Tax-Exempt Bond Examination Procedures

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Until 1995, examinations of municipal financing arrangements, that is, tax-exempt bonds, were a rarity, and Announcement 95-61 and its “Guidelines” constituted an effort to direct an enforcement initiative into an area of tax law in which the usual procedural rules do not apply, because the party examined, that is, the issuer, is not the actual “taxpayer.” For a few years after 1995 examining agents had comparatively little experience. Within the last three to four years, that deficit has been cured. The IRS’s Tax-Exempt Bond enforcement group (TEB group) have gained considerable experience. Rarely does a week pass without some news item on the enforcement activities of the IRS TEB group appearing in The Bond Buyer and other industry publications.

The entire TEB group consists of approximately 70 individuals, including approximately 43 field agents and several in the “outreach” group, devoted exclusively to obtaining compliance with the “Code and Regulations” provisions pertaining to tax-exempt bonds. The “outreach” group endeavors to educate the bond community and to obtain voluntary compliance and remediation. The field group conducts the field audits. Typically, the TEB enforcement group closes a bond examination through a closing agreement. Approximately 60 closing agreements were entered into last year.

Currently, the IRS has approximately 400 issues under examination. These examinations are now beginning to tilt in the direction of abusive and tax-shelter bond offerings. As experience and maturity have been gained, the TEB group has relied more and more upon its own accumulating experience and requested less and less guidance from the Office of Chief Counsel.

Today, as in 1995 and before, the examination of tax-exempt bonds has been procedurally awkward by reason of four attributes of tax-exempt bonds. First, for income tax purposes, the primary stakeholder in the compliance of a bond issue with “Code and Regulations” is the bondholder. The bondholder is the taxpayer. If a bond issue does not comply with Code and Regulations, the otherwise tax-exempt interest becomes taxable to the bondholder/taxpayer. However, the bondholder/taxpayer is merely a passive investor. Fault for noncompliance ought to lie with the issuer, conduit borrower, or culpable third party involved with the transaction, not with the bondholder/taxpayer. Structurally, little can be done about this. Issuers will continue to issue tax-exempt bonds, but the federal income tax burden for error must fall on the bondholder/taxpayer.

Second, the issuer, the party necessarily examined in a tax-exempt bond examination, has no statutory or other right to challenge the IRS examination in court. Congress noted this deficiency, and in passing the IRS Restructuring and Reform Act of 1998 (the “Restructuring Act”) considered affording a judicial appeal. Instead of enacting a judicial appeal, Congress provided an appeal to the IRS Appeals Office, at section 3105 of the Act. However, since 1998 only a handful of bond examinations have been appealed to an IRS Appeals Office. Approximately 95 percent of all bond examinations have been concluded by the TEB group. In four years no more than approximately a dozen cases have been appealed to the IRS Appeals Office. Sometimes a conduit borrower may be taxed under section 150(b). In these rare cases, the IRS supports judicial appeal.

Third, statutorily, the interest from an issue of tax-exempt bonds will either be entirely tax-exempt or entirely taxable. No intermediate sanction exists for an “almost qualified” issue of bonds. The statutory law affords no intermediate sanctions for good faith and slight error. This statutory weakness has not been corrected. However, the provisions set forth in section 150(b) of the Internal Revenue Code ("Code"), which deny deductions in certain change-of-use situations, have been applied in practice as intermediate sanctions. With the decline in the use of the Technical Advice procedures (below), even this thin source of authority has become more attenuated.

Fourth, by reason of the comparative rarity of examination before 1996 and of the inadequacy or entire lack of judicial remedies, there was, in 1995 and continues to be, a comparative paucity of case law concerning tax-exempt bonds. The IRS alone pretty much makes the law through the issuance of regulations and other guidance.

The statutory and regulatory framework for tax-exempt bond examinations remains today very much as it was in 1995 when Announcement 95-61 set forth the “Guidelines” for tax-exempt bond examinations. The Guidelines were incorporated into the Internal Revenue Manual, nearly verbatim, on July 8, 1999 as IRM 7.6.2.

As of January 1, 2003, IRM 7.6.2 and the Guidelines have been fully supplanted by the new “Tax Exempt Bond Examination Procedures” (the “TEB Examination Procedures”), set forth at IRM 4.81.1, IRM 4.82.1 (Examining Qualified Small Issue Bonds), and IRM 7.2.3.1 (Tax Exempt Bonds Voluntary Closing Agreement Program).
The new TEB Examination Procedures consume approximately 46 pages in contrast to the approximately 19 pages for the Guidelines. For the most part these greatly expanded TEB Examination Procedures arise from:

- the Restructuring Act, which made wholesale changes to the organization of the IRS, from that of a regional and district organization to a functional group organization; and

- the maturation of the tax-exempt bond examination program as it has scaled the learning curve, making new provisions to deal with an expanded set of circumstances.

Reorganization

The TEB Examination Procedures supply written procedures for what has actually been going on for the last few years following the restructuring of the IRS. The Guidelines became antiquated years ago, as key district directors, district counsel, and regions disappeared from the IRS organizational chart and as the Tax Exempt/Government Entities (TE/GE) division “stood up.” Some 15 pages now describe the offices, duties, responsibilities, case selection and assignment, and processing and review procedures under the new organization, compared to not quite two pages under the Guidelines. These articulations of organization and method constitute the bulk of the additional material.

Under the TEB Examination Procedures, the “top dog” is the Director, Tax Exempt Bonds. Within his, or her, responsibilities are:

- reviewing and executing closing agreements forwarded by the Manager, Outreach, Planning and Review, from the Voluntary Closing Agreement Program;

- reviewing and executing closing agreements forwarded by the Manager, Field Operations, who has no authority to execute closing agreements. IRM 4.81.1.

The TEB group contains a comparatively small and dedicated cohort, with the director able to retain “hands on” authority. This contrasts sharply with the Guidelines, under which the assistant commissioner (Employee Plans/Exempt Organizations) (AC/EP/EO) served more as an “absentee landlord” setting policy. The director retains the policy and procedure authority of the AC/EP/EO and aligns this with day-to-day program involvement. The former role of the AC/EP/EO has been assumed by the director, GE (Government Entities) and the commissioner, TE/GE, but much of the authority and responsibility of the earlier equivalent levels has devolved upon the director.

The manager of the office of Outreach, Planning and Review now resembles a chief of staff in his or her duties, with 17 articulated responsibilities, including operationally the Voluntary Closing Agreement Program, policy, outreach, and training. IRM 4.81.1.4.3.

The manager of Field Operations controls the day-to-day examination operations of the TEB group, resembling a chief operating officer, including managing the Field Operations.
managers and negotiating closing agreements. IRM 4.81.1.4.4.

The TEB Examination Procedures create a TEB focus group consisting of agents, field managers, and representatives from Outreach, Planning and Review, the Office of Chief Counsel, and the Office of Appeals. IRM 4.81.1.28. The group will meet periodically in order to enhance compliance, to identify new trends and issues, and to assist in providing workplans. In effect, the TEB Focus Group provides 360° review and input of an interactive organization.

The TEB Examination Procedures formalize the creation of a tight, focused, thinking, learning, and planning organization.

**Internal Revenue Manual Procedures**

Now, as in 1995, in this area, the IRS perceives the sensitivity of federal/state relations and alerts the Service personnel that the Tax-Exempt Bond program should take into account “the unique relationship between the federal government and the state and local governments.” However, this sensitivity manifests itself in the conduct of the audit, more than in the outcome.

The Tax-Exempt Bond program has five express primary goals:

- achieving significant levels of audit coverage;
- responding promptly to abusive transactions;
- increasing effective use of information returns;
- encouraging issuers to take an active role in ensuring that their bond issues comply with the Internal Revenue Code (“Code”) and Treasury Regulations (“Regulations”); and
- otherwise promoting voluntary compliance with the requirements of the Code and Regulations. IRM 4.81.1.2.

To implement these goals, the TEB Examination Procedures:

- create an administrative hierarchy of personnel and assign differing responsibilities and duties to those personnel (IRM 4.81.1.4);
- create sophisticated procedures for the selection of the tax-exempt bond issues to be examined (IRM 4.81.1.6.2);
- provide for an issuer level, rather than a bondholder level, examination (IRM 4.81.1.11);
- set forth procedures for complying with third-party rules for bondholders, issuers, conduit borrowers, certificates of participation, and abusive tax shelters (IRM 4.81.1.15);
- provide a multi-step process for conducting an examination, commencing prior to contact with the issuer and concluding with two alternatives.

If the examining agent’s conclusion, with his or her manager’s concurrence, is that a preliminary adverse determination is appropriate, then the examining agents consult with the manager of Field Operations and Area Counsel to determine if technical advice should be requested. If technical advice is not requested:

- the examining agent so notifies the issuer and affords the issuer an opportunity to enter into a closing agreement; and
- if a closing agreement is not entered into, the examining agent issues a preliminary adverse determination letter.

If the decision is to seek technical advice, then the examining agent submits a request for technical advice to the manager, Outreach, Planning and Review, for review and concurrence and with such, technical advice request is then sent to the National Office (more specifically, the Office of Division Counsel/Associate Chief Counsel TE/GE, in accordance with such procedures (below).

When technical advice is issued, the examining agent notifies the issuer in writing of the determination, including a copy of the technical advice; and if the determination is adverse, then as appropriate notifies the issuer of either the preliminary or proposed adverse determination and informs the issuer of its right to appeal to the Appeals Office. IRM 4.81.1.14.1.

In a perhaps unintended variation from the Guidelines, the TEB Examination Procedures do not expressly consider the possibility that the examination will be favorable to the issuer, to be concluded with a “no change” letter. Perhaps it goes without saying that if the examination is favorable to the issuer, the examination ends there.

Before 1999, the request for technical advice was a routine prelude to the issuance of an adverse determination letter. With the maturation of process and personnel, both within the IRS and within the bond community, the request for technical advice has become infrequent. Perhaps in some small measure, the administrative right of appeal, Rev. Proc. 99-35, 1999-41 I.R.B. 501, has supplemented the protections afforded by the request for technical advice. (“Technical advice” means advice or guidance in the form of a memorandum furnished by the Service’s National Office in response to a technical or procedural question that arises in an examination. Technical advice is intended to establish and maintain consistent positions.) The diminishing use of the technical advice procedure has a quite negative aspect. The bond community generally obtains only secondhand and not entirely reliable information as to the positions maintained by the IRS.

In the case of adverse determinations not appealed to the Appeals Office, the general terms of the closing agreement are set forth in order to ensure consistency of treatment and to encourage increased voluntary compliance (IRM 4.81.1.20 and 4.81.1.20.3) and the method for determining the “closing agreement amount” that the issuer would pay so that the bondholders are not taxed (IRM 4.81.1.23 and 4.81.1.24.1).
(A “closing agreement” is a binding agreement between the IRS and a taxpayer, including an issuer, that finally and conclusively settles a tax issue.) The closing agreement amount has been articulated to address:

- taxpayer exposure, in the general tax-exempt bond examination case;
- section 150(b), where conduit borrowers are subject to tax;
- arbitrage, in arbitrage cases, and;
- section 6700, in abusive tax shelters.

In the case of adverse determinations in which the issuer neither appeals to the Appeals Office, nor enters into a closing agreement, set forth procedures for determining the names of bondholders and taxing bondholders (IRM 4.81.1.18). The word “criminal” did not appear in the Guidelines. The TEB Examination Procedures contemplate that allegations of criminal violations of tax law might arise in the course of an examination and provide procedures for referrals to Criminal Investigation and possible declinations. IRM 4.81.1.7

**Closing Agreement Amount**

Prior to discussing intervening steps, the “worst case” outcome of those steps should be set in focus. Although issuers are not liable for tax when a tax-exempt bond does not comply with section 103, the Service will invite and the issuer may seek to enter into a closing agreement in order to avoid risking that the issue will be affected adversely in the marketplace, that private litigation will ensue, or that the bondholders will be taxed on the interest they receive. Among the important terms of the closing agreement is the “closing agreement amount” set forth at IRM 4.81.1.23. The TEB Examination Procedures define the “Basis for Closing Agreement Amount” to be one of the following four, depending on the nature of the proposed adjustment:

- **Taxpayer Exposure** — Generally, the closing agreement amount should be based on the taxpayer exposure, which is the amount of tax the Service could collect if bondholders paid tax on the interest they have earned and will earn on the bonds. Taxpayer exposure for any year is equal to:
  - the interest both accrued and scheduled in that year to accrue on the outstanding bonds multiplied by the relevant tax percentage; plus
  - interest at the underpayment rate on that amount. The “relevant percentage” is based on the Service’s estimate of the average investor’s highest tax bracket. In the absence of more accurate information, the Service will use 29 percent. The taxpayer exposure for prior years is calculated by adding together the taxpayer exposure for all open years. Taxpayer exposure for future years should be computed on a present value basis, using the taxable “applicable federal rate” (semiannual compounding) as the discount rate. (A formula is provided for determining taxpayer exposure in the case of variable rate bonds.);
- Section 150(b) — In cases where the conduit borrower is subject to taxation under section 150(b), the closing agreement amount is to be 100 percent of the amount determined under this section;
- Arbitrage profits — In certain cases, the closing agreement amount can be based on the amount of arbitrage earned by the issuer or another party to the transaction; or,
- Section 6700 — In addition to the above, closing agreement amounts may be based upon the application of section 6700 penalties to one or more parties to the transaction.

One of these four constitutes the “basis” for the settlement computation, the Service starting point in negotiation. Frequently this “basis” yields a comparatively enormous number.

With this starting point, the TEB Examination Procedures then define the “Closing Agreement Amount” to be:

After determining the appropriate basis for the closing agreement amount, the agent and field manager may take into account: the good faith of the parties to the transaction, the collectability of the total taxpayer exposure from bondholders; the complexity of the transaction and the hazards of litigation; the cooperation of the transaction participants with the Service during the examination; whether the violation was inadvertent and the extent of the violation; and the economic benefit derived by the transaction participants through consummation of the transaction. IRM 4.81.1.24.1

These relevant factors generally serve to reduce substantially the “closing agreement amount” from the figure that is computed under the basis for closing agreement amount.

**Examination Process**

The examination process begins prior to contact with the issuer. Mindful of the marketplace impact of examinations, examining agents are to obtain information from issuer filings with the Service, filings with a nationally recognized municipal securities information repository, and other public sources of information. IRM 4.81.1.12.

Following this pre-examination research, the examining agent will commence the examination by issuing one of four sample contact letters: a standard letter; a “project initiative” letter; a notice of an “informant” letter; or an “external sources” letter. Thereby, the issuer has some notice as to what events triggered the examination. IRM Exhibits 4.81.1-3 thru 4.81.1-6.

Following contact with the issuer, generally the examining agent will examine the bond transcript, review of relevant documents, categorization of the municipal financing arrangement, and the development of factual and legal questions. IRM 4.81.1.14.1. This process can be quite protracted,
consuming as much as one or two years, now less so with
the maturation of the program. The examining agent has
considerable latitude, as in any examination, in his or her
conduct of the examination. However, as the examining agent
concludes the examination, review by the manager (or higher
authority) is mandatory for any of the possible outcomes.

The Restructuring Act provided that the taxpayer must be
given advance notice of third party contacts, and certain other
contacts. Code section 7602(b). The TEB Examination pro-
cedures provide guidance for compliance with such require-
ments in six different contexts: general procedures; bond-
holders; issuers; conduit borrowers; certificates of
participation; and abusive tax shelters. IRM 4.81.1.15.

The examining agent must seek review by the manager
of Field Operations and the Area Counsel as to whether or
not to seek technical advice. As noted above, in a variation
from the Guidelines, among the outcomes explicitly contem-
plated, compliance with the code and regulations has not been
articulated. Perhaps the outcome from taxpayer compliance
is so obvious that it has not been set forth.

Other than the presumed ability to end the audit with a
“no change” letter, the examining agent can propose, with
his or her manager’s concurrence, either of two overlapping
processes (each of which may be a prelude to or ordinarily
culminates in closing agreement discussions):

(A) A preliminary adverse determination, the ana-
logue of the general examination’s “10-day letter,” in
which event the examining agent:

• consults with the manager of Field Operations and Area
  Counsel to determine whether technical advice should
  be requested;

• if technical advice is not requested, notifies the issuer
  of the preliminary adverse determination and provides
  the issuer an opportunity to enter into a closing agree-
  ment; and

• if no closing agreement is entered into, issues an ad-
  verse determination letter, the analogue of the general
  examination’s “30-day letter,” and advises the issuer
  of the availability of administrative appeal to the Ap-
  peals Office.

(Even if the examining agent decides not to request technical
advice, the issuer may request that the examining agent re-
quest technical advice (Rev. Proc. 2003-2, Section 7.02), and
pursue administrative appeals in the event the examining
agent declines to request technical advice.)

(B) A request for technical advice to the National
Office; and

• following the issuance of technical advice, notification
  to the issuer in writing of the determination in such
  advice; and

• if adverse, advise the issuer of the availability of ad-
  ministrative appeal to the Appeals Office. Although
  not set forth in the TEB Examination Procedures, pre-
  sumably the examining agent would endeavor to enter
  into a closing agreement before advising the issuer of
  administrative appeal to the Appeals Office. IRM

In theory, a request for technical advice may be sought at
a time when the examining agent remains uncertain as to the
proper tax treatment. More commonly, the examining agent
requests technical advice when he or she has inclined to a
preliminary adverse determination. In less than a complete
set of procedures, the TEB Examination Procedures state that
after adverse technical advice has been issued and no request
for a hearing before the Appeals Office has been received,
the examining agent is to:

• collect bondholder names, if not already done; and

• make “discrepancy adjustments” to the bondholders’
  returns, with the approval of the manager, Field Op-
  erations. IRM 4.81.1.14.2

The TEB Examination Procedures set forth a model clos-
ing agreement and the general terms of a closing agreement.
IRM Exhibit 4.81.1.1-9

Of course, the overwhelming objective is to end the ex-
amination with a closing agreement. Typically, an examina-
tion of an issue ends well before the procedural options expire.
Typically, a bond examination begins, the examining agent
reaches a preliminary decision, and, if unfavorable, closing
agreement discussions commence. “It is the policy of the Tax
Exempt Bond Program to attempt to resolve violations of
code without taxing bondholders.” IRM 4.81.1.20

Further, “If the Service is going to initiate closing agree-
ment discussions in an examination case, the agent does not
need to issue a preliminary adverse determination.” IRM
4.81.1.20.1

A TEAM, “Technical Expedited Request,” may be ob-
tained for a tax-exempt bond issue, although rarely would it
be appropriate. Rev. Proc. 2003-2, Sec. 5.02.

Closing Agreement

The TEB Examination Procedures include a model clos-
ing agreement to be used when it becomes the outcome of the
examination.

Among the provisions of the model closing agreements
are the following five key provisions:

• The issuer shall pay ________ to the IRS upon the
  issuer’s execution of this agreement. Payments of this
  amount shall be made by certified check payable to the
  U.S. Treasury and delivered to a duly authorized rep-
  resentative of the IRS.

• The bondholders are not required to include in their
gross income any interest on the bonds because of the
violations set forth herein.

• The issuer will redeem all outstanding bonds on or
  before (specify date).

[Optional: The bonds will not be redeemed with proceeds of
bonds described in section 103(a) of the code.]
In practice, this may prove a rarity. The Guidelines contained no equivalent prescription. Insofar as statutory law permits a review... " IRM 4.81.1.17. The Guidelines contained no equivalent prescription.

These provisions have support in the GAO report as a means of enhancing compliance.

Section 150(b)

Unremedied by the Restructuring Act has been the inability of issuers, the targets of tax-exempt bond examinations, to obtain judicial review. The issuers do not pay tax by reason of purported tax-exempt bonds becoming taxable; bondholders do. The bondholders have the judicial rights. However, under the narrow circumstances of section 150(b) concerning mortgage revenue bonds, qualified residential rental projects, qualified 501(c)(3) bonds, and certain exempt facility bonds, the conduit borrower can be taxed through loss of an interest deduction. In these narrow circumstances, the TEB Examination Procedures prescribe that “the primary consideration is to ensure that the bonds will be redeemed early.” IRM 4.81.1.22

These provisions have support in the GAO report as a means of enhancing compliance.

Technical Advice Procedure

The technical advice procedures applicable to tax-exempt bonds are the same as those generally available to taxpayers and are set forth in an annual revenue procedure issued by the Service, currently, Rev. Proc. 2003-2, 2003-1 I.R.B. 76. Whether initiated by the examining agent or the issuer, a request for technical advice must include the facts and issues for which technical advice is requested, a written statement clearly stating the applicable law, and the arguments in support of both the Service’s and the issuer’s positions.

In the now unusual case of requesting technical advice, ordinarily the Service initiates the request, the issuer is encouraged to set forth the above information, and the examining agent and the issuer are encouraged to mutually agree on a date for the submission by each.

If the issuer does not submit his information with the examining agent’s request, the examining agent will provide a copy of his or her statement of facts and issues. The issuer is then afforded 21 days within which to submit a statement and information unless extended.

If the Service initiates the technical advice and the taxpayer disagrees with the government’s statement, the taxpayer has 10 calendar days after receiving the government’s statement to specify any disagreement on facts and issues, or to request an extension of time in writing to disagree. The examining agent then endeavors to reach agreement on the facts and specific points at issue.

Perhaps perversely, the issuer is encouraged to comment upon any authorities contrary to its position or to state that none exists.

The examining agent will notify the issuer of its right to a conference with the National Office if an adverse decision is indicated and will ask the issuer if such a conference is desired. The issuer is entitled to one conference of right with the National Office, if an adverse decision is indicated. The term “National Office” is used here, although in some measure antiquated, since it is still used by the Service in Rev. Proc. 2003-2. More specifically, the term refers to the Division Counsel/Associate Chief Counsel (TE/GE), in the context of tax-exempt bonds.

There may be discussions between the National Office and the examining agent of other Area Office officials before technical advice is issued. When issued, the technical advice is sent to the examining agent, not to the issuer. The National Office will not discuss the contents of a technical advice until after it has been sent to the examining agent. If the examining agent, or more precisely, the Area Office, accepts the technical advice, it is then sent to the issuer and “published” (that is, made available to the public under the Freedom of Information Act) by the Service, with appropriate “deletions” of identifying information.

The examining agent must process the issuer’s case on the basis of the technical advice unless: (1) the director, Tax Exempt Bonds, or possibly the area director decides that the technical advice should be reconsidered and requests reconsideration; (2) in the case of an adverse technical advice the area director, Appeals, decides to settle the case on existing authority; (3) there are certain settlement authority circumstances; and (4) if the technical advice was submitted with alternative sets of facts, the examining agent is required to process the technical advice with the legal analysis applicable to the facts as they are ultimately determined by the examining agent.

Voluntary Closing Agreement Program

The IRS promulgated the “Voluntary Closing Agreement Program for Tax-Exempt Bonds” in Notice 2001-60, 2001-40 I.R.B. 304. Under the acronym “TEB VCAP,” the IRS seeks to obtain voluntary compliance with the “Code and Regulations” by affording to issuers a means of remediating violations of the code and regulations, in particular without taxing the bondholders. Notice 2001-60 has not been revoked, but
it appears to have been superseded by the new, and slightly revised, articulation of the program set forth at IRM 7.2.3. Generally, for a bond issue to qualify for TEB VCAP:

- an issuer must not have available to it the remedial procedures of Treas. reg. sections 1.141.12, 1.142.2, 1.144-2, 1.145-2, and 1.147-2;
- the issue must not be under examination at the time;
- the tax-exempt status of the bonds must not be in litigation nor before the IRS Appeals Office; and
- the IRS must determine that the violation was not the result of willful neglect.

The TEB-VCAP program sets forth the content of the submission to be made to the IRS. Among the statements that either the issuer or the conduit borrower must make, as the case may be, are that the issuer reasonably expected to comply with section 103 on the date of issue and that the request for a closing agreement was made promptly upon discovery of the violation.

The submission is expected to contain a proposed closing agreement and closing agreement amount, based upon the Model Closing Agreement at IRM Exhibit 4.81.1-9. The closing agreement amount to be proposed has a slightly different expression than under IRM 4.81.1. “Whether an issuer will be requested to make a payment under the closing agreement terms depends upon the facts and circumstances of the case.” And, “If a payment is requested, it will generally be paid based on an estimate of the federal income tax liability on interest accruing on the nonqualified bonds, commencing on the date of the infraction and ending on the date the nonqualified bonds are redeemed or defeased.” IRM 7.2.3.6.

Notably, an issuer or its authorized representative may initiate discussions on an anonymous basis. IRM 7.2.3.5

Section 6700

Section 6700 imposes a penalty equal to the lesser of $1,000 or 100 percent of the gross income derived by a person from an “activity” for organizing or assisting in organizing or directly or indirectly participating in the sale of any interest in a plan or activity and making or furnishing or causing another person to make or furnish a statement with respect to “the excludability of any income” that the person “knows or has reason to know is false or fraudulent as to a material matter.” The section 6700 penalties presumably apply separately to each bondholder. The IRS apparently takes the position that the penalty applies to each “bond.”

Formerly, the TEB group only rarely raises the specter of section 6700 penalties on investment bankers, investment advisors, financial advisors, bond counsel, and others. The TEB Examination Procedures now contain many provisions for applying section 6700. Likely penalty assertion will become frequent.

The TEB Examination Procedures refer to section 6700 several times, specifying authority to initiate section 6700 investigations (IRM 4.81.1.32.3(j) (the manager, Field Op-

Early Referral

Both early referral and mediation (below) are procedural alternatives available in bond audits. In practice, these procedures may be unworkable in the tax-exempt bond context, and, therefore, have less practical relevance than even Appeals Office consideration.

The Restructuring Act enacted into law an “early referral” provision permitting a taxpayer, including an issuer, to seek the early referral of an issue or issues from the examining agent to the Appeals Office, early in that the referral can occur prior to the examining agent’s conclusion of his entire audit. Issuers, as well as taxpayers generally, may seek early referral.

Under Service procedures, appropriate issues for early referral are limited to those that:

- if resolved, can reasonably be expected to result in a quicker resolution of the entire case;
- both the taxpayer and the area director (that is, the examining agent and her or his superiors) agree should be referred to the Appeals Office early;
- are fully developed; and
- are part of a case where the remaining issues are not expected to be completed before Appeals could resolve the early referral issue. Rev. Proc. 99-28, 1991-29 I.R.B. 109.

Early referral is initiated by requesting such in writing from the examining agent’s case or group manager. The early referral request must appropriately identify the taxpayer, period, etc.; state the issue for which early referral is requested; and contain a brief discussion of the material facts and law as they apply to the early referral issue, describing the taxpayer’s position.

If the case manager or group manager agrees to early referral, the examining agent will prepare a Notification Form setting forth the examining agent’s position on the issue and send it to the taxpayer. The taxpayer then has 30 days, unless extended, within which to provide a response to the case or group manager. Then, the Service’s and the taxpayer’s positions are forwarded to the Appeals Office for consideration, in accordance with routine Appeals Office procedures.

There does not appear to have been any tax-exempt bond examination yet for which early referral procedures have been utilized, but these matters change day to day. Early referral does, in theory, offer an opportunity for an expedited appeal. However, in the case of tax-exempt bonds, early referral may not prove as useful as in other tax areas because tax-exempt bond issues frequently are cumulative, with an adverse response to any issue resulting in a loss of the exclusion of

Special Reports
Mediation

In its ongoing efforts to expedite the resolution of tax controversies, the Service has now greatly broadened the availability of mediation for matters before the Appeals Office. Rev. Proc. 2002-44, 2002-26 I.R.B. 10. Mediation is not available for a few issues, namely those for which the taxpayer did not act in good faith during settlement discussions, frivolous issues, those designated for litigation, and a few others of very limited application. For those handful of tax-exempt bond cases reaching the Appeals Office, mediation can be contemplated if the parties do not reach a settlement. These procedures, so rarely if ever used in this context, have not been set forth.