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IRS Announces Closing Agreement Program for Tax-Exempt Student Loan Bonds Subject to Taxability Determination Due to Loan-Swapping

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The IRS has released [Announcement 2012-14](#), which permits issuers of student loan bonds that involved loan-swapping to request by July 31, 2012 a closing agreement involving a potentially substantial settlement payment to the IRS in order to preserve the tax-exempt status of such bonds.

Certain issuers of student loan bonds reallocated loans originally funded by a particular bond issue to another bond issue when calculating compliance with arbitrage restrictions on the spread between the yield on bond-financed loans and the applicable bond yield. The IRS has determined that such reallocations by an issuer among its own portfolios did not constitute actual sales or dispositions of the swapped loans and therefore were ineffective for tax law purposes. The reallocations therefore will be disregarded. If an issuer cannot satisfy its burden of proof in any audit that the bonds involved are not taxable arbitrage bonds if such reallocations are ignored, the applicable bonds are at risk of being declared taxable.

Various issuers of bonds that have been audited and/or that are at risk of taxability due to the IRS's position on loan-swapping have filed material event notices on EMMA regarding the applicable taxability risk. The Announcement outlines the terms of closing agreements available to issuers of such bonds that have not yet been audited by the IRS. It does not apply to bonds for which an audit is already underway. Presumably such bonds may receive harsher treatment than that available under the Announcement.

The main terms of the closing agreements offered by the IRS are:

1. An issuer seeking to enter into a closing agreement must request a settlement with respect to all of the outstanding qualified student loan bond issues (1) from which it reallocated student loans to another issue for reasons other than certain technical requirements under IRS rules and (2) to which it reallocated those loans. As drafted, this requirement appears to compel an issuer to enter into closing agreements, and pay settlements, as to all bond issues involving loan swaps, including those the issuer believes are not at risk of being declared taxable, in order to obtain relief on those bond issues that are at risk.
2. Prior to the IRS's execution and delivery of the closing agreement, the applicable issuer must pay to the IRS a settlement amount consisting of the sum of (a) forty percent (40%) of the taxpayer exposure on each issue of bonds subject to the closing agreement and (b) an amount equal to the excessive arbitrage profit on the applicable bonds from the issue date to the beginning of the first year included in the calculation of taxpayer exposure. Taxpayer exposure is generally calculated for a period beginning with the year that is three or four years

prior to the settlement date and ending at maturity (or any earlier redemption date) on the applicable bonds, and equals the present value of 29% times the interest paid or to be paid on the bonds during that period. A 40% payment of full taxpayer exposure may involve a sizable sum, depending on the amount of bonds outstanding and the projected period they will remain outstanding.

The IRS Announcement indicates that the IRS will generally process the closing agreement request and send a closing agreement to the issuer for its execution within 60 days after the IRS's receipt of a completed application for the closing agreement. Upon execution of such agreement by the issuer and the payment of the applicable settlement amount, the IRS will execute the closing agreement. The closing agreement preserves the tax-exemption of the applicable bonds notwithstanding the loan-swapping practices, but does not preclude the IRS from auditing or challenging the tax-exemption of the applicable bonds for other reasons.

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