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Advisory

December 21, 2004

PUBLIC FINANCE AND TAX

Treasury Proposes Circular 230 Regulations Affecting Bond Counsel Opinions

On December 17, 2004, the United States Treasury Department and the Internal Revenue Service issued proposed "Circular 230" regulations relating to standards of practice for bond counsel opinions ("bond opinions"). The proposed regulations were issued simultaneously with final "Circular 230" regulations affecting tax shelter opinions. The final regulations carve out bond opinions from the specific requirements applicable to tax shelter opinions, and the proposed regulations substitute separate requirements specifically applicable only to bond opinions.

The proposed regulations would not require any changes to the form of "unqualified" bond opinions, but would require bond counsel to provide certain "written advice" regarding the basis for the bond opinion to the issuer of the bonds. To that extent, arguably the proposed regulations favorably address bond market concerns that the Circular 230 final regulations would result in lengthier bond counsel opinions that would require extensive review and analysis by bond purchasers and would potentially dilute the "unqualified opinion" standard currently prevalent in the municipal bond market. It remains to be seen, however, how the bond counsel community would implement the requirement of the "written advice" memo to bond issuers (if such requirement is adopted in the final regulations affecting bond opinions) and how much of the contents of the "written advice" memo would be included in the official statement for bonds. The bond market concerns regarding the inclusion in bond opinions of extensive factual and legal tax-exemption analysis may remain unaddressed if the ultimate impact of the proposed regulations simply would be to shift such discussion from the bond opinion itself to the official statement.

What the Proposed Regulations Require

The proposed regulations would apply to "state or local bond opinions," which are defined as written advice included in bond offering materials for the issuance of municipal bonds. Such written advice would qualify as a "state or local bond opinion" excluded from the final Circular 230 regulations applicable to tax shelter opinions only if two requirements are met. First, the subject matter of the written advice as to federal tax matters must be limited to (i) the exclusion of interest on the bond from gross income under section 103 of the Internal Revenue Code of 1986, as amended, (ii) the application of the alternative minimum tax to interest on the bond; (iii) the status of the bond as a qualified tax-exempt obligation (*i.e.*, a bank-qualified bond); and/or (iv) the

status of the bond as a qualified zone academy bond. Second, the counsel delivering the opinion would need to provide “written advice” to the bond issuer satisfying the requirements set forth in the proposed regulations.

The proposed regulations specify that the “written advice” to the bond issuer would need to be provided *by* the counsel delivering the opinion *to* the bond issuer separately from the bond opinion, “in a tax certificate or in other documents included in the transcript of proceedings.” If no “transcript of proceedings” were prepared, the “written advice” could be set forth in one or more other documents made available by the counsel providing the opinion to the issuer.

The proposed regulations first would require that the bond counsel use “reasonable efforts” to identify and “ascertain” the facts, “which may relate to future events,” and to determine which facts are relevant to the bond opinion. The “written advice” delivered to the issuer “must identify and consider” all facts that counsel determines are relevant. In addition to all relevant facts, the “written advice” must contain a separate section identifying all “factual assumptions” relied upon by counsel, including reliance on projections, financial forecasts or appraisals, and a separate section identifying all “factual representations, statements or findings” relied upon by counsel. The proposed regulations state that counsel could not rely in the “written advice” on unreasonable factual assumptions or representations. Reliance is stated to be unreasonable if the counsel knows or “should know” that the information is incorrect or incomplete or the person delivering the information lacks the necessary expertise.

A second requirement for the “written advice” under the proposed regulations

is that it would need to relate the applicable law “including potentially applicable judicial doctrine” to the relevant factual underpinnings for the opinion identified as discussed above.

The proposed regulations list as a third requirement of the “written advice” that it consider all “significant Federal tax issues” relevant to the conclusions reached in the bond opinion and provide, as to each such issue, the counsel’s conclusion as to the likelihood that a taxpayer would prevail on the merits, including the facts and analysis supporting such conclusion. The final Circular 230 regulations define a tax issue as “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.” Although some reviewers of the proposed regulations are disinclined to believe that a lengthy factual and legal analysis would be required with respect to elements of the bond counsel opinion that are not identified as “significant Federal tax issues,” the proposed regulations require that the “written advice” identify all facts relevant to the opinion, and apply all law relevant to the opinion to those facts, irrespective of whether any “significant Federal tax issues” are identified.

The proposed regulations provide that counsel would be subject to censure, suspension or disbarment from practice before the IRS for willful, reckless or grossly incompetent violations of the regulations. In other words, bond counsel’s failure to deliver a “written advice” complying with the regulatory requirements, or delivery of an incomplete “written advice,” would be sanctionable.

Implications of the Proposed Regulations for the Bond Market

The proposed regulations, if finalized, clearly would have an impact on bond counsel. Standards of due diligence, of communication by bond counsel with bond issuers regarding tax exemption requirements and of documentation by bond counsel of its due diligence and analysis vary substantially across the bond community and among firms and practitioners. Even among practitioners who already comply with the spirit of what the regulations would require, the specific requirements of the regulations and the risk of sanctions affecting reputation, practice before the IRS and ability to deliver future opinions undoubtedly would require the expenditure of substantial additional effort and time on bond transactions.

Lengthy cross-certifications from the bond counsel to the issuer as to what facts and law are relevant and from the issuer to the bond counsel as to what relevant facts exist would likely be required. It is fair to say that bond counsel services would likely become more expensive to issuers and/or less attractive to certain practitioners, and that at least some transactions will be slowed down or derailed by the new requirements. It is also fair to say that the Treasury/Internal Revenue Service has heard these arguments and evidently considers more extensively documented bond analysis and more sanctions for what it considers slipshod analysis a non-negotiable requirement.

The impact on bond market is somewhat harder to forecast, but it is unlikely that it would be positive. By separating out the “written advice” requirements from the bond opinion itself, the regulations at least pay lip service to purchaser concerns about lengthening of the relatively short

“unqualified opinions” currently demanded by the bond market. But this may turn out to be form over substance. Securities laws, as well as the Securities and Exchange Commission (SEC), are clear that all material tax risks must be disclosed to bond purchasers. Whatever the impact of the regulations, one outcome that can be considered unlikely is the development of a practice involving delivery by bond counsel to issuers of separate memos identifying “significant” federal tax issues affecting the bond opinion but general omission of the “significant” issues identified in such “written advice” from the tax disclosure or bondholders’ risks sections of the official statement. Such a practice would not violate the Circular 230 requirements, but might be difficult to defend from a securities law perspective and could invite SEC enforcement actions, which the SEC has indicated it reserves the right to bring even in situations where non-disclosure results in no harm to investors. If the effect of the proposed regulations were that lengthy tax opinion analysis became more prevalent in official statements, from the perspective of bond purchasers the question of whether such disclosure would dilute the “unqualified opinion” would not be appreciably different than if such disclosure were incorporated in the bond opinion itself. And even if the delivery of the “written advice” would not result in any substantial change to the official statement disclosure, the securities law implications of the delivery of such “written advice” as part of a closing transcript, and the extent to which the closing transcript is deemed to be part of the disclosure provided or available to bondholders, would be a subject of debate.

The key question is what practice the bond counsel community and/or individual bond counsel practitioners would adopt regarding what constitutes a

“significant” Federal tax issue for purposes of the “written advice” requirement. It is theoretically possible that no “written advice” would be required on an individual bond transaction because the bond counsel concluded that there are no tax issues that the IRS could reasonably challenge. Arguably, the “NABL standard” for the level of certainty required for the delivery of a bond counsel opinion already precludes delivery of any opinion with respect to which there would be the need to disclose to an issuer that there is a “significant” tax issue. Such theoretical considerations ignore the practical impact of the proposed regulations. The IRS is actively challenging numerous transactions, with opinions delivered by bond counsel ranging from relatively unknown and infrequently active bond counsel practitioners to some of the industry’s most well known and reputable firms and practitioners. The fact that the IRS challenges a transaction does not by itself mean that the IRS position is correct or, even in instances where the IRS is correct, that bond counsel is responsible for the challenged non-compliance. But under the literal terms of Circular 230, the bond counsel’s livelihood as a tax practitioner could be at risk if the IRS challenged an aspect of a bond issue that the practitioner had not identified as “significant” in the “written advice” to the issuer. Whether or not the IRS ever established that its challenge was meritorious, to avoid sanction bond counsel would have the potential burden of establishing that an issue that the IRS actually challenged was challenged unreasonably by the IRS, and therefore did not need to be identified as “significant.” It would not be surprising under such circumstances for bond counsel to act conservatively in disclosing “significant” or potentially

“significant” tax issues in the “written advice” to the issuer. And for the reasons discussed above, once the issue is designated as “significant” or potentially “significant” in a publicly available document, it would be extremely difficult for parties to a bond transaction to avoid the conclusion that such issue also must be disclosed in the official statement.

An additional item that will need to be sorted out is Treasury’s intent regarding “no adverse effect” opinions (*i.e.*, opinions that a particular transaction involving the bonds or the security for the bonds will not adversely affect the tax-exemption of the bonds). Under the final Circular 230 tax shelter regulations, bond opinions are excluded from the general tax shelter opinion requirements only if they fall within the definition of a “state or local bond opinion,” which requires inclusion in materials delivered to a purchaser “in connection with the issuance of the bond.” The preamble to the regulations states that an opinion is a “state or local bond opinion if the opinion is redelivered unchanged, *e.g.*, if the opinion is redelivered with a qualified tender bond that is tendered to the remarketing agent and remarketed” but that “if the state or local bond opinion with respect to that bond issue is changed or otherwise updated after bonds are issued, the altered opinion is not a state or local bond opinion, and is subject to” the general tax shelter opinion requirements. It is debatable whether a “no adverse effect” opinion is an “updated” opinion, but it would seem to constitute more than simply the redelivery of the original bond opinion, and it is not readily apparent that it is delivered in connection with the “issuance” of the bonds. “No adverse effect” opinions are delivered frequently in connection with mode changes or

conversions on existing bond issues. If such opinions do not qualify as “state or local bond opinions,” they will be subject to the final regulations for tax shelter opinions (which will become effective in six months), and will need to include, within the opinion itself, the required factual and legal analysis with respect to the lack of an adverse impact on tax exemption—thereby raising, potentially, similar concerns regarding the implications of lengthier, analytical post-issuance “no adverse effect” opinions for post-issuance purchasers of bonds.

In summary, the proposed regulations sidestep—whether deliberately or not—the hard questions regarding the impact of putting bond counsel under a new second-guessing regime that would involve significant tax practice sanctions for underdisclosing tax analysis that the IRS may consider incorrect or debatable. There are dozens of legal issues that must be addressed to conclude that a bond issue is tax-exempt, and the number of potentially relevant factual considerations is unlimited. When one combines the risk of underdisclosure in the “written advice” to the issuer with potentially significant securities law

sanctions for failing to disclose to bond purchasers anything material that is disclosed by bond counsel to the issuer, the ultimate effect of these proposed regulations could be to make the sausage-making of bond opinions visible in great detail to bondholders, with unanswered questions as to the implications for bondholders of having access to such information. For that reason, the battle over the final version of these regulations is likely to continue unabated.

The notice of the proposed regulations indicates that a public hearing on such regulations will be held on March 22, 2005, that comments must be received by March 1, 2005 and that such regulations will apply to opinions delivered on or after the 120th day following publication of the final version of such regulations in the Federal Register.

If you would like further information on any subject covered in this Advisory, please contact Leonard Weiser-Varon at 617 348 1758, Maxwell Solet at 617 348 1749, or any other member of the Public Finance section.