March 15, 2005

The Honorable Mark W. Everson
Commissioner
Internal Revenue Service
Room 5226
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Proposed Amendments to the Regulations Governing Practice Before the IRS Relating to Standards for State or Local Bond Opinions and Certain Related Guidance Projects.

Dear Commissioner Everson:

I am writing on behalf of the Section of Taxation of the American Bar Association concerning Proposed Amendments to the Regulations Governing Practice Before the Internal Revenue Service Relating to Standards for State or Local Bond Opinions and Concerning Certain Related Guidance Projects Relating to Tax-Exempt Bonds. The views expressed in the attached comments represent the position of the Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

These comments pertain to proposed and final regulations published on December 20, 2004, and do not pertain to the standards of practice under the Circular 230 regulations currently in effect or any matters subject to those regulations.

Sincerely,

Kenneth W. Gideon
Chair, ABA Section of Taxation

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ABA SECTION OF TAXATION

COMMENTS ON PROPOSED AMENDMENTS TO THE REGULATIONS GOVERNING PRACTICE BEFORE THE INTERNAL REVENUE SERVICE RELATING TO STANDARDS FOR STATE OR LOCAL BOND OPINIONS AND CONCERNING CERTAIN RELATED GUIDANCE PROJECTS RELATING TO TAX-EXEMPT BONDS

(Title 31, Code of Federal Regulations, Subtitle A, Part 10)

March 15, 2005

The views expressed in these comments represent the position of the Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.1

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1These comments were prepared by members of the Section of Taxation’s Tax Exempt Financing Committee. Principal responsibility was exercised by Michael G. Bailey. Substantive contributions were made by Frederic L. Ballard, David J. Cholst, John J. Cross III, Stephen A. Edwards, Clifford M. Gerber, John T. Lutz, Floyd C. Newton III, Carol D. Olson, Loretta R. Richard, and Jeremy A. Spector. Coordinating responsibility was taken by John J. Cross III, Chair of the Committee on Tax-Exempt Financing. The comments were reviewed by Dean M. Weiner of the Section’s Committee on Government Submissions, and by Joel D. Zychick, Council Director for the Committee on Tax-Exempt Financing.
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**APPENDIX A** Possible Regulatory Revisions To Implement Selected Recommendations On Circular 230

**APPENDIX B** Comments On Certain Tax-Exempt Bond Guidance Projects That Are Related To The Proposed Circular 230 Opinion Standards For State Or Local Bond Opinions: Comments Concerning Proposed Regulations Under Section 141 Relating To The Application Of The Private Activity Bond Rules To Refunding Bonds (Reg-113007-99) And Internal Revenue Service Release Regarding Tax-Exempt Bond Record Retention Requirements
These comments address the proposed special rules for “State or local bond opinions” in Proposed Regulations governing practice before the Internal Revenue Service under Circular 230 that were published in the Federal Register on December 20, 2004, 69 Fed. Reg. 75887 (REG-159824-04) (the “Proposed Regulations”). We commend Treasury and the IRS for publishing these regulations in proposed form and providing an opportunity for public comment.

These comments also address certain aspects of the related final Treasury Regulations governing practice before the Internal Revenue Service under Circular 230 that were published in the Federal Register on December 20, 2004, 69 Fed. Reg. 75839 (TD 9165) (the “Final Regulations”). For convenience, the Proposed Regulations and the Final Regulations will be referred to by abbreviated section reference (e.g., §10.35 or §10.39). In addition, in an appendix, these comments address the relationship of other tax-exempt guidance projects to the opinion standard requirements set forth in the Proposed Regulations.

I. Executive Summary.

We commend the efforts of Treasury and the IRS to provide flexibility on ways to document tax compliance with respect to State or local bond opinions affecting obligations the interest on which is excludable from gross income under Section 103 of the Internal Revenue Code of 1986, as amended (the “Code”). Although it is uncertain whether the proposed alternative regime for State or local bond opinions ultimately will prove workable, we offer our comments on ways to more directly further the purposes of the alternative regime. We emphasize that the affected public finance market sector involves over $2 trillion in outstanding tax-exempt bonds, over 15,000 separate issuances of tax-exempt bonds annually, over 50,000 potential bond issuers and encompasses a wide range of bond issues. Set forth below are highlights of certain of our comments.

Certain Special Considerations for State or Local Bond Opinions. We include a general introduction which highlights certain special considerations for State or local bond opinions for perspective, including especially the public transparency of documentation in this area, the qualitatively different focus in this area on public purposes and attendant compliance, the costs of these rules for State and local governments, the numerous rules in this area of practice and associated complexity, and the appropriateness of due regard for these special considerations.

Purposes of Special Requirements for State or Local Bond Opinions. We suggest that an express statement of the purpose of the special requirements for State or local bond opinions would help guide understanding and implementation of those requirements. We note in particular that tax-exempt bond opinions are not typically provided with a view towards avoidance of penalties.

Fundamental Requirements to Ascertain Facts, Relate Law to Facts, and Address Significant Federal Tax Issues. We focus initially on the fundamental requirements for covered opinions and State or local bond opinions regarding the requisite needs to ascertain facts, relate relevant law to facts, and address significant Federal tax issues. We believe it is important to state explicitly in the final regulations that State or local bond opinions under §10.39 are subject to the same professional standards as covered opinions under §10.35, if that is their intent. Given the heightened importance, impact, and broadened application of these fundamental
requirements to State or local bond opinions as well as covered opinions generally, we strongly recommend further development of these standards in various respects.

Regarding the requirement to ascertain facts, we recommend validating reasonable practices regarding reliance on certifications and clarifying that the requirement to “ascertain” facts does not expand the role of tax lawyers into nonlegal roles that would require tax lawyers to verify facts independently or to be investigatory “auditors” of facts. In addition, the scope of the requirement that the written advice “identify” facts should be tailored to give due weight and consideration to the relative settled or unsettled nature of the applicable law and clarity of its application to the facts under the particular circumstances. For example, identifying that the City of Los Angeles has the sovereign power to determine that it is a political subdivision that is eligible to issue tax-exempt bonds does not further the purposes of Circular 230 in any meaningful way, even though these facts are plainly “relevant” to the Federal tax analysis of City of Los Angeles bond issues.

Regarding the requirement to relate law to facts, we ask for clarification of whether this rule applies regardless of whether a practitioner concludes that there are no significant Federal tax issues. Initially, we recommend limiting this requirement to a discussion of law relevant to significant Federal tax issues to provide a more meaningful emphasis of this requirement. Alternatively, absent clarification that the requirement to relate the relevant law to the facts applies only to the law regarding significant Federal tax issues, we recommend providing express discretion to tailor the scope and extent of discussion of relevant law and facts to give due weight to whether the particular facts and law are routine, settled, or noncontroversial under the particular circumstances. Further, we ask clarification that ordinary “plain vanilla” transactions which are part of routine governmental borrowings should require little, if any, discussion.

Regarding the requirement to evaluate significant Federal tax issues, we point out preliminarily that we prefer the approach recommended in previous comments to raise the threshold for a significant Federal tax issue from one with a reasonable basis to one with a “realistic possibility of success,” as defined in §10.34(d)(1), or similarly in Treas. Reg. §1.6694-2(b) (implying an approximately one in three or greater chance of success), because such a higher threshold would provide a more workable emphasis under Circular 230 on more clearly serious Federal tax issues. That said, we acknowledge that there may have been a sound policy basis for employing the reasonable basis standard to broaden the types of Federal tax issues covered by Circular 230. Thus, our comments generally assume that the reasonable basis standard for determining significant Federal tax issues will be retained. We focus on recommending strongly and generally that the reasonable basis standard for significant Federal tax issues be further clarified to the fullest extent possible in light of its heightened importance. In this regard, while recognizing the limitations of percentage tests, we nonetheless suggest a statement of percentage degree of success as a threshold for the reasonable basis standard for a significant Federal tax issue (e.g., at least a 20% chance of success) to give a better sense of this standard. We recommend clarifying that the reasonable basis standard generally is the same as that used for purposes of the accuracy-related penalty under Section 6662 of the Code and Treas. Reg. §1.6662-3(b)(3), but with certain suggested refinements. We suggest clarifying the nature of guidance that can be relied upon affirmatively by the Service in finding a reasonable basis for a “successful” court challenge for purposes of significant Federal tax issue determinations under Circular 230. Further, we ask for clarification that transactions that do not fall within “safe
harbor” provisions contained in regulations, revenue procedures, or other published guidance, will not ordinarily, for that reason, be presumed to raise a significant Federal tax issue.

**Certain Definitions.** We make technical recommendations on the definition of State or local bond opinion, including a recommendation to expand that definition to cover other tax opinions reasonably connected to or subsidiary to the basic interest excludability opinion under Section 103 of the Code (such as opinions concerning the 501(c)(3) status of a borrower). We also urge the Treasury Department to clarify that tax-exempt bonds are excluded from the definition of transactions with “the principal purpose” of tax avoidance or tax evasion under §10.35(b)(2)(i)(B) in a manner similar to a previous exemption from the definition of a tax shelter under Treas. Reg. §1.6662-4(g)(2)(ii). We suggest that the financing of projects and programs that serve public purposes in furtherance of a Congressionally-authorized interest exclusion properly ought not be so treated as a matter of tax policy.

**Need Workable Approach for Post-Issuance No Adverse Effect Tax Opinions.** In addition to issue date tax opinions on the excludability of interest on State and local bonds under Section 103 of the Code, which are proposed to be covered by the definition of State or local bond opinion in the Proposed Regulations, limited post-issuance tax opinions in the tax-exempt bond area are commonly rendered to address various actions (e.g., changes in interest rate modes or changes in use of tax-exempt bond financed property) that are necessary in order to enable State and local governmental issuers to satisfy ongoing tax covenants to preserve the tax exemption under Section 103 of the Code. These opinions are intended to provide assurance that such actions will have “no adverse effect” on such exemption. We make technical recommendations on how better to accommodate these common ancillary no adverse effect opinions within the limited scope opinion provision under §10.35(c)(3)(v) and otherwise.

**Electivity of Special Regime for State or Local Bond Opinions and Application of Disclaimer Exceptions.** We recommend clarifying that the special, more flexible documentation regime for State or local bond opinions under §10.39 is elective and that, alternatively, for a State or local bond opinion, a tax practitioner may decide to follow the general rules for covered opinions under §10.35. We also recommend clarifying that tax practitioners may use the disclaimer exceptions under §10.35(b)(4)(ii) and §10.35(b)(5)(ii) involving the absence of penalty protection for State or local bond opinions that otherwise would be reliance opinions or marketed opinions, respectively.

**Various Special Considerations.** We make recommendations regarding certifications in connection with refundings, certifications involving Section 501(c)(3) status and operations in connection with qualified 501(c)(3) bonds under Section 145 of the Code, and certain routine issues of tax-exempt bonds.

We request an opportunity to present oral comments at the public hearing scheduled for the proposed regulations. The foregoing executive summary provides an outline of the topics to be discussed. In our oral comments, we propose to devote an equal amount of time to each of the matters listed.
II. Introductory Perspective: Special Considerations for State or Local Bond Opinions.

The Proposed Regulations in general indicate that the same professional standards should apply to practitioners rendering opinions concerning the tax treatment of municipal bonds that are applicable to other practitioners, but provide that a more flexible approach can be used to meet those standards. We commend Treasury and the IRS for acknowledging that special considerations apply to State or local bond opinions. We agree that special approaches are appropriate for State or local bond opinions for a number of reasons, some of which have been highlighted in prior public comments and others of which we want to take the opportunity to highlight herein, in order to better set forth the general context of our comments on the Proposed Regulations.

First, such opinions always involve State and local governments. The opinions are customarily addressed to State and local governments. The tax subsidy resulting from the tax-exempt bond transaction benefits a State or local government in the form of lower interest rates, or in the form of a benefit given for a project that serves a public purpose of a State or local government. In most States, the State and its political subdivisions, agencies, and authorities are prohibited from issuing bonds unless there is a recognized public purpose. The client of the attorney rendering such an opinion is customarily a State or local government.\(^1\) This may seem to be an obvious point, but it has important implications that may not be readily apparent.

One important point is that State or local governments are almost uniformly subject to public meeting and public records requirements under various “sunshine” laws. For this reason, public finance transactions, with only rare exceptions, are uniquely subject to public scrutiny and are already transparent to the public. These transactions are therefore almost never “subject to conditions of confidentiality” or transactions “with contractual protection.” For attorneys practicing in this area, meeting all of the approval procedures required by State and local governments is often more cumbersome and time consuming than meeting the approval procedures required of private corporations, but those procedures in and of themselves generally ensure that the transaction is transparent, is open to the public and has a bona fide public purpose.

Another important point we believe bears serious consideration is that it is reasonable to conclude that State and local governments as a class in general have qualitatively different motivations in tax compliance than private corporations and individuals. Attorneys in public finance transactions serve State and local government officials whose fundamental mission is to represent and serve the public. As a whole, we believe from our experience that State and local government officials seek in good faith to be compliant with federal and State laws, including the Code.

In part for these reasons, we believe that tax-exempt bond transactions are generally compliant with Federal tax requirements. While we readily acknowledge that any area of Federal tax will inevitably have some level of noncompliance and that there has doubtless been

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\(^1\) In certain cases, the client of an attorney rendering a State or local bond opinion may be a conduit borrower or another participant. In the large majority of cases, however, a State or local government is the client.
noncompliance in certain transactions at the margins of the tax-exempt bond industry, we respectfully offer our view that the tax-exempt bond area is a largely compliant area. Indeed, we believe that the very transparency of State or local bonds tends to bring tax compliance problems to the surface.

Although the new requirements of the Proposed Regulations directly apply to tax attorneys, they will also likely have real costs to State and local governments. To the extent the Circular 230 regulations impose documentation and opinion writing requirements that are more burdensome than current practice, State and local governments will certainly ultimately bear at least part of that cost. In addition, it may be noted that some of the new requirements of the Proposed Regulations in practice would directly impose on State and local governments new recordkeeping requirements and their attendant costs. For example, §10.39(b)(1)(iii) states that a written advice “must identify in a separate section all factual representations, statements or findings relied upon by the practitioner.” As a practical matter, this means that State and local government officials will need to incur costs to help to prepare, review, and verify such representations. If the factual representations required are substantially more detailed than has customarily been required in the past, the cost of that compliance will fall on the shoulders of State and local governments.

We also note that §10.39(b) of the Proposed Regulations requires that the separate “written advice” prepared by tax counsel “must be included in the transcript of proceedings.” Although this recordkeeping requirement is not as likely as some of the other requirements of the Proposed Regulations to impose substantial new costs on State or local governments, it does again highlight the burdens of compliance with Circular 230 will be borne by State or local governments. The “transcript of proceedings” is typically properly regarded as the transcript of proceedings of a State or local government and as a public document, not as the record of the practitioner.

We acknowledge that Treasury may determine as a matter of policy that it is necessary to impose such additional costs on State and local governments to better promote tax compliance. However, we request that the imposition of such costs be carefully considered in the process of finalizing the Proposed Regulations.

Second, tax-exempt bond opinions frequently apply highly complex legal requirements to unusually complex and detailed facts. Even the simplest tax-exempt bond issue (for example, a general obligation bond to finance a public school) requires tax counsel to analyze and determine that a large number of requirements are met. More complex bond issues involve the application of a much higher number of legal requirements.\footnote{To render an approving opinion in even such a simple case, tax counsel would need to conclude, among other matters that (1) the issuer is a State or local government, (2) the bonds are validly issued under State law, (3) the bonds are incurred pursuant to the “borrowing power” under relevant case law, (4) the bond issue does not meet the “private business tests” of section 141(b) of the Code, (5) the bond issue does not meet the “private loan financing test of section 141(c) of the Code, (6) the bond issue is not an issue of “arbitrage bonds” under section 148 of the Code because of improper investment expectations, (7) the bond issue has requisite provisions to assure that...}
Complex legal requirements in themselves are not unusual in the Code. What may be somewhat more unusual about the tax-exempt bond practice is that these complex legal requirements often need to be applied to fact patterns that are themselves highly complex and that extend over uniquely long periods of time. Although a small city may issue a bond issue to finance a single public school, a state or a large city may issue a general obligation bond to finance more than 100 individual projects. A state housing authority may issue a qualified mortgage revenue bond issue to refund 20 different prior bond issues. State or local bond opinions are often opinions with respect to State or local government programs and are not limited to opinions with respect to single projects. This “programmatic” nature of many State or local bond opinions in particular requires a reasonable degree of flexibility in opinion practice.

More importantly, factual complexity can arise not only because a bond issue may finance a very large number of different projects, or refinance a large number of prior bond issues, but because many tax-exempt bond requirements do not apply only on a single date, or within a single year, but apply over the entire term of the bond issue. Application of the requirements for tax-exempt bonds may require tax counsel to look backwards and forwards for periods of 30 years or more. The application of these requirements over long periods of time will as practical matter become burdensome unless State and local governments, conduit borrowers, and tax counsel are permitted to follow practical and reasonable conventions of the sort that have historically been followed in this practice area.

The need to look backwards in time arises most prominently in refunding bonds issues. The need to look forward in time arises in almost all bond issues. The qualification of an obligation as a tax-exempt bonds frequently depends on events that occur in the future, after the date of issuance of the bond. For example, whether a bond issue consists of “arbitrage bonds” depends in large part upon how bond proceeds are actually invested. Whether a bond qualifies as a “governmental” bond depends in large part on how the facilities financed with the bonds are actually used. Marketed bond counsel opinions usually speak only as of the date of issuance of the bonds and are in large part based on factual statements by the issuer or borrower relating to its reasonable expectations. In contrast, many other types of Federal tax opinions are based on events that either have occurred or will occur in conjunction with the closing of the transaction.

Third, the apparent purpose of the special requirements for covered opinions does not readily apply to tax-exempt bond opinions. The special requirements for covered opinions in the

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3 The opinion that accompanies marketed tax-exempt bond opinions is based on a large number of subsidiary conclusions, such as whether the bonds (1) are “private activity bonds”, (2) are “arbitrage bonds”, (3) are “qualified private activity bonds”, (4) are “federally guaranteed bonds”, (5) are “hedge bonds”, (6) are “pooled financing bonds”, and (7) meet various information reporting and other procedural requirements. To resolve each of these issues, a number of sub-issues must be resolved. For example, to conclude that a bond issue consists of qualified “exempt facility” bonds, counsel must make such determinations as whether the bond issue finances capital expenditures or working capital, whether the bond issue has been allocated volume cap, whether it has received public approval, whether it meets maturity limitations, and the extent to which it finances land, to name a few. In any particular transaction, normally only certain of these requirements raise difficult issues that merit extensive legal analysis.
Final Regulations appear to be aimed at preventing inappropriate reliance by taxpayers on opinions to avoid penalties. We suggest that the imposition of penalties against holders of tax-exempt bonds is not likely to be an area of significant concern for either the IRS or bondholders.

We note that in the past regulations of Treasury have expressly recognized that it is consistent with sound policy to afford State and local government “taxpayers” with special treatment. In particular, former Treas. Reg. §1.103-13(a) provided that State and local governments could conclusively certify facts relevant to tax-exempt bond requirements. This regulation reflected a well considered Treasury policy decision that it is reasonable to extend to State and local governments a reasonable measure of deference to establish facts, including reasonable expectations, despite the risk of a degree of noncompliance. 4

Finally, the confluence of new IRS tax-exempt bond guidance with the Proposed Regulations poses particularly difficult practical problems for tax practitioners in this area. The general theme of this new guidance, which includes regulations relating to tax-exempt refunding bonds and recordkeeping requirements, is that many State or local bond opinions must take into account events that have occurred over long periods of time. We request that Treasury and the IRS consider the cumulative effects of these various guidance projects before promulgating final rules. These comments include a consideration of those other projects in Appendix B to provide a better explanation of how those projects relate to Circular 230 opinion standards.

III. General Comments on the Purposes and Approach of the Proposed Regulations

We suggest that the Proposed Regulations contain a statement of purpose of the regulations to provide better guidance regarding interpretation of the standards of practice set forth therein. 5 We understand of course that the new amendments to Circular 230 are generally intended to “restore and maintain public confidence in tax professionals” and to “ensure that tax professionals do no provide inadequate advice, and increase transparency by requiring tax professionals to make disclosures if advice is incomplete.” 6 We also understand that the general requirements for all written advice contained in §10.37 are in general comparable to the ethical standards that have historically applied to tax professionals. The Proposed Regulations and the Final Regulations do not explain why the standards of practice for “covered opinions” and “State or local bond opinions” are more detailed and rigorous than the general requirements contained in §10.37.

The structure of the Proposed Regulations and the Final Regulations indicates that the central purpose of the more rigorous standards contained in §10.35 and §10.39 is to address the use of written advice for the purpose of avoiding penalties that may be imposed on a taxpayer.

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4 Former Treas. Reg. §1.103-13(a) and the possible relevance of that regulatory approach to the Proposed Regulations are discussed in greater detail in attached Appendix B.

5 We note that Treasury and the IRS have frequently included statements of purpose in Federal tax regulations as an aid to interpretation. For example, in the tax-exempt bond area, the arbitrage regulations under section 148 and the private activity bond regulations under section 141 both begin with statements of purpose. See Treas. Reg. section 1.148-0(a) and section 1.141-2(a).

Section 10.35 expressly provides that a tax practitioner may in effect elect out of the more rigorous written advice standards that apply to “covered opinions” by making a clear disclaimer that the written advice may not be used by the taxpayer to avoid penalties, except in cases that are identified as potentially abusive. The structure of the Proposed Regulation also indicates that a tax practitioner may in most cases effectively elect out of the more rigorous requirements for “State or local bond opinions” contained in §10.39 by making the same disclaimer. Thus, the underlying basis for the more rigorous standards for “covered opinions” and “State or local bond opinions” appears to be that tax practitioners have a special obligation to provide complete and rigorous written advice in cases where a taxpayer may use that written advice to obtain a benefit under the Code and regulations (that is, the avoidance of penalties).

If this is indeed the underlying purpose of the more rigorous standards for “covered opinions” and “State or local bond opinions”, we suggest that the regulations should contain an explicit statement to that effect. If other purposes motivate these more rigorous standards, such as a policy to promote more fulsome disclosures about tax issues generally, we suggest that those purposes should also be clearly stated.

We also raise the question of underlying purpose because it is not clear how the underlying purpose of the special standards for “covered opinions” under §10.35 applies in the context of “State or local bond opinions.” In particular, we do not believe that “State or local bond opinions” are typically obtained for the purpose of avoiding penalties. Among other things, in contrast to most transactions requiring Federal tax opinions, the holders of tax-exempt bonds are typically not involved in structuring the transaction and do not engage any of the tax professionals. Suppose a State issues bonds and makes representations that it has complied with all tax-exempt bond requirements that apply as of the issue date and makes covenants that it will comply with all tax-exempt bond requirements will apply after the issue date. If an investor purchases a State bond under such circumstances, and the IRS later determines the bond not to be compliant, would the investor be subject to penalties under section 6662? The regulations and authority under sections 6662 and 6664 do not expressly address this situation, although the regulations expressly indicate that a taxpayer’s good faith reliance on a Form W-2 is generally a basis for avoiding imposition of penalties. By analogy, there would appear to be a sound technical argument that an investor that purchases a State or local bond, with appropriate representations and covenants from the State or local government issuer, in general has “reasonable cause” to report the interest received on the bond as excludable from gross income under section 103.

Moreover, as a practical matter, many investors hold tax-exempt bonds through widely-held mutual funds. In such cases, a typical investor is not aware of the specific bonds held by the mutual fund, would not know the identity of the law firms that had rendered tax opinions with respect to such bonds, and would not obtain any updated representations or Federal tax opinions regarding continued compliance of the bonds. In such circumstances, it seems highly unlikely that the IRS would seek to impose penalties against such taxpayers, or, if it did, that the courts would uphold imposition of penalties, even though no professional tax advisor had rendered an

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opinion and even though possible technical arguments for imposition of penalties might exist under section 6662 of the Code.\footnote{We note in particular that representations about Federal tax compliance in such a case are made by a State or local government, which should be an important factor in determining whether a taxpayer has reasonable cause to rely on such representations. The example assumes that the mutual fund declares and pays to investors all tax-exempt income.}

We suggest that the relationship between section 6662, section 6664 and other penalty provisions of the Code and State or local bond opinions should be further clarified and considered before the standards set forth in §10.39 are published in final form. If indeed the written advice of professional tax advisors would not in most cases be required for a bondholder to avoid imposition of penalties, most, if not all, State or local bond opinions should be exempt from the rigorous standards set forth in §10.39 of the Proposed Regulations. We emphasize that we do not seek to avoid high standards of practice in connection with rendering State or law bond opinions and note that a high “unqualified opinion” standard has traditionally applied to the tax-exempt bond industry. We note, however, that application of the substantive standards for “covered opinions” to State or local bond opinions may prove to be particularly burdensome, in light of the special circumstances we set forth in these comments. A more complete consideration of the relevance of sections 6662 and 6664 and other penalty provisions in this context could provide a basis for reasonable exceptions in this area.

A. Recommend Express Statement of Same Professional Standard.

The preamble to the Final Regulations states that “[a]fter careful consideration, the Treasury Department and the IRS have concluded that practitioners rendering tax opinions concerning the treatment of municipal bonds should be subject to the same professional standards that are applicable to all practitioners.” The preamble to the Proposed Regulations states that the proposed §10.39 sets forth minimum requirements that are “substantially similar” to those of §10.35(c).

The Proposed Regulations, however, do not expressly state the intent of Treasury and the IRS that the substantive standards under §10.39 are intended to be exactly the same as under §10.35, except for the form and manner in which the written advice is provided. Although §10.39 is for the most part a verbatim repetition of §10.35, there are a number of subtle differences that might be read to have significant practical implications, as is further discussed in these comments. For example, in discussing the requirement that a covered opinion must “relate the applicable law to … relevant facts”, §10.39(b)(1)(iv) refers to the “analysis required”, while the comparable provision in §10.35(c)(2) does not refer to “analysis.” Perhaps more importantly, the preamble to the Proposed Regulations contains statements that do not appear to comport with the substantive standards set forth in the Final Regulations, as is further discussed below.

In light of the apparent general tax policy decision to apply the same professional standards to State or local bond opinions as to other covered opinions, we believe that it is important to ensure uniform application of the basic standards. We suggest that §10.39 would be clearer if it expressly stated that the substantive standards of §10.35 apply to “State or local bond opinions”, except that the form of the opinion may be in a separate writing provided to the issuer and for other more flexible provisions that may be set forth in §10.39. We further recommend eliminating extensive repetition in §10.39 of the basic standards from §10.35 on the grounds that it is unnecessary, a potential source of confusion, and a potential source of divergent interpretations. Alternatively, in light of the distinct context in which tax-exempt bond opinions are given, it could be preferable to have the requirements of §10.39 stand on their own with no reference to §10.35. In this way, separate defined terms and requirements could be stated without causing an implicit reference back and forth between the two sections.

In either event, to implement these suggestions, we recommend that the following sentence be added to §10.39(a):

9 For example, §10.39(b)(1)(i) is an exact repetition of §10.35(c)(2)(i). Section 10.39(b)(1)(ii) and (iii) are almost exact repetitions of §10.35(c)(2)(ii) and (iii), except that sentences concerning “business purpose” in each of §10.35(c)(2)(ii) and (iii) are deleted. “Business purpose” is as important a principle in opinions concerning tax-exempt bonds as it is in other areas, except only that it typically is couched in terms of a “public purpose” or a “governmental purpose” of the tax-exempt bond issue. In addition, the similar concept of “unrelated trade or business purpose” is often an important issue with respect to qualified 501(c)(3) bonds.
The substantive requirements for State or local bond opinions are the same as the requirements for covered opinions, but the written advice for State or local bond opinions may be provided in a more flexible manner than covered opinions, in light of the special considerations that apply to State or local bond opinions. These special considerations include the unique status of State or local government issuers of tax-exempt bonds as public governmental entities, the unique context in which the taxpayer relies upon such opinions, the length of on-going compliance requirements, the factual and legal complexity of tax-exempt bond transactions, the wide range and variety of tax-exempt bond transactions, and the special administrative treatment of State and local government issuers of tax-exempt bonds as “taxpayers” in tax-exempt bond transactions.

B. Requirement to Ascertain Relevant Facts and “Due Diligence.”

1. In General.

Section 10.39(b)(1) would provide that the separate written advice provided to the issuer in connection with a State or local bond opinion must “identify and consider all facts that the practitioner determines to be relevant.” Section 10.35(c)(1) provides that this same requirement applies to covered opinions.

The structure of the Proposed Regulations and the Final Regulations suggests that the requirements to ascertain relevant facts and to relate the law to the facts are independent requirements that apply regardless of whether a particular transaction raises significant Federal tax issues. We recommend that it would be helpful to limit the requirement to ascertain facts to those facts relevant to significant Federal tax issues. If, however, this requirement was intended to be an independent requirement even in the absence of significant Federal tax issues, we have several recommendations.

Our overriding recommendation in this regard is that the regulations describe the standard for ascertaining facts in a way that clearly affirms the ability to rely on factual representations without independent verification, that does not require tax lawyers to assume nonlegal roles involving investigatory “audits” of facts, and that does not impute to tax lawyers expertise in other disciplines. This recommendation is consistent with longstanding standards regarding “due diligence” under Circular 230, such as that set forth in §10.34(c), which is discussed below, and as previously set forth in §10.33(a)(1)(ii) of the 1984 final regulations, which provided in relevant part that “a practitioner need not conduct an audit or independent verification of the asserted facts.”

To implement this suggestion, we recommend that the following sentence be added after the first sentence of §10.39(b)(1)(i):

The practitioner may rely on reasonable factual representations by a person the practitioner reasonably believes to be suitable for such representations, without the need to conduct an audit or independent verification of them.
We recommend that the phrase “without the need to conduct an audit or independent
verification” should be inserted after the words “or should know” in the fourth sentence of
§10.39(b)(1)(ii) and after the word “incomplete” in the second sentence of §10.39(b)(1)(iii). We
recommend that the following sentence be added as the penultimate sentence of §10.39(b)(1)(ii):

In determining whether a factual assumption is reasonable, a practitioner
will ordinarily not be presumed to have particular expertise in disciplines
other than the Federal tax law, such as financial analysis, valuation, or
engineering disciplines.

We recommend that the following sentence be added as the penultimate sentence of
§10.39(b)(1)(iii):

In determining whether a factual representation is reasonable, a
practitioner will ordinarily not be presumed to have particular expertise in
disciplines other than the Federal tax law, such as financial analysis,
valuation or engineering disciplines.

A second general recommendation regarding the factual inquiry is to give some
discretion to narrow the requirement to identify and ascertain facts to what is reasonable under
the particular circumstances. It would be helpful to provide some examples covering both “plain
vanilla” and complex transactions, including an example illustrating how specifically to apply
this requirement to complex or large volumes of facts. For example, as we further discuss
below, in the case of refunding bonds we recommend that a public finance attorney should be
expressly permitted to rely upon a certification of an issuer or borrower regarding compliance
with Federal tax requirements during the period the prior bonds were outstanding, without
having a requirement to investigate such past compliance.

To implement this suggestion, we recommend that the following sentence replace the
final sentence of §10.39(b)(1)(i):

The scope and extent of the relevant facts identified and considered in the
written advice may be tailored to give due weight and consideration to the
nature of the facts and the size and type of transaction, and reasonable
conventions may be employed to summarize or streamline the description
of facts for appropriate reasons, which may include the size and the
complexity of the transaction, the volume and complexity of the facts, and
other similar factors.

A third recommendation regarding the factual inquiry is to eliminate the “locational”
requirements for factual assumptions and factual representations, statements, and findings set
forth in the last sentences of §10.39(b)(1)(ii) and §10.39(b)(1)(iii), which require that the these
factual matters be set forth in “separate sections.” Instead, we recommend that tax practitioners
be given reasonable flexibility to discuss factual assumptions and factual representations in any
appropriate place under the circumstances. We expect that the most logical place for discussion
of various factual assumptions will be in the context of their relevance to particular legal issues.
To implement this suggestion, we recommend that the words “in a separate section” be deleted from the last sentence of §10.39(b)(1)(ii) and from the last sentence of §10.39(b)(1)(iii).

2. The Qualitative Standard for Ascertaining Facts and “Due Diligence.”

Set forth below is further discussion of the qualitative nature of the requirement to ascertain facts and the “due diligence” standard.

Section 10.34(c) of Circular 230 states as follows:

A practitioner advising a client to take a position on a tax return, or preparing or signing a tax return as a preparer, generally may rely in good faith without verification upon information furnished by the client. The practitioner may not, however, ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.

This standard is generally consistent with the standards of practice that have historically applied to attorneys with respect to establishing facts to provide legal opinions, including legal opinions in the tax-exempt bond area. Section 2.2 of the Report of the TriBar Opinion Committee on “Third Party ‘Closing’ Opinions”\(^\text{10}\) states as follows:

Customary diligence provides norms for establishing fact. These norms accept as fact the information provided by persons who appear to be in a position to know facts. Opinion preparation is not ordinarily an occasion to question factual information provided by apparently reliable sources nor is the opinion letter a vehicle to ferret out fraud. Of course, all relevant information known to the opinion preparers, however obtained, must be considered.

“Establishing” fact means that in accordance with customary practice (i) the opinion preparers have assembled factual information (whether in certificate, representation or other form), (ii) such information is not “unreliable” … and (iii) the information so assembled includes the facts customarily required for giving the specific opinion. Once opinion preparers have met the standard of customary diligence in “establishing” facts required to support a specific opinion, they have discharged their professional responsibility and need not gather additional information or undertake verification procedures (unless they have specifically agreed to do so).

\(^{10}\) 53 BUS. LAW. 592 (1998).
We believe that it is important to provide a positive statement in the regulations that practitioners need not conduct an audit or independent verification of facts. This limitation would be consistent with historic standards under Circular 230 and reasonable standards of practice for tax lawyers. In this regard, §10.33(a)(1)(ii) of the longstanding former 1984 final Treasury Regulations on tax shelters under Circular 230 included such a positive statement regarding the nature of factual inquiries, which provided in relevant part, as follows:

§10.33(a)(1)(ii). (1984) A practitioner may not accept as true asserted facts pertaining to the tax shelter which he/she should not, based on his/her background and knowledge, reasonably believe to be true. However, a practitioner need not conduct an audit or independent verification of the asserted facts, or assume that a client’s statement of the facts cannot be relied upon, unless he/she has reason to believe that any relevant facts asserted to him/her are untrue.

Similarly, §10.33(a)(1)(iii) and §10.35(a)(1)(iii) of the January 2001 Proposed Treasury Regulations under Circular 230, 66 Fed. Reg. 3276 (January 12, 2001) also included such a positive statement regarding the nature of factual inquiries, which provided in relevant part, as follows:

§10.33(a)(1)(iii) and §10.35(a)(1)(iii) (January 2001) A practitioner does not need to conduct an audit or independent verification of a factual representation, but the practitioner may not rely on factual representations if the practitioner knows or has reason to believe, based on his or her background and knowledge, that the relevant information is, or otherwise appears to be, unreasonable, incorrect, incomplete, inconsistent with an important fact or another factual representation, or implausible in any material respect.

Section 10.35(c)(1)(i) of the Final Regulations provides that a practitioner providing a “covered opinion” must “use reasonable efforts to identify and ascertain the facts, which may relate to future events if a transaction is prospective or proposed, and to determine which facts are relevant.” Section 10.35(c)(1)(iii) provides a further explanation of this standard:

The practitioner must not base the opinion on any unreasonable factual representations, statements or findings of the taxpayer or any other person. An unreasonable factual representation includes a factual representation that the practitioner knows or should know is incorrect or incomplete. For example, a practitioner may not rely on a factual representation that a transaction has a business purpose if the representation does not include a specific description of the business purpose or the practitioner knows or should know that the representation is incorrect or incomplete.

As we understand the “business purpose” example, it is consistent with the general standard set forth in §10.34(c) and the standard that has historically applied to counsel rendering opinions. We understand the “business purpose” example to be an elaboration of the historical standard that has applied to prudent counsel rendering opinions, not a fundamentally new
standard. Although “business purpose” may be a factual matter, it is plainly a standard that is informed by a wide body of judicial precedent that emphasizes the specific facts of each case. We understand that a bare representation that a transaction has a “business purpose” may be properly regarded as conclusory and incomplete. We understand that the example does not state and does not imply that it is in any manner improper for tax counsel to rely upon a more detailed representation describing the details of business activity, without any independent factual verification of the actual business activities of the taxpayer.

The preamble to the Proposed Regulations, however, contains the following statement, which could be read to imply that practitioners have an affirmative obligation to verify facts:

A practitioner must not base the written advice on an assumption or factual representation, statement or finding of any person unless the practitioner has exercised due diligence in identifying facts and ascertaining the relevant facts. Even if a third party has certified a representation, the practitioner is responsible for exercising due diligence. For example, a practitioner may not rely on a representation, certified or otherwise, to conclude that the requirements of the safe harbor for establishing the fair market value of a guaranteed investment contract in 26 CFR 1.148-5(d)(6)(iii) were met if the representation does not include a specific description of how those requirements were satisfied or if the practitioner knows or should know that the representation was incorrect or incomplete.

We note that this is the single instance in the Final Regulations and the Proposed Regulations that refers to a “due diligence” obligation in the context of “identifying and ascertaining” facts.\footnote{Section 10.22 of Circular 230 provides that a practitioner “must exercise due diligence”, but implies that this means that a practitioner is required to “determine the correctness” only of its own representations, not the representations of others.}

We understand that a statement in a preamble to a proposed regulation is not formal authority, but this statement appears to have been included to provide an indication of how the IRS proposes to interpret the substantive standards of the new amendments to Circular 230. The interpretation of the obligation of practitioners to “identify and ascertain facts” is of fundamental importance. If interpretations of this standard are made, we request that they be in the regulation itself. Absent further explanation, for the reasons set forth below we request that this statement be deleted from the final regulations.

A consideration of the nature and history of the regulation referenced in the preamble (Treas. Reg. §1.148-5(d)(6)(iii)) is necessary to explain why the statement has troubling implications. Section 148 of the Code in general prohibits an issuer from earning an investment profit from investing tax-exempt bond proceeds, and in many cases where such an investment profit may be earned requires the issuer to “rebate” the investment profit to the Federal government as a condition to the tax-exempt status of the bonds. For this reason, an issuer frequently may not have a financial incentive to invest tax-exempt bond proceeds at the highest
rate. Because of this consideration, the arbitrage regulations have long required that investments be purchased at fair market value and have prohibited the payment of more than fair market value for investments (a practice referred to as “yield burning”). The public finance bar and Treasury have been engaged in an extensive dialog that has spanned several decades about how to address the issue of “yield burning.” After extensive public comment, Treasury adopted Treas. Reg. §1.148-5(d)(6)(iii) in 1998, which sets forth a detailed safe harbor bidding process to establish that certain guaranteed investment contracts and other investments may be treated as acquired at fair market value.

We understand that Treasury expressly recognized in promulgating these regulations that “guaranteed investment contracts” are often intrinsically difficult to value, in large part because they often contain terms that are specifically tailored to a particular borrower’s needs. These regulations reflect a clear policy decision that a bona fide bidding procedure is a legitimate and appropriate manner to determine fair market value of such a financial instrument. The basic premise of this regulatory safe harbor is that issuers and their attorneys are ordinarily entitled to rely upon certifications of others with regard to the bidding process, without any additional “due diligence” to attempt to verify the market value of complex financial instruments. To better guide the industry in applying such a bidding procedure, the regulations set forth in great detail specific wording to include in certifications relating to the bidding process. There is probably no other regulatory provision concerning tax-exempt bonds that contains more detailed guidance regarding the form of a recommended certification. Indeed, we know of no other provision in any regulation or other guidance under the Code that contains a more detailed procedure to establish fair market value.

In light of this extraordinarily detailed safe harbor, we believe that it is by far the predominant practice among public finance attorneys in cases with a “yield burning” potential to advise issuers to follow the procedures set forth in the safe harbor and to obtain certifications that closely track the wording of the regulations. The reference in the preamble to a representation that “does not include a specific description” of how the safe harbor requirements are met describes a situation that we believe rarely occurs, assuming that a certification that follows the wording specified in the regulation is such an “adequate description.” The representation of an issuer pertains to whether an investment has been purchased at fair market value; by advising an issuer on the safe harbor requirements, and obtaining detailed certifications, in our view an attorney has met any standard of “due diligence” that can reasonably be imposed under Circular 230.

We emphasize that Treas. Reg. §1.148-5(d)(6)(iii) is a safe harbor, not a mandatory requirement. There is no implication in the regulations that the acquisition of an investment that does not use the safe harbor to ascertain fair market value is presumptively noncompliant if fair market value is otherwise reasonably established. Provided that the issuer has used some other means to establish that the fair market value requirement is met. There are surely a number of different ways that “fair market value” may be established, depending on the particular facts and circumstances involved.

Public finance attorneys are not ordinarily engaged to conduct the process of obtaining bids for financial instruments and typically do not hold themselves out as having expertise as bidding agents for financial products. Issuers typically engage a bidding agent for such services...
or, in some cases, conduct the bidding process themselves. The bidding agents that are engaged for such services are ordinarily financial advisors or investment banking firms that hold themselves out to be experts in such matters. Also, guaranteed investment contracts are commonly acquired with tax-exempt bond proceeds by issuers after the date of issuance of the bond issue, often without any involvement by bond counsel.

Public finance attorneys do not ordinarily render opinions that specifically state that the regulatory fair market value safe harbor procedure contained in Treas. Reg. §1.148-5(d)(6)(iii) has been met. In many cases, a State or local bond opinion will rely upon a representation that the issuer has acquired investments at fair market value, which representation is buttressed by detailed certifications to the effect that the procedures set forth in the regulatory safe harbor were followed.

We emphasize that Treas. Reg. §1.148-5(d)(6)(iii) sets forth a safe harbor relating purely to the question of valuation. By contrast, the Final Regulations set forth a representation regarding “business purpose” as an example of the requirement that practitioners “identify and ascertain relevant facts.” In general, the implications of that example are clear. “Business purpose”, although a matter of fact, is plainly a question that is informed by a large body of case law indicating that business purpose depends upon a taxpayer’s particular facts and circumstances. As we have stated, in that light, a bare certification that a transaction has a “business purpose” could be viewed as conclusory or incomplete. Accordingly, we understand that, in order to meet the standard of “identifying and ascertaining” facts relating to “business purpose”, more complete representations need to be obtained that specify the particular relevant facts and circumstances of a taxpayer’s business operations. In the tax-exempt bond area, an analog to a representation that a transaction has no “business purpose” might be that a bond is not an “arbitrage bond.” The question of whether a financial product is acquired at fair market value, however, is a bare question of valuation and is not a question that is similarly informed by case law, regulations or rulings.

We request clarification that an attorney ordinarily meets the obligation to “identify and ascertain” facts relating to the regulatory safe harbor by obtaining a representation in good faith from a suitable person (such as a reputable financial advisor or investment banking firm) to the effect that the procedures set forth in the regulatory safe harbor have been followed, without the need to perform any additional due diligence. We understand that a certification that is on its face defective or inconsistent with other certifications or information provided to a practitioner should not be relied upon in providing a State or local bond opinion, but that technical deviations from the detailed requirements of the safe harbor do not necessarily indicate that a certification regarding fair market value is suspect. We ask for express clarification that Circular 230 does not require that attorneys have an additional obligation to evaluate whether the bids received for such complex financial instruments reflect fair market value.

The essential problem with the statement in the preamble in our view is that it could be read to suggest that public finance attorneys will be held to a standard that assumes and requires expertise in areas other than the tax law. While this issue is present in many areas of the tax law, nonetheless it warrants highlighting that expertise concerning the Federal tax law relating to
financial transactions involving tax-exempt bonds does not imply special expertise in matters of financial markets, financial valuation, or financial analysis. 12

3. Factual Complexity and Need for Streamlining Representations and Assumptions.

As we indicate elsewhere in these comments, the facts underlying tax-exempt bond opinion are commonly very complex and detailed, for a number of reasons. First, the statutory and regulatory requirements that apply to tax-exempt bonds are extremely complex and detailed. Second, it is common for a tax-exempt bond issue to finance a large number of facilities. Third, many requirements for tax-exempt bonds apply throughout the term of the bond issue, so that certain opinions may need to take into account facts and circumstances that have occurred or will occur over long periods of time (often several decades). Thus, in many cases, a requirement that all relevant facts must be stated in detail in formal tax documents will in many cases be very burdensome, both for state and local governments and their tax counsel. We recommend that that streamlining representations and assumptions in the discussion of relevant facts be permitted. We recommend the development of exceptions for routine financings, as is further set forth below.

C. Relating Law to Facts.

Section 10.39(b)(2) would provide that the separate written advice provided to the issuer in connection with a State or local bond opinion must “relate the applicable law (including potentially applicable judicial doctrines) to the relevant facts.” Section 10.35(c)(2) provides that this same requirement applies to covered opinions. Section 10.39(b)(1)(iv) states that the “analysis required” by §10.39(b)(2) may be contained in a document that is different than a tax certificate or similar document.

The structure of the Proposed Regulations and the Final Regulations suggests that the requirement to ascertain relevant facts and to relate the law to the facts are independent requirements that apply regardless of whether a particular transaction raises significant Federal tax issues. Initially, we recommend that the need to relate the law to the facts should apply only to that law relevant to significant Federal tax issues. We believe that this approach would provide a more meaningful emphasis for this requirement.

To implement this suggestion, we recommend that the words “relevant facts” be deleted from §10.39(b)(2)(i), and that the words “facts relevant to a significant Federal tax issue” be substituted therefor.

12 Because State and local governments frequently do not have the financial resources to retain substantial in house financial and legal staffs, two factors in particular may contribute to potential tax compliance problems in the tax-exempt bond area: (1) the considerable financial complexity of certain tax-exempt bond transactions and (2) the considerable legal complexity of the requirements that apply to tax-exempt bonds. A compliance approach directed at the opinion standards of attorneys might effectively serve to reduce tax compliance problems relating to the complexity of legal requirements, but in our view such an attorney-directed compliance approach cannot be reasonably expected to serve to effectively address tax compliance problems rooted in analysis and valuation of complex financial products.
Alternatively, however, if this requirement was intended to be an independent requirement, even in the absence of significant Federal tax issues, we recommend providing express discretion to tailor the scope and extent of discussion of relevant law and facts to give due weight to the relative routine, settled, or noncontroversial nature of the particular law under the particular circumstances. For example, section 103 only applies to obligations that are validly issued by a State or local government. We suggest that there should be no implication that the written advice must discuss why the obligation is validly issued and why the issuer qualifies as a State or local government, except perhaps in the rare cases in which the status of the issuer is in fact a question that merits detailed tax analysis.

To implement this suggestion (as an alternative to the suggestion above), we recommend that the first sentence of §10.39(b)(2)(i) be replaced with the following:

The scope and extent of the written advice regarding the relation of applicable law to relevant facts may be tailored to give due weight and consideration to the relative settled or unsettled nature of the applicable law and clarity of its application under the particular circumstances.

D. Requirement to Evaluate Significant Tax Issues.

Section 10.35(b)(3) provides that “a Federal tax issue is significant if the Internal Revenue Service has a reasonable basis for a successful challenge and its resolution could have a significant impact, whether beneficial or adverse and under any reasonably foreseeable circumstance, on the overall Federal tax treatment of the transaction(s) or matter(s) addressed in the opinion.”

Preliminarily, we point out that we prefer the approach recommended previously to raise the threshold for a significant Federal tax issue generally from one with a reasonable basis to one with a “realistic possibility of success,” as defined in §10.34(d)(1), or similarly, in Treas. Reg. §1.6694-2(b) (implying an approximately one in three or greater chance of success), because such a higher threshold would provide a more workable emphasis under Circular 230 on more clearly serious Federal tax issues that particularly warrant highlighting. A practical concern with the lower standard in the Proposed Regulations and the Final Regulations is that this lower standard may tend to blur the differences between a number of less meaningful Federal tax issues. That said, we acknowledge that there may have been a sound policy basis for employing the reasonable basis standard for determining significant Federal tax issues will be retained. In general, we focus on recommending strongly and generally that the reasonable basis standard for significant Federal tax issues be further clarified to the fullest extent possible in light of its heightened importance. We appreciate Treasury and the IRS’s goal of providing an objective standard, rather than a subjective standard.

Thus, our comments generally assume that the reasonable basis standard for determining significant Federal tax issues will be retained. In general, we focus on recommending strongly and generally that the reasonable basis standard for significant Federal tax issues be further clarified to the fullest extent possible in light of its heightened importance. We appreciate Treasury and the IRS’s goal of providing an objective standard, rather than a subjective standard.

While recognizing the limitations of percentage tests, we nonetheless suggest a statement of a percentage degree of success as a threshold for the reasonable basis standard for a significant Federal tax issue (e.g., at least 20% chance of success) would help to provide a better understanding of this standard.
We recommend clarifying whether the reasonable basis standard under Circular 230 generally is the same as that used for purposes of the accuracy-related penalty under Section 6662 of the Code and Treas. Reg. §1.6662-3(b)(3), but with certain suggested refinements. In that context, Treas. Reg. §1.6662-3(b)(3) defines “reasonable basis,” as follows:

Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities set forth in §1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard as defined in §1.6662-4(d)(2). (See §1.6662-4(d)(3)(ii) for rules with respect to relevance, persuasiveness, subsequent developments, and use of a well-reasoned construction of an applicable statutory provision for purposes of the substantial understatement penalty.)

Section 1.6662-4(d)(3)(iii) lists various types of authority that may be taken into account in determining whether a position has “substantial authority” and also, under the provision referenced above, whether there is a “reasonable basis” for a position. This list includes guidance that is formally regarded as precedent for taxpayers by the IRS (such as the Code, regulations and revenue rulings), but also includes many other types of authority that the IRS generally indicates should not be relied upon by taxpayers and that is not generally regarded as precedential guidance. The listed “nonprecedential authorities” include the following:

General Explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book); private letter rulings and technical advice memoranda … general counsel memoranda … Internal Revenue Service information or press releases; and notices, announcements, and other administrative pronouncements published by the Service in the Internal Revenue Bulletin….

In certain respects, a “reasonable basis” standard applied by a taxpayer in defense of a tax position seems conceptually quite different than a “reasonable basis” standard applied by the IRS affirmatively to the question of whether an attorney has met standards of practice before the IRS, particularly as it relates to the consideration of nonprecedential guidance. In this regard, while the reasonable basis standard for accuracy-related penalties under Section 6662 of the Code allows taxpayers to take into account various nonprecedential authorities, it seems somewhat inappropriate for the IRS to take the position that a tax practitioner’s failure to consider such nonprecedential authority violates standards of practice before the IRS, particularly because the IRS carefully admonishes taxpayers not to rely upon such guidance as a general matter. Such authority is typically released by the IRS with a relatively low level of review. If such nonprecedential authority is regarded as informing the “reasonable basis” standard, the preparers of State or local bond opinions and covered opinions will functionally be required to review and consider all such authority as if it were formal precedent. At the same time, the issue of the
consideration of nonprecedential guidance is particularly vexing in the tax-exempt bond area because there is very limited judicial precedent on Federal tax issues related to tax-exempt bonds and this lack of judicial precedent is due in part to structural procedural difficulties in obtaining judicial review for Federal tax questions in this area, since bondholders rather than State or local governmental issuers are treated as taxpayers entitled to challenge adverse IRS decisions.

To address the difficult question regarding the types of authorities that may be considered for purposes of the reasonable basis standard in determining significant Federal tax issues under Circular 230, we recommend that one possible approach would be to limit the types of authorities that the IRS could consider for this purpose to precedential authorities that generally would be regarded by courts as legal precedents. One reason for so limiting eligible authorities relied upon by the IRS to precedential authorities is that it would give some meaning to the portion of the Circular 230 definition of a significant Federal tax issue which requires that the IRS have a reasonable basis for a “successful challenge” in that it would focus this standard on authorities that reasonably may be considered in a judicial challenge.

We recognize that it may be an appropriate goal to have a uniform standard applicable to tax practitioners and the IRS alike for purposes of the reasonable basis standard under Circular 230 and related provisions such as accuracy-related penalties.

If Treasury does intend that any nonprecedential authority may inform the “reasonable basis” standard as it will be applied by the IRS, we recommend that Treasury clarify further which types of authority are generally the most significant and what types of nonprecedential authority are inappropriate for this purpose. In this regard, private letter rulings, technical advice memoranda, and other similar determinations made by the Office of Chief Counsel represent a formal legal interpretation by IRS attorneys with jurisdiction over a particular subject matter.

By contrast, certain other forms of “authority” may be released by the IRS without approval by the Office of Chief Counsel, but nonetheless may articulate substantive Federal tax positions. In this regard, for example, the TE/GE Division of the IRS has regularly released to the public “Continuing Professional Education” materials. Some of these materials articulate substantive IRS positions, but may not have been subjected to formal review by IRS or Treasury attorneys. We in particular request clarification that “authority” that is not identified as having

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13 For example, an article entitled “Valuation of Government Securities – Yield Burning” contained in the IRS 2003 Continuing Professional Education Technical Instruction Program for Tax Exempt Bonds contains the following analysis:

The Service is aware of situations where the escrow provider sold the initial Treasury securities and purchased different Treasury securities or other eligible investments between the sale date and the issue date of the advance refunding bonds. Amounts received as a result of such sale and repurchase of Treasury securities were not included in the computation of the yield on the escrow.

Since the initial purchase of the Treasury securities has a direct nexus to the advance refunding bonds, the earnings from the trades of these securities prior to their delivery to the issuer must be included in computing the yield on the investments in the escrow. By excluding the earnings of these trades, the yield on the escrow is lower. Therefore, escrow churning is another form of yield burning.
been approved by attorneys in the Office of Chief Counsel or Treasury will not be cited or relied upon by the IRS in determining that a State or local bond opinion or a covered opinion raises a significant Federal tax issue.

We also request clarification regarding how “safe harbors” set forth in regulations, revenue procedures, revenue rulings and other published guidance may inform the “reasonable basis” standard. In particular, we request that Treasury and the IRS expressly clarify that a transaction will not be regarded as raising a significant Federal tax issue merely because it falls outside of such a safe harbor provision. We note that safe harbor provisions have long had a prominent role in the tax-exempt bond area, in part because of the historical “unqualified opinion” standard.

One particularly important example in the tax-exempt bond area is Rev. Proc. 97-13, as amended, which sets forth certain safe harbor terms for service contracts that do not give rise to “private business use” of bond-financed property. Rev. Proc. 97-13 describes several common types of service contracts, but many types of common service contract arrangements are simply not addressed by the revenue procedure. The IRS has in fact affirmed that Rev. Proc. 97-13 does not establish substantive limitations for determining when a contract is noncompliant by issuing private letter rulings holding that service contract arrangements with terms beyond those permitted under the revenue procedure do not give rise to private business use. In that light, we request that the final Circular 230 regulations state, as an example, that a tax-exempt bond issue involving a service contract for use of the financed property that does not meet a Rev. Proc. 97-13 safe harbor does not presumptively raise a significant Federal tax issue.

Certain safe harbors in published guidance, such as Rev. Proc. 97-13, establish safe harbors regarding matters of legal interpretation (in the case of Rev. Proc. 97-13, whether a service contract results in “private business use”). Other published guidance safe harbors, however, solely concern matters of fact. A prominent example in the tax-exempt bond area is Treas. Reg. §1.148-5(d)(6)(iii), which, as is discussed in detail above, sets forth a safe harbor bidding procedure to establish the fair market value of certain investment contracts. The discussion of this safe harbor provision in the preamble to the Proposed Regulations could be read to imply that a State or local bond opinion concerning a bond issue involving the acquisition of an investment contract pursuant to a procedure not meeting this factual safe harbor presumptively raises a significant Federal tax issue. We request that the final Circular 230 regulations clarify that a failure of an acquisition of an investment contract to meet the fair market value safe harbor contained in Treas. Reg. §1.148-5(d)(6)(iii) does not, in and of itself, raise a significant Federal tax issue.

To implement these suggestions, we recommend that the following be added to §10.35(b)(3) after the last sentence thereof:

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Thus, this article makes the important statement that investments made and closed before the date of issuance of a bond issue need to be treated as if they were actually made with bond proceeds. To our knowledge, this is the only instance where the IRS has made such a statement, but it has broad implications.
In general, except as provided herein, the *reasonable basis* standard for determining whether a Federal tax issue is significant is the same as that used for purposes of the accuracy-related penalties under Section 6662 of the Code and Treas. Reg. §1.6662-3(b)(3). In determining whether the IRS has a *reasonable basis* for a *successful challenge* hereunder, however, the IRS will consider only authorities that a court would view as legal precedent. [Alternatively, provide further clarification on types of nonprecedential guidance that can be considered.]

A significant Federal tax issue does not exist solely because the facts on which an opinion is based fail to meet a particular “safe harbor” provided by the Treasury Department for the purpose of satisfying a relevant requirement of law or fact.

V. **Definition of “State or Local Bond Opinion.”**

We understand that the Proposed Regulations and the Final Regulations are intended to provide special treatment for tax-exempt bond opinions that are included in materials marketed to investors to accommodate longstanding practice in the public finance industry. The Final Regulations, however, define “State or local bond opinion” fairly narrowly to the exclusion of a number of tax-exempt bond opinions that have customarily been provided to investors. Section 10.35(b)(9) defines a “State or local bond opinion” as follows:

A *State or local bond opinion* is written advice with respect to a *Federal tax issue* included in any materials delivered to a purchaser of a State or local bond in connection with the issuance of the bond in a public or private offering, including an official statement (if one is prepared), that concerns only the excludability of interest on a State or local bond from gross income under section 103 of the Internal Revenue Code, the application of section 55 of the Internal Revenue Code to a State or local bond, the status of a State or local bond as a qualified tax-exempt obligation under section 265(b)(3) of the Internal Revenue Code, the status of a State or local bond as a qualified zone academy bond under section 1397E of the Internal Revenue Code, or any combination of the above.

First, tax-exempt bond opinions provided to investors customarily address other Federal income tax matters that may properly be regarded as incidental to the main opinion regarding the tax-exempt status of the bonds. For example, it is very common for a tax-exempt bond opinion (or tax disclosure in an official statement) to discuss the treatment original issue discount and premium. Tax-exempt bond opinions (or tax disclosure in an official statement) also commonly discuss or reference the treatment of receipt of tax-exempt interest under other provisions of the Code, such as section 86 (dealing with Social Security and Tier 1 Railroad Benefits) and section 832 (dealing with insurance company taxable income).

Literally, any marketed opinion that addresses such ancillary tax matters will not be treated as a “State or local bond opinion” and will be subject to the requirements for covered opinions after June 20, 2005. We submit that such a result is not consistent with the apparent intent of the Final Regulations and the Proposed Regulations. Accordingly, our principal recommendation here is that the definition of “State or local bond opinion” be expanded to
include and “any Federal income tax matters” that are rendered on the same date, included in the same offering materials and reasonably ancillary to the opinions currently listed in the definition.

We note that, if the standards under §10.39 are intended to be substantively the same as the standards under §10.35, there appears to be no compelling policy reason to define “State or local bond opinion” narrowly in a manner inconsistent with customary practice.

To implement this suggestion, we recommend that the following be added to the end of the first sentence of §10.35(b)(9)(i) (the definition of State or local bond opinion) prior to the semicolon: “or any Federal tax matters that are reasonably ancillary to such opinions.”

Second, the definition of “State or local bond opinion” expressly excludes any opinions delivered after the issue date of a bond issue, even though the delivery of such opinions is customary in certain cases. The preamble to the Proposed Regulations indicates only one exception to this narrow definition:

An opinion … is a State or local bond opinion even if the opinion is delivered unchanged, e.g., if the opinion is redelivered with a qualified tender bond that is remarketed. If the State or local bond opinion with respect to that bond is changed or otherwise updated after the bonds are issued, the altered opinion is not a State or local bond opinion, and is subject to the requirements of §10.35.

Tax-exempt bonds are very commonly redelivered to investors in connection with changes that do not result in a technical “reissuance” of the bonds. In such cases, bond counsel commonly render opinions that no reissuance has occurred and such opinions may be provided to investors in offering materials. We recommend that such opinions provided to investors in reoffering materials be included in the definition of “State or local bond opinion.” Again, we emphasize that if the standards under §10.39 are intended to be substantively substantially the same as the standards under §10.35, there is no compelling policy reason to define “State or local bond opinion” narrowly in a manner inconsistent with such customary practice.

Third, bond counsel commonly render additional opinions (included in so-called “supplemental bond counsel opinions”) to the effect that Federal tax disclosure contained in an official statement or other offering material is accurate. We request clarification that Federal tax opinions contained in such supplemental bond counsel opinions will ordinarily be treated as part of the State or local bond opinion.

Fourth, bond counsel opinions often rely on the Federal tax opinions of other counsel. For example, a State or local bond opinion with respect to an issue of “qualified 501(c)(3) bonds” commonly expressly rely on the opinion of another counsel to the effect that the borrower or other user of the financed property is an organization described in section 501(c)(3) of the Code. In addition, in certain situations an attorney rendering a State or local bond opinion may rely on the opinion of another counsel with respect to a particularly difficult technical question, such as whether a particular facility qualifies as an “exempt facility” or whether a particular aspect of the transaction causes the bonds to be “arbitrage bonds.” We request
clarification that such relied upon opinions are appropriately treated as part of the State or local bond opinion.

One additional technical point on the definition of “State or local bond opinion” is that final signed opinions are not customarily “delivered” to purchasers of bonds. Instead, investors typically only receive an official statement including the form of the opinion in substantially final form. Accordingly, the definition would be more accurate if it referred to materials “delivered or made available in substantially final form” to purchasers.

In summary, we recommend that the language of the definition be modified so that it is clear that the opinion itself may be of limited scope and need not be delivered at the time of the bond offering.

To implement these suggestions, we recommend that the lead-in language of §10.35(b)(9) be modified to read as follows:

Written advice relating to Federal tax matters included in bond offering materials (as defined in §10.39(c)), whether or not the advice is included in the bond offering materials or is of limited scope, is a State or local bond opinion, if –

In addition, we recommend that §10.35(b)(9)(ii) be modified to read as follows:

The practitioner provides the issuer of the bond written advice that satisfies the requirements set forth in §10.39 with respect to the written advice given by the practitioner.

In order to avoid market disruption, we suggest that Treasury and the IRS provide that the Final Regulations will not apply to “State or local bond opinions” as more broadly defined until final regulations relating to State or local bonds become effective.

Such a delayed effective date could be made in the same manner that Announcement 2004-29 provided a delayed effective date for the requirements for State or local bond opinions.

VI. Definition of “Principal Purpose” to Avoid or Evade Tax.

Section 10.35 of the Final Regulations provides substantially stricter requirements for covered opinions concerning transactions “the principal purpose” of which is tax avoidance or evasion of any tax imposed by the Internal Revenue Code than for covered opinions concerning transactions “a significant purpose” of which is the avoidance or evasion of any tax imposed by the Code. Among other things, an opinion concerning a “significant purpose” arrangement may avoid “covered opinion” status if certain specified disclaimers are made, as is set forth in §§10.35(b)(4)(ii) and 10.35(b)(5)(ii). The disclaimer exception, however, expressly does not apply to an opinion concerning a “the principal purpose” arrangement. Our understanding is that Treasury in general intends to treat tax-exempt bonds as arrangements having “a significant purpose” of tax avoidance or evasion.
We recommend the exclusion of tax-exempt bonds from the definition of “the principal purpose” of tax avoidance or tax evasion under §10.35(b)(2)(i)(B) in a manner similar to a previous exemption from the definition of a tax shelter under Treas. Reg. §1.6662-4(g)(2)(ii) on the grounds that the financing of projects and programs that serve a public purpose in furtherance of a Congressionally-granted interest exclusion under section 103 ought not be treated as having such a principal purpose a matter of tax policy. In addition, we believe that “the principal purpose” test should look to the purpose of the bondholder. Because the principal purpose of the bondholder is to receive an economic return of principal and interest, “the principal purpose” test should not be met absent highly unusual circumstances. In addition, bonds issued to refinance prior bonds (“refunding bonds”), including advance refunding bonds, are generally subject to additional requirements of the Code; if an issue of refunding bonds meets these requirements the bond issue should be presumed not to have as its principal purpose the avoidance of Federal tax.

To implement this suggestion, we recommend that the following definition (or another definition comparable to Treas. Reg. §1.6662-4(g)(2)(ii) be added to §10.35(b):

The principal purpose of an entity plan or arrangement is not to avoid or evade Federal tax if the entity, plan or arrangement has as its purpose the claiming of exclusions from income, deductions or other tax benefits in a manner consistent with the statute and Congressional purpose. For example, an entity, plan or arrangement does not have as its principal purpose the avoidance or evasion of Federal tax solely as a result of issuing, purchasing or holding an obligation bearing interest that is excluded from gross income under section 103.

VII. Treatment of “No Adverse Effect” and Other Post-Issuance Opinions.

In addition to tax opinions rendered on the date of issuance regarding the excludability of interest on State and local bonds under section 103 of the Code which are proposed to be covered by the definition of State or local bond opinion in the Proposed Regulations, tax counsel very commonly render post-issuance tax opinions in the tax-exempt bond area to address various actions (e.g., changes in interest rate modes or changes in use of tax-exempt bond financed property) that are necessary in order to enable State and local governmental issuers to satisfy ongoing tax covenants to preserve the tax exemption under section 103 of the Code and to provide assurance that such actions will have “no adverse effect” on such exemption. In general, we believe that the Final Regulations will need to be amended technically in various respects to accommodate these common no adverse effect opinions in the limited scope opinion provision under §10.35(c)(3)(v) and otherwise.

One of the major themes in the development of the federal income tax law relating to tax-exempt bonds since the enactment of the Tax Reform Act of 1986 is the imposition of requirements on issuers and borrowers of tax-exempt bonds to comply with tax-exempt bond requirements throughout the term of the bonds, and not only to comply on the issue date. For example, the Tax Reform Act of 1986 expressly subjected most tax-exempt bonds to a “rebate” condition that requires continued monitoring of investments. In addition, regulations under section 141 published in 1997 effectively require many issuers and borrowers to monitor use of bond-financed property throughout the term of a bond issue. Accordingly, tax-exempt bond
opinions are commonly rendered after the issue date of a bond issue to address whether continuing requirements are met. These opinions include rebate opinions and opinions that the tax-exempt status of a bond issue is not adversely affected by (1) change in use of bond-financed property, (2) reinvestment of bond proceeds, (3) substitution of a credit enhancer, (4) change in interest rate mode, (5) substitution of a conduit borrower, (6) substitution of a surety bond for a funded reasonably required reserve fund, (7) defeasance of bonds and (8) obtaining an interest rate hedge with respect to bonds.

If such post-issuance opinions are not included within the definition of “State or local bond opinions”, they will be considered under the standards of §10.35. If such a post-issuance opinion addresses a significant Federal tax issue and concludes to a level or more likely than not that the matter would be resolved in the bondholder’s favor, we assume that the opinion would be a “reliance opinion” under §10.35(b)(4), and therefore a “covered opinion”, unless the appropriate disclaimers are made. In the most typical cases, however, bond counsel will conclude that the opinion addresses no “significant Federal tax issue”, so that the opinion should not be treated as a “reliance opinion.”

Such a post-issuance opinion would also be treated as a “covered opinion”, however, if it were a “marketed opinion.” In general, an opinion is treated as a “marketed opinion” under §10.35(b)(5) if the practitioner “knows or has reason to know that the written advice will be used or referred to by a person other than the practitioner … in promoting, marketing or recommending” the bond to one or more taxpayers. Bond documents currently vary regarding who receives such post-issuance opinions, but typically such opinions are not delivered to bondholders and sometimes expressly state that they are not intended to be relied upon by bondholders. Such opinions may be delivered to one or more of the issuer, the borrower, the bond trustee, the credit enhancer (if one exists) and the remarketing agent (if one exists). None of these addressees is customarily expected to “use or refer to” the “no adverse effect opinion” in connection with the marketing of the bonds. Certain of such possible addressees (for example a bond trustee), however, might be obligated to notify bondholders if a required opinion is not obtained and might be obligated to provide “no adverse effect” opinions to bondholders upon request. We request clarification that, under such circumstances, a post-issuance opinion will not ordinarily be treated as a “marketed opinion.”

To implement this suggestion, we recommend that language to the following effect (or, alternatively, an example reflecting this point) be added under §10.35(b)(5)(i) or a comparable provision of §10.39:

Written advice concerning the exclusion from gross income of interest on State or local bonds will not be treated as a marketed opinion solely because it is delivered to a bond trustee that acts as a fiduciary of the bondholders (e.g., a “no adverse effect” opinion delivered pursuant to an issuer’s tax covenant to preserve the tax-exempt status of interest on the bonds in the case of a change in use of the bond-financed facility).

Regarding the possible use of the limited scope opinion provision under §10.35(c)(3)(v), we suggest a couple of technical revisions. First, the limited scope opinion provision includes a requirement that the “practitioner and the taxpayer agree” that the scope of the opinion is limited.
In the tax-exempt bond area, that provision may be unworkable in many circumstances unless the concept of the “taxpayer” is expanded to include not only the actual owners of the tax-exempt bonds, who often are unknown, but also the State or local governmental “issuer” of the tax-exempt bonds. The issuer is the party treated nominally as the taxpayer for purposes of many IRS audit-related provisions and is the party with whom the tax practitioner discusses tax requirements. In addition, the limited scope provision and its attendant disclosures are inapplicable to marketed opinions and this constraint may make certain no adverse effect opinions ineligible for this provision absent further clarification that these no adverse effect opinions generally will not be considered marketed opinions.

To implement this suggestion, we recommend that the following sentence should be added to §10.35(c)(3)(v):

In the case of a State or local bond opinion, the practitioner and the taxpayer will be deemed to have agreed that the scope of the opinion may be so limited if the opinion is rendered pursuant to procedures set forth in bond documents and relates to events subsequent to issuance of the bonds.

VIII. Elective Application of §10.35 Rather Than §10.39

We request clarification that practitioners may choose to apply the requirements of §10.35 to tax-exempt bond opinions rather than §10.39. We commend Treasury and the IRS for providing flexibility to meet the substantive opinion requirements for “State or local bond opinions” by providing a separate “written advice” and we expect that, in most cases, practitioners will follow the separate “written advice” approach set forth in §10.39. There may be some cases, however, where the simplest and most practical approach is to provide an opinion meeting the covered opinion requirements of §10.35. We note that the ability to choose to apply §10.35 to tax-exempt bond opinions appears to be implicit in the definitional scheme set forth in §10.35(b)(9) of the Proposed Regulations. Because a “State or local bond opinion” is defined in part as an opinion in which the practitioners “separately provides to the issuer of the bond written advice”, if a practitioner does not follow the “separate written advice” approach, presumably §10.35 would apply.

In this regard, we note that it is uncertain whether the “separate written advice” approach will be practical or workable in some cases. In some cases, because of securities law disclosure considerations, disclosure counsel or underwriter’s counsel may require disclosure to investors of the contents of the separate written advice. In such cases, the simpler and more practical approach may be to simply include the entire contents of the separate written advice in a single opinion.

To implement this suggestion, we recommend that §10.35(b)(9)(ii) be amended to add at the end the following: “or the practitioner provides written advice that satisfies the requirements set forth in §10.35.”

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Sections 10.35(b)(4)(ii) and 10.35(b)(5)(ii) provide that practitioners may, in effect, opt out of treatment as a reliance opinion or a marketed opinion if certain specified prominent disclaimers are made involving, among other things, the absence of penalty protection. Our recommendation in this section is related to our recommendation in the previous section to clarify the relationship between the special provisions for defined State and local bond opinions under §10.39 and the general provisions for covered opinions under §10.35. In particular, here, we recommend expressly clarifying that tax practitioners may use these opt-out disclaimer exceptions for any State or local bond opinions that otherwise would be treated as reliance opinions or marketed opinions under §10.35 absent the special provisions for State and local bond opinions under §10.39. Although we are unsure of the extent to which the municipal market would accept these opt-out disclaimers, we would appreciate having the flexibility to use these disclaimers in the same manner as comparable tax opinions in other areas.

Further, we request clarification on the exact wording of the required disclaimer in the context of tax-exempt bond opinions. In the case of the typical tax-exempt bond transaction, the bondholder is not in possession of any facts or circumstances that bear on whether the interest on the bonds is excludable from gross income under section 103; instead, those facts are in the possession of the issuer or borrower of the tax-exempt bonds. The status of the bondholder may, however, affect the treatment of the tax-exempt interest received (such as in the case of an insurance company). In that light, we recommend that a disclaimer substantially similar to the following should meet the requirement of §10.35(b)(5)(ii)(C):

Each bondholder should seek advice based on the bondholder’s particular circumstances from an independent tax advisor regarding the effect of the receipt of interest on the bonds on the bondholder’s overall Federal income tax liability under the bondholder’s particular facts and circumstances.

That is, we request clarification that the disclaimer does not need to imply that the taxpayer should seek advice from an independent tax advisor regarding whether the bond issue complies with the requirements of sections 141 through 150, but only how the taxpayer must treat the receipt of tax-exempt income based on the particular facts and circumstances of that taxpayer. We suggest that such a disclaimer would be consistent with the substantive intent of §10.35(b)(5).

X. Other Special Considerations.

A. Special Considerations for Refunding Bonds.

Public finance attorneys commonly render Federal tax opinions with respect to tax-exempt refunding bonds. In many years, the volume of tax-exempt refunding bonds is comparable to the volume of tax-exempt bonds issued for new projects and programs. Opinions with respect to refunding bonds involve special considerations, in large part because they often necessarily rely upon certifications and other representations with respect to facts, prior
compliance and other matters that relate to events occurring over very long periods of time. In general, we request clarification that reliance on such representations will be consistent with Circular 230, in light of the unique facts and circumstances that apply to opinions with respect to refunding bonds.

Recent interpretive guidance by the IRS that would expressly require continuous compliance over the entire term of a bond issue has presented difficult new challenges for attorneys rendering opinions with respect to tax-exempt bonds. In particular, the publication of proposed regulations on “refunding bonds” and the release of interpretive materials on recordkeeping requirements suggests that issuers need to establish compliance over very long periods in a manner that is not consistent with prior practice of State and local government issuers and other borrowers of tax-exempt bonds and their tax counsel. The confluence of these new requirements with new opinion standard requirements under Circular 230 may substantially increase the tax compliance costs of State and local governments, and presents a number of practical opinion standard problems.

We believe that some discussion of and comment on the proposed regulations on “refunding bonds” and interpretive materials on tax-exempt bond recordkeeping requirements is necessary to explain why the proposed Circular 230 opinion standards will present great problems in practice. Most importantly, the proposed refunding regulations would require that the issuer and bond counsel in many cases treat a refunding bond issue and the prior bond issue as a single “combined issue”, so that actual use of the financed property during the period the prior bond was outstanding must be determined. Accordingly, we include in Appendix B comments on these related IRS guidance projects. We suggest that the impact of the Proposed Regulations on tax practice can be properly evaluated only in the context of recent IRS interpretations of the substantive requirements that apply to tax-exempt bonds.

The compliance, recordkeeping and opinion standard burden with respect to refunding bonds can be illustrated by simple examples:

Example 1. Suppose on January 1, 2007, County issues 20-year bonds to refund bonds issued in 1997. The 1997 bonds in turn refunded bonds originally issued in 1987 to finance various purposes, including an administration building, a county hospital, and county parks. The County reasonably believes that the amount of private business use of the administration building, county hospital, and county park has not exceeded the permitted amount of private business use since 1987, but has not retained records of any actual contracts for use of those facilities for more than a reasonable period of three years. How does the County, or its bond counsel, determine whether the County is required to apply the combined issue rule to determine the amount of private business use of the 2007 refunding issue? Under the proposed regulations, the County would be required to establish the amount of actual private business use during the shortened measurement period (which, in this case, would be the period from 1987 through 2007). In addition, the proposed regulations suggest that the County should maintain records of all contracts for use of the facilities for the period of 1987 to at least 2227.
In such a case, how does the County’s bond counsel “identify and ascertain” the facts and “identify and consider” the relevant facts for the prior period from 1987 through 2007 in an approving opinion with respect to the bonds? How does bond counsel “relate the applicable law to the facts” for the period from 1987 to 2007?

The foregoing example is actually simpler than many real life situations.

Example 2. Suppose instead that the tax-exempt bonds were issued to refinance 12 different hospital facilities for a large hospital system. Each facility may have 10 or more contracts for use of the facility that could give rise to private business use. To “identify and ascertain” facts, does a bond counsel need to specifically review and discuss each such contract that had been in place since 1987? As a practical matter, such prior contracts are not usually available to review.

Example 3. Suppose instead that the tax-exempt bonds were issued by a State to finance 100 different separate facilities. To “identify and ascertain” facts and “relate law to facts” does bond counsel need to specifically review and discuss any contracts for use of those facilities that had been in place since 1987? Again, as a practical matter, such prior contracts will not usually be available for review.

The practical answer is that bond counsel should be permitted to rely upon a good faith certification of the issuer that there has been no “private business use” during the period the prior bonds were outstanding. Such an approach permitting reasonable reliance on certifications of State or local governments would acknowledge the practical reality that State or local bond opinions are commonly in effect opinions relating to governmental programs over long periods of time, and are not limited to opinions relating to the treatment of a single financed project on a single date. Such a reasonable approach, however, does not appear to be consistent with the literal requirements of §10.39. We suggest that it is entirely reasonable and appropriate for a State or local bond opinion to rely upon such a certification delivered by a State or local government. If such an approach is not expressly permitted under Circular 230, we recommend that the regulatory interpretations of sections 141 through 150 relevant to refunding bonds expressly provide that good faith certifications of State and local governments will be conclusive, if they are consistent with existing facts.

The very long terms of many tax-exempt bond issues plainly present compliance, recordkeeping and opinion standard problems that are potentially very burdensome. Although most governmental issuers and 501(c)(3) borrowers of tax-exempt bonds retain some records of how bond proceeds were spent, it is not common for issuers and 501(c)(3) borrowers to maintain detailed records relating to use of bond-financed property for unreasonably long periods of time. We suggest that the burden of compliance, recordkeeping and opinion standard requirements must be balanced against the real magnitude of the policy concern, and in particular take into account the unique status of state and local governments.

Similar issues relate to refundings of “qualified private activity bonds” issued under sections 142, 143 and 144 of the Code. For example, in the case of qualified mortgage revenue
bonds issued under section 143, a single issue commonly may refund portions of 20 prior issues. The qualification of the refunding bond under section 143 and associated requirements depends in part on whether each of the prior issues was compliant. The issuer customarily may certify that each of the prior bond issues received a proper allocation of “volume cap” and that the proceeds were appropriate used for the programmatic purposes required by section 143. We suggest that it is reasonable and appropriate for bond counsel to rely upon such certifications (which may include certifications regarding prior tax compliance) in rendering State or local bond opinions.

B. Special Considerations for Qualified 501(c)(3) Bond Opinions.

Federal tax opinions with respect to “qualified 501(c)(3) bonds” also present special opinion standard problems. The proceeds of “qualified 501(c)(3) bond” issues are typically loaned to a 501(c)(3) organization to finance projects that further the exempt purposes of the borrower. Under section 145(a)(1) of the Code, all of the property financed with such bonds must be owned by a 501(c)(3) organization or a State or local government. Under section 145(a)(2) of the Code uses of the financed property for any “unrelated trade or business use” are restricted. Thus, the tax-exempt status of such bonds generally depends upon (1) the conclusion that the borrower or other user is a 501(c)(3) organization and (2) the conclusion that the financed property is not used for an unrelated trade or business use, except to the limited extent permitted.

In light of these requirements, State or local bond opinions with respect to qualified 501(c)(3) opinions typically rely upon an opinion of the borrower’s counsel that the borrower is an organization described under section 501(c)(3) of the Code. Such section 501(c)(3) opinions take a number of different forms, but usually address both the organizational and the operational tests under section 501(c)(3).

Because the 501(c)(3) status of an organization may depend on an evaluation of its overall operations, the task of “identifying and considering” all relevant facts in an approving opinion could be a daunting task with respect to any large 501(c)(3) organization. For example, would an opinion or separate writing need to address each contract of the organization and specifically consider whether it involves inurement or private benefit? Section 501(c)(3) borrowers include major hospital systems, universities and other educational institutions, and cultural institutions. The operations of many such organizations are commonly very complex. In addition, the finding that an organization is engaged in unrelated trade or business activities does not result in the loss of status as a 501(c)(3) organization, unless those activities are more than insubstantial. Again, the only reasonable and practical approach with respect to rendering such an opinion is to rely upon more general certifications provided by the organization, coupled in many cases with the counsel’s practical experience representing the organization.

We suggest that the best approach in many cases, however, is to expressly provide that it is consistent with Circular 230 standards for a State or local bond opinion to rely upon a

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14 As is set forth above, we recommend that such “relied upon” opinions will be treated as part of State or local bond opinions.
certification by a borrower or user of bond proceeds that it is an organization that meets the operational test described in section 501(c)(3) of the Code in that it generally is engaged in activities primarily in furtherance of its exempt purposes and that not more than an insubstantial amount of its activities involve any “unrelated trade or business.”

To implement this suggestion we recommend that the regulations contain the following statement:

In rendering a State or local bond opinion that depends upon the status of an organization as an organization described in section 501(c)(3) of the Code, it is reasonable for a practitioner to rely upon a certification of a responsible officer of the organization that the organization meets the operational test set forth in Treas. Reg. §1.501(c)(3)-1(c), without conducting independent investigation of the operations of the organization, so long as the practitioner does not know, or have reason to know that such representation is incorrect.

C. Special Considerations for Routine Governmental Bond Issues.

Although, as we have indicated, many tax-exempt bond issues involve highly complex fact patterns and legal issues, some tax-exempt obligations involve quite simple fact patterns and only straightforward legal issues. For example, State and local governments commonly acquire equipment for their general governmental purposes (such as fire trucks or computers) by means of installment purchase agreements or financing leases that are treated as tax-exempt obligations. The existing tax-exempt bond regulations expressly provide that a category of such governmental obligations is appropriately relieved of the burden of certifying facts relating to Federal tax compliance.

Treas. Reg. §1.148-2(b)(2)(i) generally provides that “an officer of the issuer responsible for issuing the bonds must, in good faith, certify the issuer’s expectations as of the issue date.” This certificate must “state the facts and estimates that form the basis for the issuer’s expectations.” Treas. Reg. §1.148-2(b)(2)(ii), however, provides the following exception to the certification requirement:

An issuer is not required to make a certification for an issue … if –

(A) The issuer reasonably expects as of the issue date that there will be no unspent gross proceeds after the issue date, other than gross proceeds in a bona fide debt service fund (e.g., equipment lease financings in which the issuer purchases the equipment in exchange for an installment payment note); or

(B) The issue price of the issue does not exceed $1,000,000.

The clear policy decision underlying this provision is that State and local governments should be relieved of a tax certification burden for the most simple and straightforward types of tax-exempt obligations. We believe that this policy decision is appropriate and was well considered when this provision was published in final form in 1993.
If a State or local government should not as a policy matter be required to provide tax certifications in such cases, Circular 230 should not indirectly require such certifications. Accordingly, we request that final regulations applicable to State or local bond opinions provide that neither §10.39 nor §10.35 applies to transactions described in Treas. Reg. §1.148-2(b)(2)(ii), with certain possible additional requirements discussed below, other than such certifications or factual inquiry as may be necessary to assure qualification for such provisions.

Section 1.148-2(b)(2) is directly concerned with certifications relating to the arbitrage rules under section 148 of the Code (that is, rules relating to investment of proceeds rather than use of bond-financed property). Accordingly, a fair reading of the exception contained in Treas. Reg. §1.148-2(b)(2)(ii) is that it is intended to identify transactions that generally do not tend to present difficult questions relating to investment of proceeds. In order to further identify cases that generally do not tend to present difficult questions relating to use of bond-financed property, we suggest that final regulations provide that §10.39 and §10.35 do not apply to opinions relating to obligations that (1) are described in Treas. Reg. §1.148-2(b)(2), (2) are “governmental bonds” (that is, obligations that are not “qualified private activity bonds”), and (3) finance property that is not subject to any agreements permitting use by a person other than a State or local government.

We believe that such an exception would help to mitigate the tax compliance burden indirectly imposed on State and local governments by Circular 230 opinion standards. This, and other possible exceptions to the §10.39 opinion standards, might be further supported by a conclusion that, even if the IRS were to determine that a bond issue did not comply with the tax-exempt bond requirements, the IRS would not impose penalties on the holder of such an obligation with respect to failure to report the interest received by the taxpayer.15

Some of our members also suggest that an exception to the §10.39 opinion standards be made for other general obligation bond issues, such as general obligation issues having a term of less than 3 years and an issue price of less than $10 million.

XI. Best Practices for State or Local Bond Opinions

We commend Treasury and the IRS for setting forth “best practices” for tax advisors in §10.33 of the final regulations and for clarifying that these best practices are aspirational, not mandatory. We believe that it is appropriate for Treasury to ask practitioners in different areas of Federal tax practice to seriously consider how these best practices can best be implemented in each area of practice, and whether additional aspirational best practice standards are appropriate.

In that light, members of the Committee on Tax-Exempt Financing are actively considering additional aspirational “best practices” that take into account the special factors that apply to State or local bond opinions, in the same spirit as the aspirational best practices set forth in the final regulations. We note that State or local bond opinions conventionally state that the opinion “is subject to the condition that the Issuer comply with all requirements of the Internal Revenue Code of 1986, as amended, that must be satisfied subsequent to the issuance of the

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15 In fact, State and local bonds of this type are commonly sold without approving Federal tax opinions.
Bonds in order that the interest thereon be, and continue to be, excludable from gross income for federal income tax purposes” and that “the Issuer has covenanted to comply with all such requirements.”

Although we believe that State and local governments are in general a class of “taxpayers” that is unusually receptive to voluntary compliance measures, in actual practice State and local government issuers typically do not employ tax experts on their professional staffs, in part because of the budgetary constraints. As we have indicated above, the applicable requirements are commonly highly complex and extend for periods of 30 years or more. Accordingly, there is a practical concern whether State and local government officials will fully understand the nature of such continuing requirements unless efforts are made to explain the requirements in non-technical terms that are understandable by those who are not tax attorneys. Because of this practical concern, many bond counsel have adopted the practice of providing State and local government issuers, and other borrowers of tax-exempt bond proceeds, with “letters from bond counsel”, or other materials that attempt to set forth the nature of the continued compliance requirements in non-technical terms.

Accordingly, we are considering suggesting as a best practice standard the following:

In addition to the best practices that generally apply to tax practitioners under Treasury Circular 230, best practices for attorneys rendering State or local bond opinions include the following:

In the case of a State or local bond opinion that is subject to the condition that the issuer comply with all requirements of the Internal Revenue Code that must be satisfied subsequent to the issuance of the Bonds in order that interest thereon be, and continue to be, excludable from gross income for federal income tax purposes, communicating with the issuer in a manner understandable to those without training in Federal tax law matters, either in writing or orally, the nature of such requirements.

We are not recommending that such additional practices should be or need to be formally incorporated into the aspirational best practices set forth in Circular 230. We do wish to inform the IRS and Treasury that we are undertaking to seriously implement best practices that are tailored to the most important compliance concerns raised by the special considerations in this area of practice. In the long run, we submit that such voluntary best practice measures may further compliance more than very specific and detailed mandatory requirements for the form of tax advice.

The best practices set forth in §10.33 provide that best practices include “communicating clearly with the client regarding the terms of the engagement” and that the advisor “should have a clear understanding with the client regarding the form and scope of the advice or assistance to be rendered.” We expect that, after publication of the final regulations, bond counsel firms generally will be even more careful and rigorous than in the past in defining the scope of advice in engagement letters. Among other things, we expect that engagement letters relating to State or local bond opinions will commonly state engagement terms that are substantially similar to the following: (1) that the attorneys are not engaged to verify facts, and do not undertake to verify

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facts; (2) that the attorneys are not engaged as experts in financial analysis or financial projections, are not engaged to verify the accuracy of financial analyses, financial projections, or similar reports, and are not engaged to render any opinions regarding the accuracy of such reports; (3) that the attorneys are not engaged as experts in valuation, including valuation of financial instruments and financial products, are not engaged to verify the accuracy of valuation matters, and are not engaged to render opinions regarding valuation matters; and (4) that the attorneys are not engaged as experts in engineering or similar disciplines, including opinions relating to the useful life or placed in service date of assets, are not engaged to verify the accuracy of engineering matters, and are not engaged to render opinions relating to such matters. We believe that such terms of engagement are entirely consistent with both the letter and spirit of Circular 230 and with the historical understanding of the role of tax attorneys. We believe that such terms of engagement are entirely consistent with the requirement in Circular 230 that practitioners “use reasonable efforts to identify and ascertain facts”, because tax attorneys are not generally engaged to provide advice on matters and disciplines beyond their expertise. If this understanding is in any respect incorrect, we ask that Treasury and the IRS provide further guidance.

XII. Conclusion

We appreciate the opportunity to provide comments. Should you wish additional information on any of the matters discussed in this paper, please contact Michael G. Bailey (312)832-4504 mbailey@foley.com, John J. Cross III (202)682-1487 jcross@hawkins.com, or Dean M. Weiner (213) 430-6638 dweiner@omm.com.
§ 10.35 Requirements for covered opinions.

(b) Definitions.

(3) A Federal tax issue is a question concerning the Federal tax treatment of an item of income, gain, loss, deduction, or credit, the existence or absence of a taxable transfer of property, or the value of property for Federal tax purposes. For purposes of this subpart, a Federal tax issue is significant if the Internal Revenue Service has a reasonable basis for a successful challenge [we note preference for previously-suggested higher standard of a realistic possibility of success, as defined in §10.34(d)(1) and Treas. Reg. §1.6694-2(b)] and its resolution could have a significant impact, whether beneficial or adverse and under any reasonably foreseeable circumstance, on the overall Federal tax treatment of the transaction(s) or matter(s) addressed in the opinion. [In general, except as provided herein, the reasonable basis standard for determining whether a Federal tax issue is significant is the same as that used for purposes of the accuracy-related penalties under Section 6662 of the Code and Treas. Reg. §1.6662-3(b)(3).] In determining whether the IRS has a reasonable basis for a successful challenge hereunder, however, the IRS will consider only authorities that a court would view as legal precedent. [Alternatively, provide further clarification on types of nonprecedential guidance that can be considered.] A significant Federal tax issue does not exist solely because the facts on which an opinion is based fails to meet a particular “safe harbor” provided by the Treasury Department for the purpose of satisfying a relevant requirement of law or fact.”

(5) Marketed opinion.

(iii) Written advice concerning the exclusion from gross income of interest on State or local bonds under Section 103 of the Code will not be treated as a marketed opinion solely because it is delivered to a bond trustee that acts as a fiduciary of the bondholders (e.g., a “no adverse effect” opinion delivered pursuant to an issuer’s tax covenant to preserve the tax-exempt status of the interest on the bonds in the case of a change of use of a bond-financed facility).

(9) State or local bond opinion. Written advice relating to Federal tax matters included in bond offering materials (as defined in §10.39(c)), whether or not the advice is included in the bond offering materials or is of limited scope, is a State or local bond opinion, if–

(i) The written advice as to Federal tax matters addressed in the bond offering materials consists only of advice that concerns the excludability of interest on a State or local bond from gross income under section 103 of the Internal Revenue Code, the application of section 55 of the Internal
Revenue Code to a State or local bond, the status of a State
or local bond as a qualified tax-exempt obligation under
section 265(b)(3) of the Internal Revenue Code, the status
of a State or local bond as a qualified zone academy bond
under section 1397E of the Internal Revenue Code, or any
combination of the above, or any Federal income tax
matters that are reasonably ancillary to such opinions; and

(ii) The practitioner provides the issuer of the bond written
advice that satisfies the requirements set forth in §10.39
with respect to the written advice given by the practitioner.

(10) Exceptions to principal purpose arrangements. The principal purpose of
an entity plan or arrangement is not to avoid or evade Federal tax if the entity, plan or
arrangement has as its purpose the claiming of exclusions from income, deductions or other tax
benefits in a manner consistent with the statute and Congressional purpose. For example, an
entity, plan or arrangement does not have as its principal purpose the avoidance or evasion of
Federal tax solely as a result of issuing, purchasing or holding an obligation bearing interest that
is excluded from gross income under section 103.

(c) Covered opinions.

(3) Evaluation of significant Federal tax issues.

(v) Limited scope opinions.

(C) In the case of a State or local bond opinion, the
practitioner and the taxpayer will be deemed to have agreed that the scope of the opinion may be
so limited if the opinion is rendered pursuant to procedures set forth in bond documents and
relates to events subsequent to issuance of the State or local bonds.

§ 10.39 Requirements for State or local bond opinions.

(a) In general. A practitioner who provides a State or local bond opinion shall
comply with the standards of practice in this section. The substantive requirements for State or
local bond opinions are the same as the requirements for covered opinions, but the written advice
for State or local bond opinions may be provided in a more flexible manner than covered
opinions, in light of the special considerations that apply to State or local bond opinions. These
special considerations include the unique status of State or local government issuers of tax-
exempt bonds as public governmental entities, the unique context in which the taxpayer relies
upon such opinions, the length of on-going compliance requirements, the factual and legal
complexity of tax-exempt bond transactions, the wide range and variety of tax-exempt bond
transactions, and the special administrative treatment of State and local government issuers of
tax-exempt bonds as “taxpayers” in tax-exempt bond transactions.

(b) Requirements for separately provided written advice. A practitioner providing a
State or local bond opinion must separately provide to the issuer of the bond written advice that
satisfies each of the following requirements. For purposes of this section, the written advice may
be set forth in a tax certificate or in other documents included in the transcript of proceedings, or, if no transcript is prepared, in one or more other documents made available to the issuer, provided that the documents constituting the written advice taken together satisfy each of the following requirements.

(1) Factual matters.

(i) The practitioner must use reasonable efforts to identify and ascertain the facts, which may relate to future events, and to determine which facts are relevant. The practitioner may rely on reasonable factual representations by a person the practitioner reasonably believes to be suitable for such representations, without the need to conduct an audit or independent verification of them. The scope and extent of the relevant facts identified and considered in the written advice may be tailored to give due weight and consideration to the nature of the facts and the size and type of transaction and reasonable conventions may be employed to summarize or streamline the description of facts for appropriate reasons, which may include the size and complexity of the transaction, the volume and complexity of the facts, and other similar factors.

(ii) The practitioner must not base the written advice on any unreasonable factual assumptions (including assumptions as to future events). An unreasonable factual assumption includes a factual assumption that the practitioner knows or should know is incorrect or incomplete. A factual assumption includes reliance on a projection, financial forecast or appraisal. It is unreasonable for a practitioner to rely on a projection, financial forecast or appraisal if the practitioner knows or should know that the projection, financial forecast or appraisal is incorrect or incomplete or was prepared by a person lacking the skills or qualifications necessary to prepare such projection, financial forecast or appraisal. The written advice must identify all factual assumptions relied upon by the practitioner. In determining whether a factual assumption is reasonable, a practitioner will ordinary not be presumed to have particular expertise in disciplines other than the Federal tax law, such as financial analysis, valuation, or engineering disciplines.

(iii) The practitioner must not base the written advice on any unreasonable factual representations, statements or findings of any person. An unreasonable factual representation includes a factual representation that the practitioner knows or should know is incorrect or incomplete. The written
advice must identify all factual representations, statements or findings relied upon by the practitioner. In determining whether a factual representation is reasonable, a practitioner will ordinarily not be presumed to have particular expertise in disciplines other than the Federal tax law, such as financial analysis, valuation or engineering disciplines.

(iv) If the facts required to be identified and considered under this paragraph (b)(1) are set forth in a tax certificate or other similar document that is included in the transcript of proceedings and the analysis required by paragraphs (b)(2) and (b)(3) of this section is set forth in a separate document, the practitioner may incorporate the facts required to be identified or considered in the separate document by reference to the tax certificate or other document.

(2) **Relate law to facts.**

(i) The written advice must relate the applicable law (including potentially applicable judicial doctrines) to the facts relevant to a significant Federal tax issue. The scope and extent of the written advice regarding the relation of applicable law to relevant facts may be tailored to give due weight and consideration to the relative settled or unsettled nature of the applicable law and clarity of its application under the particular circumstances.

(ii) The practitioner must not assume the favorable resolution of any significant Federal tax issue except as provided in paragraph (d) of this section, or otherwise base an opinion on any unreasonable legal assumptions, representations, or conclusions.

(iii) The written advice must not contain internally inconsistent legal analysis or conclusions.

(3) **Evaluation of significant Federal tax issues—**

(i) In general. The written advice must consider all significant Federal tax issues that are relevant to the overall conclusion provided in the State or local bond opinion with respect to the application of section 103 of the Internal Revenue Code, section 55 of the Internal Revenue Code, section 265(b)(3) of the Internal Revenue Code, or section 1397E
of the Internal Revenue Code, or any combination thereof, except as provided in paragraph (d) of this section.

(ii) Conclusion as to each significant Federal tax issue. The written advice must provide the practitioner's conclusion as to the likelihood that a taxpayer will prevail on the merits with respect to each significant Federal tax issue considered in the written advice. The written advice must describe the reasons for the conclusions, including the facts and analysis supporting the conclusions.

(iii) Evaluation based on chances of success on the merits. In evaluating the significant Federal tax issue(s) addressed in the written advice, the practitioner must not take into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement if raised.

(c) Bond offering materials. The term bond offering materials means any written materials delivered to a purchaser of a State or local bond in connection with the issuance of the bond in a public or private offering, including an official statement (if one is prepared).

(d) Competence to provide opinion; reliance on opinions of others.

(1) The practitioner must be knowledgeable in all of the aspects of Federal tax law relevant to the opinion being rendered, except that the practitioner may rely on the opinion of another practitioner with respect to one or more Federal tax issues unless the practitioner knows or should know that the opinion of the other practitioner should not be relied on. If a practitioner relies on the opinion of another practitioner regarding a significant Federal tax issue, the relying practitioner must identify the other opinion and set forth in the written advice the conclusions reached in the other opinion.

(2) The practitioner must be satisfied that the combined analysis of the opinions, taken as a whole satisfy the requirements of this section.

(e) Relation between special rules for State and local bond opinions under §10.39 and general rules for covered opinions under §10.35.

(1) Electivity of §10.35 for State and local bond opinions. In the case of a State and local bond opinions, a practitioner may elect to apply §10.35 in lieu of §10.39.

(2) Application of disclaimer provisions to State and local bond opinions. In the case of a State or local bond opinion that otherwise meets the definition of a reliance opinion or a marketed opinion under §10.35, a practitioner may apply the respective disclaimer provisions for reliance opinions under §10.35(b)(4)(ii) or marketed opinions under §10.35(b)(5)(ii), as applicable.

(f) Certain special rules for specified circumstances.

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(1) Special rules for representations regarding prior compliance. In connection with providing written advice with respect to a State or local bond opinion, a tax practitioner may rely in good faith upon a certification of a State or local government issuer or a borrower of tax-exempt bond proceeds with respect to prior compliance with any requirement contained in sections 103, 141 through 150, and 1394, provided that the representation is consistent with represented facts on the date the written advice is provided.

(2) Special rules for Section 501(c)(3) exempt status matters. In rendering a State or local bond opinion that depends upon the status of an organization as an organization described in section 501(c)(3) of the Code, it is reasonable for a practitioner to rely upon a certification of a responsible officer of the organization that the organization meets the operational test set forth in Treas. Reg. §1.501(c)(3)-1(c), without conducting independent investigation of the operations of the organization, so long as the practitioner does not know, or have reason to know that such representation is false.

(g) Effective date. This section applies to State or local bond opinions that are rendered on a date that is on or after 120 days after publication of the final regulations in the Federal Register.
APPENDIX B

COMMENTS ON CERTAIN TAX-EXEMPT BOND GUIDANCE PROJECTS THAT ARE RELATED TO THE PROPOSED CIRCULAR OPINION STANDARDS FOR STATE OR LOCAL BOND OPINIONS

COMMENTS CONCERNING PROPOSED REGULATIONS UNDER SECTION 141 RELATING TO THE APPLICATION OF THE PRIVATE ACTIVITY BOND RULES TO REFUNDING BONDS (REG-113007-99) AND INTERNAL REVENUE SERVICE RELEASE REGARDING TAX-EXEMPT BOND RECORD RETENTION REQUIREMENTS

Implications of the proposed refunding regulations. On May 14, 2003 the IRS published proposed regulations on the definition of private activity bonds applicable to tax-exempt bonds issued by State and local governments. The proposed refunding regulations concern the application of the private activity bond restrictions of section 141 of the Code to refunding issues.

In general, section 141(a) of the Code defines a private activity bond as any bond that meets either (1) the private business use test in section 141(b)(1) and the private security or payment test in section 141(b)(2) (collectively, the private business tests) or (2) the private loan financing test in section 141(b)(2). The private business use test is generally met if more than 10 percent of the proceeds are used for any private business use. The private security or payment test is generally met if the payment of the principal of, or interest on, more than 10 percent of the proceeds of an issue is directly or indirectly (1) secured by property used or to be used for a private business use, (2) secured by an interest in respect of such property, or (3) to be derived from payments, whether or not to the issuer, in respect of property, or borrowed money, used or to be used for a private business use.17

Final regulations under section 141 were published on January 16, 1997. Among other things, the 1997 regulations provided that the amount of private business use of property financed by an issue is equal to the average percentage of private business use of that property during a measurement period. The measurement period begins on the later of the issue date of the bond issue or the date the property is placed in service and ends on the earlier of the last date of the reasonably expected economic life of the property or the latest maturity of any bond of the issue financing the property (determined without regard to any optional redemption dates). This provision is referred to in these comments as the “measurement-over-the-term” rule.

For purposes of these comments, the most significant provision in the proposed refunding regulations is the rule that permits, and in some cases requires, a refunding bond issue and the prior bonds that it refunds to be regarded as a single “combined issue” for private business use.

17 The proposed regulations apply to “governmental” bond issues, as well as to qualified 501(c)(3) refunding bonds under Treas. Reg. §1.145-2(b). Under section 145(a) of the Code, the private business tests of section 141 are applied with certain modifications. Among other things, the permitted thresholds are reduced from 10% to 5% and unrelated trade or business activities, as defined under section 513, are treated as private business use.
purposes. These comments principally focus on the implications and operation of the “combined issue” rule. In particular, the “combined issue” rule as stated in the proposed refunding regulations would impose substantial new compliance, recordkeeping and retention burdens on issuers of tax-exempt bonds and substantial new opinion standard burdens.

The proposed refunding regulations generally provide that the amount of private business use of a refunding issue is based on the separate measurement period for the refunding issue. This general rule is consistent with prevailing practice. This general rule is also consistent with the implications of certain examples contained in the final private activity bond regulations. See Treas. Reg. §1.141-7(i), Example 8, which states that “in general, reasonable expectations must be separately tested on the date that refunding bonds are issued.” We agree that this general rule is appropriate.

The proposed refunding regulations also generally provide that an issuer can choose to determine the amount of private business use “during the combined measurement period” – that is, by regarding the refunding bonds and the refunded bonds as a single combined issue. We agree that this permissive rule is appropriate.

The proposed refunding regulations further provide, however, that in certain cases an issuer is required to treat refunding bonds and refunded bonds as a “combined issue” for purposes of determining the amount of private business use. This provision appears to be based on a conclusion that the “combined issue” approach is the logical corollary of the general “measurement over the term” rule for determining the amount of private business use contained in the 1997 final regulations. The provision appears designed to prevent issuers from inappropriately taking advantage of the “measurement over the term” rule by “front-loading” private business use during the earlier years of a bond issue and then refunding that issue in order to exceed the amount of private business use that would otherwise be permitted.

In its specific operation, the combined issue rule provides that private business use must be measured over the “combined measurement period” if the prior issue satisfies the private business use test, “based on a measurement period that begins on the first day of the combined measurement period and ends on the issue date of the refunding issue” (which period is referred to in the proposed regulations as the “shortened measurement period”).

The combined issue rule is arguably a logical extension of the “measurement-over-the term rule” adopted in 1997. As a practical matter, however, the combined issue rule would impose substantial new burdens on tax-exempt bond issuers and their counsel that are disproportionate to the perceived potential for abuse. Most importantly, the combined issue rule would impose compliance and recordkeeping burdens on issuers, and related opinion standard requirements, that are substantially more burdensome than current prevailing practice.

**Implications of IRS Release regarding Record Retention Requirements.** In January 2004, the IRS Tax Exempt Bond Program posted “FAQs regarding Record Retention Requirements” on its website. This recordkeeping release states that it is “not to be cited as an authoritative source on these requirements.” The release is, however, the only public guidance that the IRS has ever provided on the recordkeeping requirements that apply to tax-exempt bonds.
Although it purports to be descriptive of existing law, the TEB recordkeeping release contains many statements and provides many implications that are not fully supported and that are not consistent with prevailing practice. For example, the TEB release implies that issuers are required to retain “documentation evidencing use of bond-financed property by public and private sources (i.e., copies of management contracts and research agreements)” and “documentation evidencing all sources of payment or security for the bonds” for the entire term of a bond issue (or chain of refunding bond issues), even if the term of the bond issue (or chain of refunding bond issues) may extend for 40 years or more.

We believe that the IRS TEB program should be commended for opening a dialog on recordkeeping requirements and soliciting comments on this matter. We suggest, however, that recordkeeping requirements in this area merit reasonable administrative relief in formal published guidance.

The recordkeeping considerations are unique in this area for a number of reasons, including the following: (1) the customary long term nature of tax-exempt bond issues; (2) the special status of state and local governments; and (3) the multiple levels of “taxpayers” who are affected (i.e., state and local governments, conduit borrowers, and bondholders).

Many aspects of the TEB recordkeeping release are beyond the scope of these comments. Certain points, however, are particularly relevant to our comments on how Circular 230 standards should be applied to Federal tax opinions relating to refunding bonds. First, although the TEB recordkeeping release asserts that state and local government issuers have affirmative recordkeeping burdens, in fact section 6001 of the Code imposes recordkeeping burdens only on persons “liable for tax.” The release cites no authority for an assertion that the Code directly imposes recordkeeping requirements on issuers of tax-exempt bonds.

Second, one of the bases for recordkeeping requirements is that the “penalties” for “change of use” of property financed with qualified private activity bonds apply to conduit borrowers under section 150(b) of the Code, such as the section 501(c)(3) organization borrowers of the proceeds of qualified 501(c)(3) bonds. It is important to emphasize, however, that the section 501(c)(3) “penalties” are subject to the ordinary statutory periods of limitation on assessment. Whatever recordkeeping obligation that applies to 501(c)(3) organization borrowers of tax-exempt bond proceeds under section 150(b) of the Code would presumably extend for a 3-year or 6-year statutory limitations period, and not for the entire 30-year or 40-year term of a bond issue.

Third, no reference is made to whether it is appropriate as a matter of policy to extend reasonable administrative relief to state and local government issuers of bonds with respect to recordkeeping, in light of the special status of such “taxpayers” as government units serving public purposes, which are subject to public control and scrutiny.

Fourth, no reference is made to the complex considerations of burdens of proof that apply to tax-exempt bonds, and, in particular, to the manner of application of the private activity bond rules. The structure of section 141 of the Code can reasonably be read to imply that Congress intended that state or local governmental and qualified 501(c)(3) bonds be presumed to meet the use-of-proceeds requirements if a State or local government provides a good faith certification.
regarding its reasonably expected use on the date of issuance, unless improper use is established. By contrast, the proceeds of “qualified private activity bonds” (other than qualified 501(c)(3) bonds) in general must affirmatively be spent on particular qualifying purposes. It is both consistent with the structure of the Code and the special status of state and local governments and 501(c)(3) organizations to apply more liberal standards of burdens of proof to the use-of-proceeds requirements for governmental and qualified 501(c)(3) bonds.

In addition, the TEB recordkeeping release makes no reference to the application of section 7491 of the Code, which was enacted in the IRS Restructuring and Reform Act of 1998 to shift the burden of proof to the IRS in certain cases.

**Reasonable reliance on tax certifications.** We suggest that the best approach to addressing the compliance, recordkeeping and opinion standard burdens that would be imposed by the proposed Circular 230 regulations and the proposed refunding regulations is to permit state and local government issuers and 501(c)(3) organization borrowers of tax-exempt bonds proceeds to rely on good faith certifications made on the date of issuance of refunding bonds, including good faith certifications regarding the prior use of the financed property and prior compliance with the requirements of the Code. There is considerable historical precedent for such a certification approach and it is consistent with prevailing practice.

A regulatory rule permitting issuers to rely on certifications was contained in the former arbitrage regulations from 1979 to 1993. The regulations provided that, under section 103(c) of the Internal Revenue Code of 1954, “the determination of whether an arbitrage bond depends on the issuer’s reasonable expectations, as of the date of issue, regarding the amount and use of proceeds of the issue.” Former Treas. Reg. §1.103-13(a)(2). The regulations further provided that a “State or local governmental unit may certify, in the bond indenture or a related document, reasonable expectations of the issuer on the date of issue as to future events.” Former Treas. Reg. §1.103-13(a)(2)(A). Such a certification did not establish conclusions of law, but was conclusive regarding reasonable expectations. The regulation provided that the “certification must set forth (in brief and summary terms) the facts and estimates on which the issuer’s expectations are based and state that, to the best of the knowledge and belief of the certifying officer, the issuer’s expectations are reasonable.” Treas. Reg. §1.103-13(a)(2)(D).

The certification provision also contained the following “disqualification” provision:

(A) If a certification contains a material misrepresentation, the Commissioner may disqualify the issuer. The Commissioner will publish notice that the Commissioner is disqualified in the Internal Revenue Bulletin. The disqualification will not affect bonds issued before the notice is published.

(B) An issuer that is disqualified may not certify an issue …

(C) The Commissioner will give an issuer reasonable opportunity to be heard before it is disqualified.

(D) If appropriate, the Commissioner may requalify an issuer.
The IRS never published any procedures implementing the disqualification provision and appears never to have disqualified an issuer under this provision.

The certification provision reflected a policy decision that the IRS should reasonably afford state or local governments a degree of deference to establish facts related to tax-exempt bond issues. This policy decision was grounded in the special status of State or local governments: such “taxpayers” serve public purposes, are directly accountable to the public, and are subject to public scrutiny. In addition, the certification provision reflected a policy decision that it is appropriate for the IRS to take steps to reasonably avoid disruption of the tax-exempt bond markets as much as is consistent with sound tax administration.

The certification provision was interpreted in Rev. Rul. 85-182, 1985-2 CB 39. That revenue ruling held that a certification made by an issuer “in bad faith” is not conclusive. There is no indication that Congress subsequently intended that the certification provision should be removed from the regulations. To the contrary, when the requirements for tax-exempt bonds were substantially amended in the Tax Reform Act of 1986, the Conference Report expressly stated that Congress intended that “to the extent not amended, all principles of present law continue to apply under the reorganized provisions” of the Code. Conf. Rep. No. 99-841 at II-686.

The certification provision was removed from the regulations without comment when final regulations under section 148 of the Code were published in 1993. We understand, however, that there is no indication that any policy decision was made at that time, or any other time, indicating that the certification approach is inappropriate for administration of certain requirements applicable to tax-exempt bonds under the Code and regulations. Instead, it is understood that one reason for the removal of the provision is that procedures for its implementation had not been adopted.

We suggest that a similar certification provision should be included in final regulations under section 141 of the Code and be acknowledged under final Circular 230 regulations. State and local governments should be expressly permitted to rely on good faith certifications, made as of the issue date of refunding bonds, regarding the prior use of the financed property. In our view, the regulations should provide that such certifications are conclusive, except in the case of certifications made “in bad faith” as set forth in Rev. Rul. 85-182. Finally, we believe that the regulations provide that an issuer or a 501(c)(3) borrower that makes a certification in “bad faith” alternatively could be “disqualified”, so that the issuer (or borrower) would no longer be entitled to conclusively rely on future certifications.

We further suggest that the IRS publish a revenue procedure setting forth procedures for the disqualification of an issuer that the IRS believes has made a certification in bad faith.

We do not believe that such an approach would detract from effective tax administration of the requirements that apply to tax-exempt bonds, but rather believe that such an approach could result in a higher level of compliance by fostering a cooperative relationship between the IRS and issuers and 501(c)(3) borrowers. We believe that State and local government issuers and 501(c)(3) borrowers of tax-exempt bonds generally seek to be compliant with tax
requirements. The recommended approach would extend a reasonable degree of deference to the
good faith public determinations, taking into account the special status of these “taxpayers.”

We believe that such an approach is consistent with the allocation and accounting rules
for allocating bond proceeds to expenditures set forth in Treas. Reg. §§1.141-6(d) and 1.148-
6(d). Among other things, these rules provide that an issuer generally must account for the
allocation of proceeds to expenditures not later than 18 months after of the later of the date the
expenditure is paid or the date the project, if any, is placed in service. These rules do not,
however, specify any particular required form of recordkeeping. In any event, the most onerous
recordkeeping burdens that would be imposed by the proposed refunding regulations relate to
how bond-financed property is used over the term of a series of refunding issues, not to how
bond proceeds were originally spent.

We fully appreciate that the IRS has a legitimate interest in monitoring compliance with
the tax-exempt bond use-of-proceeds rules by examining tax-exempt bond issues. We do not
believe that such an approach would render such examinations impractical or unduly
burdensome for the IRS. For example, under our recommended approach, the IRS would be able
to examine the process taken by officials of the issuer to make a good faith certification of prior
use of bond-financed property. If the IRS determines on examination that an issuer has made
such a certification in bad faith, the IRS could take steps to disqualify the issuer. We believe
that, if the IRS establishes disqualification procedures, the risk of disqualification will be taken
seriously by issuers and would in general foster a greater level of compliance.18

We recognize that different policy and tax administration provisions may apply to an issuer that elects to use the
“combined issue” rule to a refunding bond issue to its advantage, as contrasted to an issuer that desires to avoid the
burden of the mandatory imposition of the combined issue rule. For example, suppose a County issues 20-year
bonds in 2007 that refund bonds originally issued in 1987. If the bond-financed property was treated as entirely
used for governmental purposes since 1987, the combined issue approach would enable the County to permit 20%
private business use (and private security and payments) for the entire 20-year term of the refunding bonds.
Alternatively, the County may simply seek to test the refunding issue separately, so that it could permit only 10%
private business use (and private security and payments) during the 20-year term of the refunding bonds. It might be
argued that a higher recordkeeping burden or tax compliance monitoring requirement is appropriate in cases where
an issuer elects to use the combined issue rule to its benefit.

We suggest that the certification provision should apply in cases where an issuer or borrower
elects to apply the combined issue rule to its benefit as well as in cases where the issuer simply seeks to establish
that the combined issue rule is not required, but that refunding regulations might additionally prospectively impose a
reasonable requirement of tax compliance monitoring as a condition to conclusive reliance on a good faith
certification. For example, refunding regulations might provide that, to obtain the benefits of a conclusive
certification regarding prior use of bond-financed property in the case of elective use of the combined issue rule, an
issuer or 501(c)(3) borrower would be required to establish that it performed a reasonable review of actual use
arrangements in place during the first five-years the bonds are outstanding. Such a tax compliance review would be
consistent with the timing for monitoring rebate compliance.

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