An Introduction to

IRS Audits of Tax-Exempt Bonds

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DISCLAIMER: Nothing in this booklet should be construed or relied upon as legal advice. Instead, this booklet is intended to serve as an introduction to the general subject of tax-exempt bond audits, from which better informed requests for advice, legal and financial, can be formulated.

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CHAPTER ONE

Introduction

The purpose of this booklet is to introduce interested parties (particularly issuers of tax-exempt debt) to the Internal Revenue Service ("IRS") tax-exempt bond audit process. This booklet is not intended to serve as a treatise on tax-exempt bond audits, and many potential legal and practical issues are not addressed. We hope that readers find this booklet to be informative, and that, in the event of an IRS tax-exempt bond audit, better informed requests for advice, legal and financial, can be formulated as a result of having read this booklet.

The authors are members of the Public Finance Tax Department at Orrick, Herrington & Sutcliffe LLP, and have represented issuers, conduit borrowers, investment banks and bondholders in numerous tax-exempt bond audits. Orrick is the nation's premier bond counsel firm, ranked number one for more than a decade,[1] with experience in virtually every form of debt offering.

1 Rankings for securities transactions of various types are performed annually by Thomson Financial, which has ranked Orrick number one in the country as bond counsel since prior to 1990. In 2005, Orrick served as bond counsel for 474 issues, totaling $4.2 billion.

CHAPTER TWO

Overview of the IRS Tax-Exempt Bond Examination Program

Tax-exempt bonds are a multi-trillion dollar industry. Thomson Financial reports that, in 2005 alone, the top 25 bond counsel firms in the country assisted qualified issuers of tax-exempt debt in issuing nearly 15,000 tax-exempt debt offerings, totaling nearly $350 billion of long-term debt and nearly $48 billion of short-term debt.[2] The benefit of borrowing through the tax-exempt market is obvious: issuers may borrow at a lower interest rate than they otherwise would be able to realize on the taxable market because the interest on tax-exempt bonds is not subject to federal (and, often, state or local) income tax.

The benefit to State and local governments derived from their ability to borrow on the tax-exempt market does not come without a price. The Treasury Department ("Treasury") has estimated that in fiscal year 2006 the loss of federal tax revenue through the issuance of tax-exempt bonds will be approximately $35 billion. Treasury and the IRS, therefore, have a strong incentive to limit the amount of tax-exempt debt on the market, and to rein in those debt issuances and market participants whom Treasury and the IRS believe are acting outside the bounds of the law.

Created in 1999 as part of the IRS's reorganization efforts, the Tax-Exempt Bond office ("TEB") of the Tax-Exempt and Government Entities (TE/GE) Division of the IRS is responsible for, among other things, ensuring that tax-exempt bonds are in compliance with the Internal Revenue Code of 1986 (the "Code"). TEB's primary method of ensuring that tax-exempt bonds are in compliance with the Code is

2 Short-term debt is defined as debt with a scheduled maturity of 13 months or less.

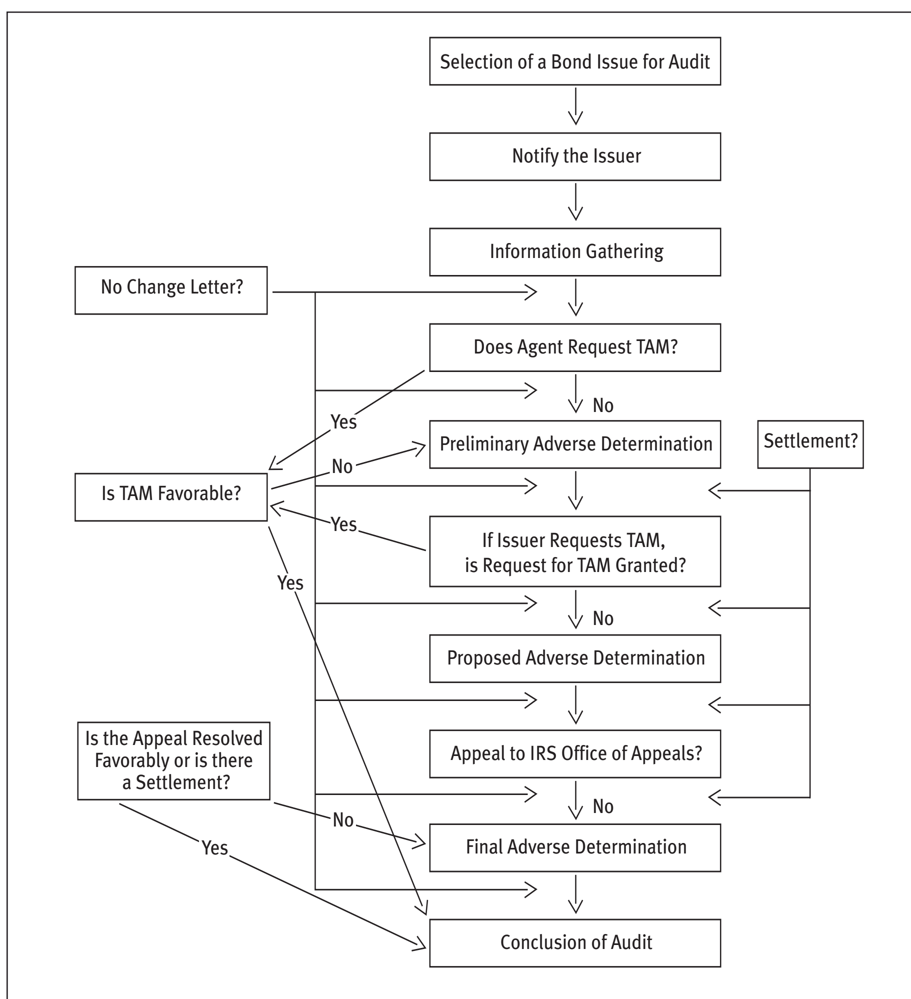
through its Examination Program. The stated goals of the TEB Examination Program are to: (1) achieve significant levels of pre-issuance and post-issuance compliance, (2) respond promptly to abusive transactions, (3) increase the effective use of information returns, (4) encourage transaction participants to take an active role in ensuring that their bond issues comply with the Code and Treasury Regulations, and (5) promote voluntary compliance with the requirements of the Code and Treasury Regulations.

The TEB Examination Program has transformed the tax-exempt bond market. In 2005, TEB closed 483 audit examinations of tax-exempt debt issues and entered into 57 closing agreements through the group's Voluntary Compliance Agreement Program ("VCAP") (discussed in Chapter Seven). For 2006, TEB has announced that it will seek to close 480 audit examinations and enter into 60 closing agreements through VCAP. Although these audit numbers represent a small fraction of the total number of tax-exempt bond issues issued in a given year, when an issue is audited by the IRS, it often leads to a time-consuming and expensive process for all transaction participants. It is against that backdrop that we begin.

CHAPTER THREE

Commencement and Stages of a Tax-Exempt Bond Audit

Figure 1: Stages of a Tax-Exempt Bond Audit



A. Selection of a Bond Issue for Audit

A tax-exempt bond issue[3] may be selected for audit examination in any one of five ways: (1) IRS information gathering projects and compliance initiatives (i.e., a "random" audit), (2) review of returns filed by issuers or returns of issuances involving conduit borrowers, (3) referrals from other federal agencies, informants, news articles, or internal IRS sources, (4) information items prepared by IRS revenue agents for follow-up action, or (5) pickups of cases related to a current examination or expansion of a claim into a field examination.

B. Notifying the Issuer

Upon selection of a bond issue for audit, the examining agent is required to notify the issuer of the specific tax-exempt bond issue under audit, and, in most cases, the reason for the examination. The notification to the issuer may identify the audit as a random examination, as an audit pursuant to a TEB project initiative, or as an examination of a specific problem, including one based on information relating to the particular bond issue. Sample initial contact letters from the IRS to an issuer are set forth in Figure 2 (targeted audit) and Figure 3 (random audit).

In general, throughout the initial stages of the audit and up through the determination of taxability, the issuer of the tax-exempt bonds under audit is treated as the "taxpayer," even though, technically, the issuer will not be the party subject to taxation in the event the bonds in question are deemed taxable. Thus, while bondholders could ultimately be liable for taxes upon the completion of an audit, the issuer and other parties to the transaction (such as a conduit borrower and/or the underwriter) generally negotiate disputes regarding the tax status of a bond issue. Treating the issuer as the taxpayer permits the IRS to discuss and disclose information relating to the audit with the issuer, which might otherwise be viewed as restricted taxpayer information that the IRS could only discuss with bondholders.

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3 Although this booklet refers only to an issue of bonds being under audit, the same consideratiaons apply in the event of an IRS audit of tax-exempt notes, lease obligations, commercial paper or other forms of debt issued by or on behalf of a State or local government.

Figure 2: Sample IRS Contact Letter for a Targeted Audit

Issuer:

Person to Contact:
Badge No.:
Contact Address:
Contact Telephone Number
Date:

RE: [Name of bond issue]

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 because of information we received from external sources or developed internally that causes a concern that the debt issuance may fail one or more provisions of sections 103, 141-150 of the Internal Revenue Code.

Please review the enclosed Information Document Request and mail all requested documents to the address noted above. Other items may be requested as the examination proceeds.

If you desire 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.

During the examination, the Internal Revenue Service may need to contact various third parties including, but not limited to, underwriters, financial advisors, bond counsel and various counsel to third parties, investment banks, conduit borrowers, trustees, credit enhancers, insurers, program administrators and any other parties having a transactional relationship to the bonds being examined. These contacts may be necessary to complete our determination of the status of the bonds under section 103 of the Internal Revenue Code.

We are providing this notice to you in accordance with section 7602(c)(1) of the Internal Revenue Code. You are not required to take any action on account of this notice.

Thank you for your cooperation in this matter. Please feel free to call or write if you have any questions or concerns about this matter or are unable to promptly respond to the Information Document Request.

Figure 3: Sample IRS Contact Letter for a Random Audit

Issuer:

Person to Contact:
Badge No.:
Contact Address:
Contact Telephone Number
Date:

RE: [Name of bond issue]

We have selected the debt issuance named above for examination.

The IRS routinely examines municipal debt issuances to determine compliance with Federal tax requirements.

Please review the enclosed Information Document Request and mail all requested documents to the address noted above. Other items may be requested as the examination proceeds.

If you desire 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.

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Thank you for your cooperation in this matter. Please feel free to call or write if you have any questions or concerns about this matter or are unable to promptly respond to the Information Document Request.

In contrast, the IRS is more limited in its communication with the conduit borrower of the bond proceeds unless a disclosure waiver is provided by the issuer.

As discussed below, because the issuer is not the true taxpayer with respect to interest on the bonds, the issuer's rights, in particular the right to a judicial review of an IRS determination (as discussed in Chapter Six), are limited. The issuer's inability to readily bring a direct challenge to the IRS's adverse determination regarding the tax exemption of bonds is the single-most important factor affecting the audit process and the result of many audits, including the terms of settlement. In certain cases, a conduit borrower that faces potential tax liability under Section 150(b) of the Code may have the opportunity to pursue judicial review of issues that are also relevant to the tax-exempt status of the bonds.

C. Information Gathering

Audits of tax-exempt bonds are conducted in substantially the same manner as any other tax audit. As depicted in Figure 2 and Figure 3, the initial contact letter from the IRS will usually contain an Information Document Request ("IDR"), requesting the transcript for the bond issue, as well as other documents deemed relevant by the agent. For an issue that is selected for audit on a random basis, the information requested by the IDR may be quite general, whereas for a targeted audit, the IDR may request specific and detailed information and documents that provide a sense of the IRS's concern(s) and preliminary view of the audit. As the audit proceeds, the IRS may send additional IDRs to the issuer or to other parties. The IRS may also issue a subpoena to obtain documents and information relating to the bonds. At any time during the information gathering process, the issuer has the option of submitting a brief or other document setting forth its position with respect to the audit.

The Code generally provides that the IRS may not contact any party other than the taxpayer (deemed to be the issuer for purposes of the audit) without first providing reasonable notice in advance to the taxpayer that contacts with parties other than the taxpayer may be made. In addition, the IRS is required to periodically provide the

taxpayer a record of parties contacted during the audit. To avoid such restrictions, the initial contact letter from the IRS might ask the issuer to execute an IRS Form 8821, *Tax Information Authorization*, authorizing the IRS to discuss the audit with other parties, including the Securities and Exchange Commission or a conduit borrower without notifying the issuer.

D. No Change vs. Continuation of Audit

Following the completion of the information gathering process, the agent, with the concurrence of his or her manager, may determine that the audit is to be closed with no changes or tax liability. If such a conclusion is reached, the agent will issue what is commonly referred to as a "no-change" letter. A sample no-change letter is set forth in Figure 4. If, on the other hand, the agent concludes that there is an issue with respect to the tax-exempt status of the bonds in question, the audit continues. It is worth pointing out that the IRS may issue a no-change letter at any point during the audit process, which effectively terminates the audit. The IRS reserves the right to commence a new audit at a later date with respect to a bond issue, even after it has issued a no-change letter and closed the audit.

E. Settlement

The IRS and the issuer may elect to reach a settlement with respect to the audit. A settlement may be reached at any stage in the audit, including prior to the IRS making a preliminary adverse determination regarding the bonds. In limited circumstances, a party other than the issuer may enter into a settlement agreement with the IRS to resolve the audit. Indeed, it is the stated policy of the TEB program to attempt to resolve violations of the Code without taxing bondholders. Often, this means reaching a settlement with the issuer through the execution of a closing agreement, which provides that there is no change to the tax-exempt status of the bonds. Of course, the issuer will seek to negotiate a payment that represents the lowest percentage of "taxpayer exposure" or other alternative that the IRS will accept.

Figure 4: Sample No-Change Letter

```
Issuer:                                Person to Contact:
                                       Badge No.:
                                       Contact Address:
                                       Contact Telephone Number
                                       Date:



RE: [Name of bond issue]

We have recently completed our examination of the bond issue named
above.  We have decided to close the examination with no change to
the position that interest received by bondholders is excludable
from gross income under section 103 of the Internal Revenue Code.

Please note that if the need to open another examination arises on
this bond issue, any change resulting from that future examination
may affect all open years of bondholders from the issue date of the
bonds.

Thank you for your cooperation in this matter.

                                       Sincerely,
```

Pursuant to TEB administrative procedures, a closing agreement should be narrowly drafted to cover only those issues raised during the audit. A closing agreement will generally follow the TEB model closing agreement (see Figure 5). Upon entering into a closing agreement, the IRS treats the interest paid on the bonds subject to the audit as being excludable from gross income but reserves the right to examine issues not covered by the closing agreement, and may later declare the interest on the bonds taxable for reasons other than those covered in the closing agreement.

Generally, the negotiation of the closing agreement amount is based upon "taxpayer exposure" for those years that are open for examination under the applicable statutes of limitation, which is the amount of tax the IRS could have collected if

bondholders were required to pay tax on the interest they received or that has accrued on the bonds. Taxpayer exposure for any year is equal to the interest accrued and scheduled to accrue in that year on the outstanding bonds multiplied by the relevant tax percentage, plus interest. The relevant tax percentage is based upon the IRS's estimate of the average investor's highest tax bracket, and, unless a more accurate assessment is known, generally equals 29% for purposes of settlement discussions. Taxpayer exposure for future years is computed on a present value basis to the date of the settlement, using the applicable federal rate as the discount rate. In the evaluation of an appropriate settlement amount, the IRS may take into account factors such as the collectibility of the total taxpayer exposure, the cooperation of the transaction participants during the examination, whether the violation was inadvertent, the egregiousness of the violation and the economic benefit derived by the transaction participants. Because agents and field managers will generally require that the issuer agree to redeem part or all of the outstanding bonds, the closing agreement amount is usually based in part on the taxpayer exposure for each of the open years under applicable statutes of limitation, which is generally 3 years, and for the time until the bonds are retired.

Example:

Assume an issuer issues $20,000,000 of tax-exempt bonds in 2001 with the following debt profile:

Year	Principal	Interest	Year	Principal	Interest
2002	$2,000,000	$1,000,000	2007	$2,000,000	$500,000
2003	$2,000,000	$900,000	2008	$2,000,000	$400,000
2004	$2,000,000	$800,000	2009	$2,000,000	$300,000
2005	$2,000,000	$700,000	2010	$2,000,000	$200,000
2006	$2,000,000	$600,000	2011	$2,000,000	$100,000
			Total	$20,000,000	$5,500,000

Assume that, in 2005, the IRS audits the bond issue and, on July 1, 2006, the issuer and the IRS determine to enter into a closing agreement. Based upon the above, the years with open statutes of limitation would include 2003, 2004, 2005 and 2006. For each of 2003, 2004 and 2005, the base taxpayer exposure would equal $261,000, $232,000 and $203,000, respectively (29% of $900,000, $800,000 and $700,000, respectively). The IRS would also seek taxes attributable to 2006 to the date of settlement of $87,000 (29% of $300,000, which is one-half of the $600,000 interest due in 2006). In addition, the IRS would seek to impose interest based upon the IRS underpayment rate for prior years. If the closing agreement did not require that the issuer immediately retire the outstanding bonds, the IRS would seek payment for future years as well, calculated in the same manner (29% of the scheduled interest due to be paid for each of years 2006 through 2011) and present valued from each respective April 15 tax payment date to the date of settlement at the applicable federal rate. In the case of variable rate bonds, for future periods, interest may be based on the average interest rate paid to date, the last rate paid or the appropriate fixed swap rate less 50 basis points.

In addition, or as an alternative, to the above, the IRS may seek a settlement based in whole or in part on the interest deduction available to a conduit borrower or other tax consequences under Section 150(b) of the Code.[4] For example, in addition to, or instead of, requiring a settlement amount based upon taxpayer exposure, the IRS might substitute as the closing agreement amount the amount of taxes attributable to the disallowance of the deduction for interest paid on the bonds that a conduit borrower took or will take in the future. The IRS might also deem that, instead of, or in addition to, total taxpayer exposure, the closing agreement amount is more appropriately based upon any investment arbitrage profit earned by the issuer or another party to the transaction. Finally, closing agreement amounts may be based upon the application of Code Section 6700 penalties to one or more parties to the transaction. In such instances, the closing agreement should state that the payment is being made pursuant to Section 6700, and that the payment amount is a nondeductible penalty for purposes of federal income taxes. Section 6700 penalties are discussed in Chapter Eight of this booklet.

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4 In accordance with the Internal Revenue Manual, TEB agents and field managers should in most cases seek as a maximum amount a payment of 100% of total taxpayer exposure for open and future tax years.

Figure 5: Model Closing Agreement

Closing Agreement on Final Determination Covering Specific Matters

Under section 7121 of the Internal Revenue Code (the ("Code"), (the "Issuer") and the Commissioner of the Internal Revenue (the "Commissioner" or "IRS") makes this closing agreement (the "Agreement").

WHEREAS, the parties have determined the following facts and, made the following legal conclusions and representations:

A. This Agreement is in settlement of issues raised in an examination of the bonds (the "Bonds").

B. The Internal Revenue Service has made a (preliminary) determination that the Bonds fail to meet the requirements of section 103 of the Code because (short synopsis of legal conclusion).

C. The IRS has formally asserted any claims against the Issuer, or sought to tax any holders of the Bonds on interest income of the Bonds.

D. The terms of the Agreement were arrived at by negotiation between the Issuer and the IRS and may differ from the terms of settlement of other bond issues examined or to be examined by the IRS.

E. This Agreement is for the benefit of the past, present and future registered and beneficial owners of the Bonds (collectively, the "Bondholders").

[Insert additional premises on which the Agreement is based including violations giving rise to interest on bonds being includable in gross income under section 61.]

NOW IT IS HEREBY DETERMINED AND AGREED PURSUANT TO THIS CLOSING AGREEMENT EXECUTED BY THE PARTIES HERETO UNDER CODE SECTION 7121 THAT FOR FEDERAL TAX PURPOSES:

1. The Issuer shall pay to the IRS upon the Issuer's execution of this Agreement. Payments of this amount shall be made by certified check payable to the U.S. Treasury and delivered to a duly authorized representative of the IRS. Payment of this amount will not be made from proceeds of bonds described in section 103(a) of the Code.

2. The Bondholders are not required to include in their gross income any interest on the Bonds because of the violations set forth herein.

3. The Issuer will redeem all outstanding Bonds on or before (specify date). [Optional: The Bonds will not be redeemed with proceeds of bonds described in section 103(a) of the Code.]

Figure 5: Model Closing Agreement (continued)

4. The Agreement does [does not] require that the bonds be redeemed.

5. [Optional: Within 30 days after the date this Agreement is executed by the IRS, the Issuer must notify all Bondholders in writing that the Bonds will be redeemed on the next redemption date, which is (specify date).]

6. [Optional: The Conduit Borrower will not be denied, pursuant to section 150(b)(specify paragraph) of the Internal Revenue Code, a deduction for interest paid on the Bonds because of the violations set forth herein.]

7. [Optional: This Agreement will not preclude the Internal Revenue Service from pursuing a separate adjustment against the Conduit Borrower in order to deny the deduction for interest paid on the financing provided by the Bonds pursuant to section 150(b) (specify paragraph) of the Code.]

8. [Optional: The Conduit Borrower agrees that all payments made pursuant to this Agreement shall be nondeductible for federal income tax purposes and, as such, will not attempt to deduct, amortize, or recover any portion of such payment.]

9. [Optional: The Conduit Borrower is entitled to deduct the amount paid pursuant to this closing agreement on its (specify year) federal income tax return (Form (specify form)), pursuant to section 162 of the Code.]

10. [Optional: The Internal Revenue Service will not treat the (defined property) as "tax-exempt bond financed property" for purposes of section 168 of the Code from and after the date of issuance of the Bonds.]

11. This Agreement is executed with respect to a federal income tax liability of the Bondholders.

12. No income shall be recognized by any Bondholder as a result of this Agreement or any payments made pursuant to this Agreement.

13. No party shall endeavor by litigation or other means to attack the validity of this Agreement.

14. The amount paid by the issuer pursuant to this Agreement is not refundable, or subject to credit or offset under any circumstance.

15. This Agreement may not be cited or relied upon by any person or entity whatsoever as precedent in the disposition of any other case.

16. The Issuer shall execute, upon the Issuer's execution of this Agreement, a consent meeting the requirements of section 6103(c) of the Code permitting the disclosure to the general public of information concerning the existence and subject matter of this Agreement. (Attachment I).

```
17. This Agreement is final and conclusive except that:

  a. The matter it relates to may be reopened in the event of fraud,
malfeasance, or misrepresentation of a material fact;

  b. It is subject to the Internal Revenue Code sections that
expressly provide that effect be given to their provisions
(including any stated exception for Code section 7122)
notwithstanding any other law, rule of law; and

  c. If it relates to a tax period ending after the effective date
of this Agreement, it is subject to any law, enacted after the
Agreement date that applies to that tax period.

By signing, the above parties certify that they have read and agreed
to the terms of this Agreement.
```

F. Technical Advice

If, after reviewing the information forwarded by the issuer, the agent responsible for the audit, with the approval of his or her supervisor, determines that there is an issue deserving of further review, the agent may refer the case to the IRS Office of Chief Counsel for technical advice. Technical advice, published in the form of a Technical Advice Memorandum (a "TAM"), is intended to establish the proper interpretation and application of the law to the facts of a specific case. Because a TAM can determine the outcome of an audit, seeking technical advice is a formal part of the audit procedures, and taxpayers have certain rights to participate in the process of obtaining technical advice.

If technical advice is requested by either the agent or the taxpayer, the usual procedure is for the agent and the taxpayer to negotiate an agreed upon statement of facts and for each side to present their legal position separately. The process is usually, although not necessarily, adversarial. If the parties cannot agree on the facts, the IRS Office of Chief Counsel will make its determination based on the facts put forward by the agent. The taxpayer is entitled to a conference in Washington, D.C., if the IRS Office of Chief Counsel is inclined to issue a negative TAM. It is almost always desirable to pursue this right.

If the TAM is favorable, the case is closed, unless the agent has other issues he or she wishes to pursue. If the TAM is negative, the audit continues.

G. Preliminary Adverse Determination

After gathering information regarding the bond issue under audit, determining that there is a question regarding the tax-exempt status of the bond issue, concluding that a TAM is not needed, and assuming no settlement has been reached, the IRS agent reviewing the bond issue will normally send the issuer a preliminary adverse determination. The preliminary adverse determination informs the issuer that a preliminary determination has been made that the interest paid on the bond issue is not excludable from gross income under Section 103 of the Code, gives a summary of the facts and law deemed relevant by the IRS, and provides one or more reasons for the IRS's conclusion that the bonds are taxable.

The preliminary adverse determination will notify the issuer that the issuer may request an informal conference with an IRS supervisor to discuss a potential settlement, request a TAM and/or contact the Office of the Taxpayer Advocate. If the examining agent has not previously requested a TAM, it is at this point that the taxpayer may request that the agent do so. A request may be made either orally or in writing. If the agent concludes that a TAM is not warranted, the agent may deny the request. The issuer may appeal the agent's decision to the agent's supervisor, and then, if denied by the supervisor, appeal to the Director of TEB. The decision of the Director of TEB is final.

The issuer will typically submit a written response to the preliminary adverse determination providing additional or different facts related to the bonds and an analysis of the applicable law. Following the receipt of the preliminary adverse determination, the issuer will frequently engage in settlement discussions with the IRS.

H. Proposed Adverse Determination

Following the preliminary adverse determination, and assuming the issuer and the IRS do not settle or the IRS has not been persuaded to terminate the audit, the IRS will normally issue a proposed adverse determination. The proposed adverse determination will notify the issuer that the IRS has concluded its examination of

the bond issue under audit, and has concluded that the interest paid to bondholders is not excludable from gross income under Section 103 of the Code. The proposed adverse determination, like the preliminary adverse determination, will provide a summary of the facts and law deemed relevant by the IRS, and one or more reasons for the IRS's conclusion that the bonds are taxable.

The proposed adverse determination will encourage the issuer to immediately contact the reviewing agent to continue/commence settlement negotiations through a closing agreement. In addition, or alternatively, the issuer is advised that it may request an administrative appeal of its case to the Office of Appeals of the IRS or contact the Office of the Taxpayer Advocate.

I. IRS Office of Appeals

Upon receiving a proposed adverse determination from the IRS, the issuer has 30 days (unless such time is extended by reason of settlement negotiations or an agreement with the agent) to request an administrative appeal of its case to the Office of Appeals of the IRS. The Office of Appeals is separate and independent from the IRS field office auditing the bond issue. An appeal to the Office of Appeals must include a detailed written response to the proposed adverse determination and any further explanation of the issuer's position regarding the factual or legal issue(s) in dispute.

The purpose of the Office of Appeals is to provide an independent review of the case. It is strongly disposed to settling cases. The appeals officer reviews the agent's file, and the taxpayer has the opportunity to brief and argue its position. The Office of Appeals is not permitted to communicate ex-parte with the field office concerning the case. Unlike the field office, the Office of Appeals is supposed to consider the hazards the IRS would have in litigating an adverse determination.

If a TAM has been issued, the appeals officer will be inclined to follow the TAM, but is not obligated to do so. The officer may still compromise or concede the case on the facts, the law, litigation hazards, etc. If there has not previously been a request for technical advice, either the appeals officer or the taxpayer may request technical

advice at that stage. If the TAM is favorable, that will end the audit. If the TAM is negative, the appeals officer, although not technically bound to follow the TAM, is more likely to do so in a matter with which he or she was directly involved.

J. Final Adverse Determination

If the case is not resolved with the Office of Appeals, there is no further administrative process with the IRS. Nor is there an opportunity to reopen settlement discussions. At this point, the issuer must wait for a final determination of taxability through the issuance of a final adverse determination. If the IRS has not already done so, it will contact the trustee for a list of bondholders. The trustee is not required to provide such a list without the issuance of a summons, but is not legally prevented from providing the list.

CHAPTER FOUR

Retaining Expert Legal Assistance

The importance of retaining expert legal assistance in the event of a tax-exempt bond audit cannot be overstated. When contacted by the IRS in connection with an audit, an issuer should immediately retain expert legal assistance—even before responding to the IRS. As highlighted in Part E of Chapter Three, the stakes, even in (relatively) small bond issues, can be incredibly high, and often run into the millions of dollars. Although the issuer may have nothing to hide, it should nonetheless engage knowledgeable counsel to assure that matters are properly presented to the IRS. Even where an issuer is fully indemnified by a conduit borrower, the issuer is well advised to engage counsel. The issuer may not be the only transaction participant that should engage counsel. In many audits, the conduit borrower, underwriter, bond counsel, credit enhancer and other transaction participants become deeply involved in the audit and benefit from counsel.

It is common in the early stages of an audit for the IRS to request various documents or interview financing participants. In some cases, the IRS may even ask the issuer to waive certain of its rights. An issuer should consult with legal counsel before complying with any of these requests. Privilege and other rights, which may turn out to be critical, are easily waived by mistake. An issuer's rights in the audit process are limited, and should be protected zealously.

After deciding to hire legal counsel to represent it before the IRS, the next question an issuer is usually faced with is "Who should I hire?" Normally, an issuer would consult its bond counsel firm with respect to tax questions related to its tax-exempt bond issues. However, handling a tax-exempt bond audit requires different experience and skills than analyzing the tax aspects of bonds at the time of their issuance. While many bond counsel firms are perfectly capable of advising issuers on

the tax aspects of a financing, few such firms have the experience and breadth of knowledge required to handle an audit. In addition, often there is a conflict of interest in having a bond counsel firm that rendered a tax-exempt bond opinion represent the issuer before the IRS. The potential for actual conflicts may be addressed in a variety of ways, including a conflict waiver, appointment of a co-counsel or a law firm other than bond counsel to manage the audit.

When an issue of bonds is under federal tax audit, an issuer should seek to retain not only a firm with experience and knowledge of the tax aspects of municipal bonds, but also a firm with a wealth of experience in representing issuers in audits before the IRS. A law firm with a broad and varied tax controversy experience is best able to address the various issues, procedural and substantive, that may arise in an IRS audit. Counsel should be able to advise the issuer regarding the applicable constraints on the IRS, and whether an issuer need (or should) supply information or materials requested by the IRS. Audit counsel should be able to advise the issuer on how to keep the costs of the audit down. In the event of settlement negotiations, if warranted, counsel should be willing to and capable of bringing the various financing participants, including potentially bond counsel, to the table to discuss settlement contributions and terms. Audit counsel should also advise the issuer of any potential claims the issuer might have against other financing participants.

Ultimately, the decision to hire expert legal counsel, and the competence of such counsel, in the event of an IRS audit is one of the most important decisions that an issuer will make. In an environment of increased IRS scrutiny, an issuer simply cannot leave its legal position in an audit to chance.

CHAPTER FIVE

Public Disclosure of an IRS Tax-Exempt Bond Audit and SEC Enforcement

An issuer of tax-exempt bonds must promptly upon receipt of notification from the IRS of the commencement of a bond audit, and throughout the audit process, evaluate and re-evaluate the obligation and propriety of making disclosure to investors and potential investors regarding the existence and processing of the audit. Numerous questions regarding disclosure relating to the audit may arise for consideration by the issuer and other transaction participants. When should disclosure be made? To whom should disclosure be made and by what means? What should the disclosure say? When is an update of disclosure regarding the audit appropriate?

Although there are guiding principles of law relating to publicly offered and traded municipal securities that will assist the issuer in addressing these questions, resolution of these issues will turn on the specific facts relating to the particular bond issue.

The primary guiding principles are established by the antifraud provisions of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission (the "SEC") Rule 10b-5 promulgated thereunder. An issuer's obligation to make disclosure regarding the audit may also be impacted by a continuing disclosure agreement entered into pursuant to SEC Rule 15c2-12, which indirectly regulates disclosure practices relating to municipal securities. Thus, an issuer has an obligation to make disclosure regarding post-issuance matters, such as an IRS audit, where the issuer has agreed to do so, e.g., a continuing disclosure agreement, or the issuer is making other disclosure to the market that would be inaccurate or materially omitting in light of

the circumstances under which the disclosure is made. These principles, nevertheless, require consideration of the specific facts and circumstances.

Prompt public disclosure upon the initiation of an IRS audit and with respect to all significant developments relating to the audit has been strongly encouraged by representatives of the National Federation of Municipal Analysts, who assert that the bond market has a right to be informed of the bond audit, as it may materially affect the pricing of the bonds. This theme has been echoed by representatives of the SEC, who have frequently sought to remind issuers and their counsel regarding disclosure responsibilities. In his presentation made in September 2005, SEC Commissioner Roel Campos noted that issuers and lawyers undermine investor confidence in municipal securities "by keeping them in the dark for months while negotiating with the IRS and taking appeals" regarding a proposed adverse determination for audited bonds. IRS TE/GE personnel have often stated in public comments and in communications directly to issuers that the issuer has an obligation under applicable securities laws to make public disclosure regarding the audit. Such statements may seem odd in light of the fact that application of the federal securities laws is not within the province of the IRS, and some have suggested that such assertions by the IRS are a thinly veiled attempt to pressure issuers to seek a settlement of the audit as a consequence of the adverse market reaction that may follow disclosure of the audit.

Nevertheless, the issuer's requirement to make disclosure is based entirely on an evaluation of the materiality of the information regarding the audit. For example, materiality may be affected by whether the audit is a random audit or a targeted audit based on the IRS's identification of particular facts and concerns. Another factor that may weigh on materiality is the nature of any identified potential tax law problem; that is, while any tax law violation could potentially adversely affect the tax-exempt status of the bonds, some violations are more serious than others and some may be readily cured by financial payments or other actions, e.g., a late or insufficient payment of arbitrage rebate that is not caused by willful neglect of the issuer. Materiality may also be affected by the ability and willingness of the issuer or other transaction participants to take remedial action, including a financial payment.

At each stage, and for every development, relating to a bond audit, consideration must be given to whether public disclosure should be made. For an issuer that is not presently making public disclosure regarding its securities, public disclosure regarding the audit may not be necessary. Even where an issuer is coming to market with a new issue of bonds and a new official statement, the audit of an unrelated bond issue that may raise unrelated concerns may not mandate disclosure of the audit. Rule 15c2-12 and related continuing disclosure agreements generally requires public notice to be given regarding "adverse tax opinions or events affecting the tax exempt status of the security." However, it is not always clear at what stage of an audit, and under what circumstances, there is an event that invokes this standard for disclosure. And, of course, not all bond issues are subject to Rule 15c2-12 or to continuing disclosure requirements, e.g., many variable rate bond issues and bonds issued prior to July 1995.

There is substantial evidence that the existence of an IRS audit of a tax-exempt bond may materially affect the price of the bonds in the secondary market. This pricing impact has been recognized by the SEC, bond analysts, the IRS, investors and issuers. In many cases, the interest rate for variable rate bonds must be reset to a premium above the normal tax-exempt rate at the time of any remarketing immediately following the disclosure of information regarding a bond audit. Often the rate required to remarket the bonds in such circumstances will be the equivalent of a taxable interest rate, or close to it. For fixed-rate bonds, the market value for bonds may be adjusted in the secondary market to reflect the risk of taxability as a consequence of the audit. However, there is no certainty as to how the market will assimilate information regarding an audit into the pricing or interest rate for the bonds. There may be a seemingly inconsistent reaction from bond issue to bond issue.

Some have observed that the marketplace does not seem to be able or willing to fully digest information regarding an audit to distinguish among situations that may create a minimal risk regarding the tax-exemption or a significant risk. Furthermore, the marketplace does not appear to reflect the fact that virtually all IRS bond audits are resolved without the IRS making a final determination of taxability of the bonds and the assessment of taxes against bondholders. There is evidence that significant price

or rate movements in reaction to information regarding a bond audit may be a consequence of a relatively small number of investors who seek to purchase bonds that are subject to an audit in order to realize a high rate of interest that will eventually be proven to be tax-exempt by the favorable resolution or settlement of the audit. One might argue that the evidence that information regarding bond audits frequently affects the price or rate of the bonds is irrefutable evidence that the information is material. On the other hand, since the market often reacts in an irrational manner, it is arguable that the price or rate movements are not the reflection of a "reasonable" investor. It is against this backdrop of market reaction to audit information that issuers must evaluate their disclosure responsibility.

As noted, an issuer may determine to make a disclosure regarding the commencement of an IRS bond audit. During the course of the investigation of facts by the IRS, the issuer may determine that information has come to its attention that should be communicated to investors and potential investors, e.g., facts relating to the bonds are identified that the issuer was not previously aware of and that may indicate a tax law violation. Upon receipt of a preliminary adverse determination and a subsequent proposed final adverse determination, the issuer must again evaluate its disclosure obligation. Obviously, disclosure made at the time of the opening of the audit tends to make it an easier decision for the issuer to disclose subsequent developments with respect to the audit. The SEC, IRS and investors have been particularly vocal in arguing that the receipt of a preliminary and proposed adverse determination warrants disclosure.

Most commonly, disclosure regarding a bond audit is accomplished through providing a notice to the Nationally Recognized Municipal Securities Information Repositories ("NRMSIRs"), which may be efficiently achieved through DisclosureUSA, an internet-based disclosure filing system. Where the disclosure is not mandated or governed by Rule 15c2-12 or a continuing disclosure agreement, but the issuer decides to make disclosure, the NRMSIRs may nevertheless serve as an efficient and ready means for making disclosure. In some cases, disclosure may be appropriately made by direct communication to existing owners of the bonds or to identified potential investors.

The disclosure regarding an audit should identify the bonds by name of issuer, name of issue and CUSIP numbers. The disclosure often will consist of a short description of the audit and a summary of any specific information that has been provided by the IRS regarding the nature of the audit, including the topics that may have been identified by the IRS for investigation. Issuers should avoid elaborating on the specific facts that have been identified in the communication from the IRS. Some issuers have avoided the question of how to best summarize the communication from the IRS by simply providing a full copy of the audit letter, preliminary or proposed adverse determination or other communication received from the IRS as the content of the disclosure, e.g., the issuer provides a copy of the preliminary adverse determination.

Failure to properly address disclosure responsibilities relating to the bond audit can exacerbate the problems associated with the audit by adding a securities law violation on top of a tax law violation. Prompt and regular consultation with counsel is necessary.

In several instances, an IRS bond audit has been followed closely by an investigation by the SEC. The SEC may be interested in the conduct or statements by any of the transaction participants. Bond counsel's unqualified legal opinion, the disclosure of tax risks and other matters in the Official Statement, the sale of investment securities to the bond issuer, the payment of disclosed and undisclosed fees are examples of some of the elements of tax-exempt bond transactions that have been the focus of SEC inquiries and enforcement activities.

A particular transaction structure or technique that is utilized in several bond issues and that becomes the subject of IRS audits may be particularly likely to attract the attention of the SEC. In any event, issuers and other transaction participants should be wary of the potential for the SEC following close on the heels of the IRS. As a consequence, it is often prudent for legal counsel working on the IRS audit to also have the expertise to respond to an SEC inquiry or consult with other counsel with such expertise.

CHAPTER SIX

Taxing Bondholders

Upon a final determination of taxability with respect to a bond issue, the IRS will begin the process of collecting taxes from bondholders without further notice to the issuer. From this point, the issuer has no further formal role in the audit process and no rights to participate directly in the following steps unless there is a "substantial change in circumstances" regarding the issuer's appeal. If a bondholder initiates a court action, as described below, the issuer may have the ability to intervene in the proceeding or file an amicus brief. The issuer may also have some derivative rights under the bond documents. All of these rights to participate in the process will be indirect and are untested in the context of a municipal bond audit.

As discussed in Chapter Three, the statute of limitations will limit the IRS's ability to collect tax from the bondholders. In general, the IRS must assess tax within three years after the bondholder's tax return was filed.

If the bondholders have filed tax returns for particular tax years during the term of the bonds, the IRS will send the bondholders statutory notices of deficiency, also known as "90-Day Letters." The 90-Day Letters will identify the amount of tax (and any interest, penalties or other payments) due and the basis for the deficiency determination. Once a 90-Day Letter has been mailed, the bondholder has 90 days to file a petition contesting the deficiency in the U.S. Tax Court. Alternatively, the bondholder may contest the deficiency by paying the tax, filing a claim for refund contesting the deficiency and, after disallowance of the refund claim, filing a refund action in the U.S. District Court of its tax residence or the U.S. Court of Federal Claims in Washington, D.C.

A bondholder may appeal an adverse decision of the trial court. Decisions of the U.S. Tax Court and the U.S. District Court may be appealed to the U.S. Court of Appeals for the circuit containing the bondholder's tax residence. Decisions of the U.S. Court of Federal Claims may be appealed to the U.S. Court of Appeals for the Federal Circuit, in Washington, D.C. The Internal Revenue Code states that the judgments of these appeals courts are final, subject only to review by the U.S. Supreme Court.

If the bondholders have not filed tax returns for particular tax years during the term of the bonds and the bonds are still outstanding, the IRS will instruct the issuer to notify the nominee paying interest to the bondholders to send Forms 1099-INT (a report of taxable interest income) to those bondholders. Ordinarily, this would require the bondholders to report the interest income on their next tax returns. Bondholders who wish to contest the characterization of interest as taxable may omit the interest from their tax returns if they explicitly disclose the omission in an addendum to their returns. The disclosure should identify the omission and any basis for the omission, including any opinion of counsel or other expert tax advice that the bondholder is relying upon. Filing this disclosure will start the applicable limitations period to run.

CHAPTER SEVEN

Voluntary Compliance Agreement Program (VCAP)

In 2001, the IRS implemented its voluntary closing agreement program ("VCAP") for tax-exempt bonds. The goal of VCAP is to permit issuers of tax-exempt bonds to resolve violations of the Code through voluntary closing agreements with the IRS. In general, VCAP encourages issuers to resolve violations of the Code through closing agreements at amounts less than full taxpayer exposure.

VCAP is not available if: (1) absent extraordinary circumstances, the tax law violation can be remediated under existing remedial action provisions or tax-exempt bond closing agreement programs contained in the Treasury Regulations or other published guidance, (2) the bond issue is under audit examination, (3) the tax-exempt status of the bonds is at issue in any court proceeding or is being considered by the Office of Appeals, or (4) the IRS determines that the violation was due to willful neglect. Perhaps the most important item listed above as a condition to the VCAP procedure is that an issuer can only utilize VCAP before the initiation of an audit.

In order to request a closing agreement under VCAP, an issuer or its authorized representative must submit a statement setting forth a description of the violation, the procedures and policies that will be instituted to assure future compliance with the Code, that the bond issue is eligible for VCAP (i.e., the circumstances set forth in (1) through (4) of the preceding paragraph do not apply), that the request for a closing agreement was promptly undertaken upon the discovery of the violation and that the payment of the closing agreement amount, if any, will not be made with proceeds of bonds the interest on which is exempt from taxation under Section 103 of the Code. The statement must also include proposed closing agreement terms, and, if applicable, a computation of the proposed closing agreement amount.

An issuer may initially request a closing agreement under VCAP on an anonymous basis. However, until the name of the bond issue is disclosed to the IRS, an anonymous request for a closing agreement under VCAP will not prevent the IRS from initiating an audit examination of the bond issue.

CHAPTER EIGHT

Section 6700 Penalties

A. Overview

Added in 1982, Section 6700 of the Code imposes a penalty on persons who participate in promoting abusive tax shelters. For purposes of Section 6700, a tax shelter may include a tax-exempt bond issue. A bond issue need not be under audit for the IRS to seek to impose Section 6700 penalties on a financing participant. With respect to municipal bonds, the penalty applies to any person who—

(A) organizes, or assists in the organization of, any investment plan or arrangement, or participates, directly or indirectly, in the sale of any interest in any investment plan or arrangement, AND

(B) makes or furnishes or causes another person to make or furnish a statement with respect to the excludability of any income by reason of participating in such investment plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter, or a gross valuation overstatement as to any material matter.

Section 6700 penalties may apply to bond counsel, investment bankers and their counsel, issuers and their counsel, conduit borrowers and their counsel, financial advisors, feasibility consultants and engineers, and other persons, who (1) are involved in the organization or sale of the bonds, and (2) know or have reason to know that their opinions, offering documents, reports, or other statements (or materials on which they relied in making such statements) are false or fraudulent as to any matter material to the tax exemption of the interest on the bonds.

The amount of the 6700 penalty is equal to the lesser of (i) $1,000, or (ii) if the person establishes that it is lesser, 100% of the gross income derived (or to be derived) from such activity. In seeking to apply Section 6700, the IRS has asserted that the $1,000 penalty amount is measured by $1,000 per each individual bond (e.g., each $5,000 denomination). In October of 2004, the penalty rate for activities that involve a statement regarding the tax benefits of participating in a plan or arrangement that the person knows or has reason to know was false or fraudulent (the so-called "promoter penalty") was modified. The promoter penalty is now equal to 50% of the gross income derived by the person from the activity for which the penalty is imposed.

B. Burden of Proof and Statute of Limitations

The IRS bears the burden of proof, and must establish by a preponderance of the evidence, all of the elements of a Section 6700 violation. In order to impose a Section 6700 penalty, the IRS need not show that there was actual reliance by the taxpayer on the false or fraudulent statement or actual underreporting of tax.

There is no statue of limitations for imposing a Section 6700 penalty.

C. A Trend Toward Section 6700 Penalties

Over the past few years, the IRS has shown an increasing predilection towards imposing, or threatening to impose, Section 6700 penalties. In 2003, the IRS and a bond counsel firm entered into the first tax-exempt bond Section 6700 penalty settlement agreement. Since that time, the IRS has initiated numerous Section 6700 investigations. In an article published in the Bond Buyer on October 22, 2003, Charles Anderson, manager of field operations for the IRS's tax-exempt bond division, stated "[a]t a minimum, you're going to see an increased interest on our part in opening [Section] 6700 investigations...[w]e really think that using an aggressive Internal Revenue Code Section 6700 approach to cases is the way to go."

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