



NATIONAL FEDERATION OF MUNICIPAL ANALYSTS

POSITION PAPER ON PROPOSED REGULATIONS REGARDING TAX OPINIONS UNDER IRS CIRCULAR 230

The NFMA believes that application of the new definition of “tax shelter opinions” and other provisions set forth in the Proposed Regulations ¹ to tax opinions rendered with respect to debt issued by state and local governments is unwarranted and unnecessary, would undermine established industry practice and would prove extremely disruptive to the municipal bond market. For reasons summarized below, we strongly recommend that the Proposed Regulations be amended to provide that unqualified tax-exemption opinions rendered in conformance with the NABL Model Bond Opinion Project ² (“tax-exempt opinions”) be exempted from the scope and application of the Proposed Regulations.

Rationale

1. Prevailing Practice in the Industry Requires Adherence to High Standards of Care. In the explanatory provisions to the Proposed Regulations the Treasury Department states that the new regulations are designed “[t]o restore, promote, and maintain the public’s confidence” in the issuance of professional tax advice with respect to tax-advantaged investments. Although it is public knowledge that the IRS is investigating certain abuses in connection with tax-exempt transactions in the municipal market, abusive transactions constitute a miniscule portion of the municipal market and any tax opinions that may have facilitated such transactions are not representative of the quality of the overwhelming majority of tax-exempt opinions rendered in the municipal market. Prevailing practice in the municipal market requires adherence to high standards of care with respect to the issuance of tax opinions. Institutional investors insist upon and are routinely furnished with unqualified tax-exempt opinions that reflect a low tolerance in the municipal marketplace for any equivocation as to the tax-exempt nature of the interest on municipal obligations. In rendering unqualified opinions that interest is not subject to federal income tax, practitioners are well aware that bondholders wholly rely on their opinions and will hold them to the highest standards of accountability if the Internal Revenue Service challenges an opinion. The virtually universal requirement that tax-exempt opinions be unqualified opinions, and the attendant high standard of care used in rendering these opinions, makes application of Federal regulations dealing with reasoned and/or qualified “tax shelter” opinions typically delivered under a lower standard of care both unnecessary and counterproductive.

2. Municipal Obligations Fund Legitimate Public Purposes and are not Tax Shelters. Municipal bonds are issued in accordance with Section 103 of the Internal Revenue Code to finance a broad spectrum of essential public goods and services. The ability of state and local government units to issue debt is an integral and vital component to the effective administration of government and is a right long recognized by Congress. The fact that interest earned on these

obligations is excluded from federal income taxation is a consequence of deliberate federal policy, not a tax-avoidance device. State and local government obligations are not issued to create tax shelters but to fund essential government purposes. Imposition of new regulations with respect to tax-exempt opinions would add potentially burdensome costs and create increased uncertainty, thereby reducing the cost-savings that the federal tax-exemption is intended to provide to state and local governments.

3. Adoption of the Proposed Regulations Could Erode Opinion Standards in the Marketplace. To the extent that the Proposed Regulations force investors to consult with independent tax advisors before investing in tax-exempt bonds, this could lead to an erosion of the foregoing opinion standards. Under existing practice, Bond Counsel is assigned exclusive responsibility to examine relevant tax law and to render an unqualified opinion as to whether interest earned on state and local government obligations is excludable from gross income. Centralizing responsibility for tax analysis and opinion writing in this manner exposes Bond Counsel to considerable liability and forces it to undertake an important gatekeeper role to screen out questionable transactions with due caution and care. If the Proposed Regulations are adopted, two factors may work to erode opinion standards: (i) subjecting unqualified tax-exempt opinions to standards designed for less conservative opinions rendered at a “more likely than not” or lesser opinion standard will blur the distinction between tax-exempt opinions and less certain “tax shelter” opinions; and (ii) since investors would be required to retain advisors to scrutinize the lengthier and reworded tax opinions resulting from the application of actual or perceived Circular 230 requirements, bond counsel may be more inclined to issue qualified opinions and to relax its traditional gatekeeping function.

4. NABL’s Re-Affirmation of Unqualified Opinion Standards Preserves Reliability and Integrity in Opinion Writing. The NABL Model Bond Opinion establishes opinion standards consistent with both the requirements of the law and the needs of the municipal bond market. It reflects substantial thought and input from investor groups as well as NABL practitioners, and recognizes that the marketplace demands that the discipline imposed by the unqualified opinion standard be followed. The NABL Model Bond Opinion Report explains that Bond counsel may render an “unqualified” opinion regarding the validity and tax exemption of bonds if it is “firmly convinced” that, under applicable law in effect on the date of the opinion, “the highest court of the relevant jurisdiction, acting reasonably and properly briefed on the issues, would reach the legal conclusions stated in the opinion”. With respect to federal income tax matters, it specifically provides that bond counsel may give an unqualified opinion if it has a high degree of confidence that, upon due consideration of the material facts and all of the relevant sources of applicable law on federal income tax matters, either the IRS itself or an appropriate court would reach the federal income tax conclusions stated in the opinion. These standards set forth in the NABL Model Bond Opinion Report were scrutinized by industry groups, including the NFMA and the Investment Company Institute, and found to afford investors with appropriate protection and safeguards against substandard opinion writing in the municipal market.

5. Circular 230 Opinions Would be Inefficient and Disruptive of Existing Market Arrangements. If tax-exempt opinions were to become subject to the Proposed Regulations, the cost of opinion writing and the allocation of tax risk within the municipal marketplace would be substantially altered to the detriment of the municipal marketplace. As it now stands, issuers retain specialized counsel to review applicable federal tax law and render a tax opinion. Provided

that a tax opinion is unqualified and carries with it the high degree of confidence ascribed in the NABL Model Bond Opinion, investor confidence in these opinions are extremely well founded. If established practice is altered such that investors are required to make an independent assessment of tax opinions on municipal obligations to determine whether the revised format and greater length of the tax-exemption discussion masks a qualitative deterioration in the level of certainty asserted by the opinion, this would work to the profound disadvantage of the entire marketplace in at least two respects. First, institutional investors would be required to retain independent legal counsel to review tax opinions at considerable ongoing expense and likely delay in the issuance process. Considering that the overwhelming majority of municipal transactions qualify for tax exemption under clear authority and established rules and regulations, it is both unnecessary and unreasonable to burden institutional investors and mutual funds with an additional layer of expense. Not only does this create waste and redundancy for the investors, it indirectly increases borrowing costs of all state and local government units because investors will need to earn incremental yield to recoup additional expenses and to compensate for the increased uncertainty over whether the revised opinions are the “same” substantively as the “unqualified” and unreasoned tax exempt opinions delivered under current standards and practices. Second, if all investors are required to retain independent tax advisors, this will prove even more problematic to retail investors who lack the resources to retain special tax counsel and may be forced to exit the market. This would not only be unfair to retail investors but also prove extremely costly to governmental issuers due to the restriction in liquidity that is apt to result from the loss of retail investors.

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1. The Proposed Regulations are set forth in 31 CFR Part 10 [Reg-122378-02] RIN 1545-BA70 (hereinafter cited as the “Proposed Regulations”).
 2. The Model Bond Opinion Report, 2003 Edition, prepared by the National Association of Bond Lawyers (hereinafter cited as the “NABL Model Bond Opinion Report”).