for a price that is not equal to its fair market value.

Prior § 1.148-5(d)(6)(iii), which applies to the New Bonds, provided a safe harbor for establishing fair market value for GICs if the following rules were followed:

> (A) The issuer makes a bona fide solicitation for a specified GIC and receives at least three bona fide bids from providers that have no material financial interest in the issue (e.g., as underwriters or brokers);
>
> (B) The issuer purchases the highest-yielding GIC for which a qualifying bid is made (determined net of broker's fees);
>
> (C) The yield on the GIC (determined net of broker's fees) is not less than the yield then available from the provider on reasonably comparable GICs, if any, offered to other persons from a source of funds other than gross proceeds of tax-exempt bonds;
>
> (D) The determination of the terms of the GIC takes into account as a significant factor the issuer's reasonably expected drawdown schedule for the amounts to be invested, exclusive of amounts deposited in debt service funds and reasonably required reserve or replacement funds;
>
> (E) The terms of the GIC, including collateral security requirements, are

reasonable; and

(F) The obligor on the GIC certifies the administrative costs that it is paying (or expects to pay) to third parties in connection with the GIC.

Section 1.148-1(b) provides that a GIC includes any nonpurpose investment that has specifically negotiated withdrawal or reinvestment provisions and a specifically negotiated interest rate, and also includes any agreement to supply investments on two or more future dates (e.g., a forward supply contract).

The safe harbor for GICs was amended on December 30, 1998 for bonds issued on or after March 1, 1999 and, at the issuer's election, for bonds issued between December 30, 1998 and March 1, 1999. Section 1.148-5(d)(6)(iii) of the current regulations provides a safe harbor for establishing the fair market value for GICs and investments purchased for a yield restricted defeasance escrow. The provisions in the safe harbor for investments for a yield restricted defeasance escrow includes the following requirements relating to the solicitation, the bids, and the selection of the winning bidder.

With respect to the solicitation, the issuer must make a bona fide solicitation for the purchase of the investment. A bona fide solicitation is a solicitation that satisfies certain requirements including,

1. The bid specifications must include all material terms of the bid. A term is material if it may directly or indirectly affect the yield or the cost of the investment.

2. The terms of the bid specifications must be commercially reasonable. A term is commercially reasonable if there is a legitimate business purpose for the term other than to increase the purchase price or reduce the yield of the investment.

3. All potential providers must have an equal opportunity to bid. For example, no potential provider is given the opportunity to review other bids (i.e., a last look) before providing a bid.

4. At least three reasonably competitive providers must be solicited for bids. A reasonably competitive provider is a provider that has an established industry reputation as a competitive provider of the type of investments being purchased.

With respect to the bids, the safe harbor sets forth requirements that include,

1. The issuer must receive at least three bids from providers that the issuer solicited under a bona fide solicitation meeting the requirements of § 1.148-5(d)(6)(iii)(A) and that do not have a material financial interest in the issue.

2. At least one of the three bids described in the previous paragraph is from a reasonably competitive provider, within the meaning of § 1.148-5(d)(6)(iii)(A)(7).

3. If the issuer uses an agent to conduct the bidding process, the agent cannot bid to provide the investment.

With respect to the selection of the winning bidder, the safe harbor sets forth certain requirements including,

1. The winning bid must be the lowest cost bona fide bid (including any broker's fees). The lowest cost bid is either the lowest cost bid for the portfolio or, if the issuer compares the bids on an investment-by-investment basis, the aggregate cost of a portfolio comprised of the lowest cost bid for each investment. Any payment received by the issuer from a provider at the time a GIC is purchased (e.g., an escrow float contract) for a yield restricted defeasance escrow under a bidding procedure meeting the requirements of § 1.148-5(d)(6)(iii) is taken into account in determining the lowest cost bid.

2. The lowest cost bona fide bid (including any broker's fees) must not be greater than the cost of the most efficient portfolio comprised exclusively of State and Local Government Series Securities from the United States Department of the Treasury, Bureau of Public Debt. The cost of the most efficient portfolio of State and Local Government Series Securities is to be determined at the time that bids are required to be submitted pursuant to the terms of the bid specifications.

The safe harbor requires that the provider of the investments certify the administrative costs that it pays (or expects to pay, if any) to third parties in connection with supplying the investment, and that the issuer retains certain records.

Qualified administrative costs are permitted to be taken into account in computing the yield on nonpurpose investments. Generally, qualified administrative costs are reasonable, direct administrative costs, other than carrying costs, such as separately stated brokerage or selling commissions, but not legal and accounting fees, recordkeeping, custody, and similar costs. Generally, overhead costs and similar indirect costs of the issuer such as employee salaries and office expenses are not qualified administrative costs. Generally, administrative costs are not reasonable unless comparable to administrative costs that would be charged for the same investment or a reasonably comparable investment acquired with a source of funds other than gross proceeds of tax-exempt bonds. § 1.148-5(e)(2)(i). The regulations also provide a safe harbor for broker's commissions or similar costs with respect to investments purchased for a yield restricted defeasance escrow. Section 1.148-5(e)(2)(iv).[2]

---

[2] § 1.148-5(e)(iv) is effective for bonds issued on or after March 1, 1999 and, if the issuer elects, for bonds issued between December 30, 1998 and March 1, 1998.

An option has been defined as the right, but not an obligation, to purchase or sell property for a fixed or stipulated price within a specified time. See Koch v. Commissioner, 67 T.C. 71, 82 (1976). The issue of what is an option has been explored in the open transaction rules. Under those rules, the IRS has applied such treatment to classic or simple options as described in Rev. Rul. 58-234, 1958-1 C.B. 234 and Rev. Rul. 78-182, 1978-1 C.B. 265. In elaborating upon the options covered in Rev. Rul. 58-234, the IRS noted that options terminate automatically if not exercised and that upon timely exercise they are terminated and become contracts of sale.

The courts and the IRS have consistently looked to economic realities in determining whether a contract is an option, thus finding certain contracts not to be options in substance even though they were labeled and styled as options. Halle v. Commissioner, 83 F.3d 649 (1996): Rev. Rul. 85-87, 1985-1 C.B. 268; Rev. Rul. 82-150, 1982-2 C.B. 110.

Options shift the risk of changes in the economic value of property. Halle, 83 F.3d at 657. A call option generally becomes favorable to exercise when the value of the underlying property increases and a put option generally becomes favorable to exercise as a result of a decrease in the value of the underlying property. See Laureys v. Commissioner, 92 T.C. 101, 102 - 104 (1989). In the case of a put option, if the market value of the underlying property were to rise above the exercise price, the put would normally not be exercised and would be allowed to lapse. See Rev. Rul. 78-182.

Courts have distinguished option contracts, which afford option holders unilateral rights, and bilateral sales contracts where the parties have reciprocal rights and obligations. United States Freight Co. v. U.S., 422 F.2d 887 (Ct. Cl. 1970); Elrod v. Commissioner, 87 T.C. 1046 (1986); Estate of Charles T. Franklin, 64 T.C. 752 (1975). These courts have declined to grant option treatment to transactions in which the putative option holder incurred an obligation beyond the payment of a premium by allowing an asserted option to lapse.

ANALYSIS

A. May the price paid for the Sale Rights[3] be used to reduce the yield on the Escrows?

It appears that the Authority is arguing either that the Forward Supply Agreements are GICs or that the Sale Rights are options for federal tax law purposes that are married to the Treasury securities in the escrow.

---

[3]The “Sale Right” is described in detail above with respect to Escrow A. There is an analogous right in Escrow C, and we use the term generically to describe both rights.

1. Is the Forward Supply Agreement a GIC?

The definition of GIC includes any nonpurpose investment that has specifically negotiated withdrawal or reinvestment provisions and a specifically negotiated interest rate, and also includes any agreement to supply investments on two or more future dates.

While this definition appears broad, we believe that generally it does not include open market securities deposited in a yield restricted defeasance escrow. In the bidding regulations, the safe harbors distinguish between investments purchased for a yield restricted defeasance escrow and GICs. The safe harbor provisions for determining fair market value and brokerage fees for GICs are different than the safe harbor provisions for determining fair market value and brokerage fees of investments for a yield restricted defeasance escrow. Section 1.148-5(d)(6)(iii) and (e)(2)(iii) and (iv). As noted in the preamble to those regulations,

> The term guaranteed investment contract generally does not include investments purchased for a yield restricted defeasance escrow. However, the term guaranteed investment contract does include escrow float contracts and similar agreements purchased for a yield restricted defeasance escrow. In addition, the term guaranteed investment contract includes debt service fund forward agreements and debt service reserve fund agreements (e.g., agreements to deliver United States Treasury obligations over a period of time).

In addition, by having two different safe harbor provisions, the current regulations suggest that the definition of a GIC would not include an investment that was bid with a GIC when that investment would otherwise not be a GIC. While these regulations do not apply to the New Bonds, the regulations did not modify the definition of GIC or suggest that a narrower definition of GIC applies for that regulation provision.

In this case, all of the Treasury securities necessary to meet all of the Escrow Requirements (as of Date 1) were provided on Date 1. It does not appear that Provider B remained the owner of Treasury securities, using those securities only as collateral for its obligation to meet the Escrow Requirements. In addition, no securities were required to be provided in the future. While certain rights in the Forward Supply Agreements, when viewed as separate investments, might meet the GIC definition, we think it unlikely that these rights can turn investments that otherwise would not be GICs into GICs when entered into in the same contract. Accordingly, it is doubtful that the Forward Supply Agreements are GICs.[4]

---

[4]We only address whether the Forward Supply Agreements are GICs, not whether any particular rights in that contract might be a GIC.

2. Are the Sale Rights options for federal tax law?

We also believe that there is a substantial question about whether the Sale Rights constitute options for federal tax law purposes. The description in the Forward Supply Agreements of the Sale Rights as “options” does not control whether the arrangements are options for federal income tax purposes. Rather, all surrounding facts and circumstances need to be considered to determine whether the Sale Rights are options for federal income tax purposes. Halle, 83 F.3d 649.

Though there may be others, a couple of significant features in the Sale Rights call into question their status as options. Unless cash-settled,[5] a typical option contemplates that the option will ripen, upon exercise, into a contract of sale between the optionee and optionor at the specified exercise price. Rev. Rul. 58-234. In this case, the Sale Rights may not ripen into contracts of sale with Provider A, the purported option writer. Rather, the actual buyers may be third parties or possibly an affiliate of Provider A. Moreover, the actual buyers will not purchase the escrow securities at the exercise price guaranteed by Provider A. Rather, Provider A will simply compensate the Authority for the difference if the stipulated exercise price, i.e., the Guaranteed Amount, is greater than the amount received from the highest bidder for the Escrow Securities.

Put options are typically unilateral arrangements that are exercised by the optionee when the value of the underlying property is less than the exercise price. Moreover, a put optionee is typically only out of pocket the cost of the put premium in the event that the put is out-of-the money, i.e., the value of the property is more than the exercise price. In that situation, the option will simply lapse.

The Sale Rights operate differently. These rights are not strictly unilateral in nature. Rather, there is a conditional obligation upon the Authority to make further payment, beyond the option premium, if it sells Escrow Securities for more than the Guaranteed Amount. This further obligation makes the Sale Rights appear more bilateral (though conditionally so) in nature. It appears that Authority’s conditional obligation to make such further payment, in the event the Escrow Securities increase in value, is inconsistent with option status. United States Freight Co., 422 F.2d 887.

3. Were the Sale Rights separate investments that were acquired at greater than fair market value?

---

[5] It would seem difficult for the Authority to argue that its arrangement is a cash-settled option because an actual sale must occur for the Guaranteed Amount to be paid and because it appears possible that the Authority, the supposed optionee, will have to make a cash payment to Provider A if the Escrow Securities sell for more than the Guaranteed Amount.

If the Authority decides to argue that the Sale Rights are investments in themselves, we would need further development to address the Authority's argument. However, we address one of your questions on this issue; whether the Sale Rights provide any benefit to the Authority. The Sale Rights provide certainty to the Authority that it will receive the Guaranteed Amount if it sells the Escrow Securities. In order to exercise the Sale Rights, the Authority must eliminate a portion of the Escrow Requirements. If the cost of eliminating the Escrow Requirements is less than the Guaranteed Amount, the Sale Rights will provide a benefit to the Authority.

B. Whether the Authority paid greater than fair market value for the Forward Supply Agreements.

Consistent with an argument that the Forward Supply Agreements are GICs, it appears that the Authority wishes to rely on the safe harbor bidding rules of § 1.148-5(d)(6)(iii) for establishing fair market value. Because we think it is unlikely that the agreements are GICs, we think it unlikely that the safe harbor applies to the agreements. Failure to meet the safe harbor does not mean that the Authority paid greater than fair market value for the investments. However, the regulations applicable to this transaction contain a presumption against fair market value for investments not traded on the established securities market. While the Treasury securities deposited in the escrows are traded on an established securities market, the Forward Supply Agreements, which contain the Sale Rights and the float rights, do not appear to be investments traded on an established securities market. Accordingly, we presume that the Forward Supply Agreements were not traded at fair market value.

<u>CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS</u>

It appears that the Authority treated the Forward Supply Agreements as GICs. [redacted]

---

6 [redacted]

[redacted]

[redacted]

[redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call if you have any further questions.

Mary E. Oppenheimer
Assistant Chief Counsel
By: REBECCA L. HARRIGAL
Branch Chief
Tax-Exempt Bonds Branch