



CDIAC SURVEYS ISSUERS ON NATIONAL ASSOCIATION OF BOND LAWYERS PROPOSAL

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In November 2001, the National Association of Bond Lawyers (NABL) distributed draft legislation to its membership and other interested parties that proposes to change the application of penalties for tax-exempt bonds that the Internal Revenue Service (IRS) determines are taxable. The proposal has three key components:

- (1) Shifting the tax liability for bonds determined to be taxable from the bondholder to the issuer,
- (2) Allowing the issuer to appeal an adverse IRS decision beyond the IRS Appeals Division by virtue of the shift in tax liability, and
- (3) Empowering the Secretary of the Treasury to establish a procedure for determining penalty amounts, both monetary and non-monetary, based upon consideration of several factors.

NABL states that as beneficiaries of the subsidy provided by tax-exempt bonds, issuers should have a strong incentive to ensure the continued tax-exempt status of these bonds. Bondholders have no ability to ensure compliance with federal tax law yet they currently bear the ultimate tax liability. By shifting the tax liability, bondholders are held harmless and issuers gain additional means by which to challenge IRS decisions.

Upon learning of the NABL proposal, the California Debt and Investment Advisory Commission (CDIAC) formed a working group of public and private sector professionals from its Technical Advisory Committee to analyze the proposal and to provide suggestions on how CDIAC could best serve local issuers in responding to the proposal. As a result of these suggestions, CDIAC conducted a survey of local government issuers to determine their past interactions with the IRS and their knowledge/opinions of the NABL proposal.

Survey Design

Using its database of debt issuance, CDIAC sent a survey of the NABL proposal to a random sample of 200 local government and nonprofit organization bond issuers. The sample was designed to capture a proportional representation of

issuers from all types of organizations that issued debt in 2001. The year 2001 was chosen because it was the most recent, complete year of data in CDIAC's database.

CDIAC asked 14 questions requiring a "Yes/No" or multiple choice response. Most questions also allowed for additional comments from the issuer. Along with the survey, CDIAC included a short description of the NABL proposal.

Survey Results

CDIAC received 54 survey responses from local government organizations, including cities, counties, school districts, redevelopment agencies, community facilities districts, special districts, joint powers authorities and non-profit organizations. While the number of respondents by organization type is too small for the survey results to be considered "robust" in a statistical sense, the responses provide a glimpse of the widespread opinions among various government agencies on the proposal and its potential effects.

The first half of CDIAC's survey focused on issuer's dealings with the IRS. Of the 54 respondents, four (two school districts, a county, and a city) indicated that they have been subject to an IRS audit of their bond issues. One of the four audits resulted in a negative finding; however, the issuer was not found at fault. Rather, the issuer indicated that the IRS was entering into a settlement agreement with one of the finance team members on the bond issue. While three of the four agencies audited felt their dealings with the IRS were satisfactory, one of the three agencies indicated that it found the audit process protracted and time-consuming. One of the four issuers felt its dealings with the IRS were unsatisfactory, and particularly was troubled by the IRS' lack of understanding of local government finances.

The remainder of CDIAC's survey focused on California issuers' opinions of the NABL proposal and how it would affect their debt issuance. Figure 1 provides a breakdown of issuers' opinions of the proposal (including its components). Most of the issuers (83 percent) were not aware of the proposal prior to CDIAC's survey. Issuers' responses to the key aspects of the proposal were mixed—44 percent support it while 54 percent do not support at least one component of

it. In looking at the breakout by organization type, half of all school districts surveyed favor the proposal as drafted while one-third of the counties and less than half of the cities and other organization types support all of the components of it. Of those agencies that do not support the proposal as drafted, 62 percent believe issuers should be given the right to appeal an adverse IRS decision without shifting the tax liability from the bondholder to the issuer. Almost a quarter of all agencies (comprised entirely of cities and school district issuers) feels that current law should remain the same at this point in time. Opinions were nearly equally divided regarding whether the Secretary of the Treasury should be allowed to establish a graduated penalty system. Forty-five percent of issuers believe that the Treasury should establish this system while 42 percent do not feel that the Treasury should be given this responsibility.

**Figure 1
Survey of NABL Proposal: Issuers' Opinions**

	Number of Agencies	Percent	Number of organizations			
			Cities	Counties	School Districts	Other
Aware of Proposal Before Survey:						
Yes	9	17%	3	2	4	0
No	45	83%	14	1	22	8
Total	54	100%	17	3	26	8
Support for NABL Proposal in its Entirety:						
Yes	24	44%	7	1	13	3
No	29	54%	10	2	12	5
Unsure-No response	1	2%	0	0	1	0
Total	54	100%	17	3	26	8
If Full Proposal Not Supported, then Support for Subcomponents:						
A. Shift in Tax Liability and/or Ability to Appeal Decision to Higher Court:						
Right to Appeal Without						
Shift in Liability	18	62%	5	2	7	4
Right to Appeal With						
Shift in Liability	1	3%	0	0	0	1
No change to Current Law	7	24%	4	0	3	0
Unsure-No response	3	10%	1	0	2	0
Total	29	100%	10	2	12	5
B. Treasury Should Set Graduated Penalties:						
Yes	13	45%	3	1	5	4
No	12	42%	6	1	5	0
Unsure-No response	4	14%	1	0	2	1
Total	29	100%	10	2	12	5

Figure 2 provides a breakdown of issuers’ perceptions regarding the impact of the NABL proposal on debt issuance. Issuers were asked if they believe an IRS audit negatively affects the issuer being audited. Almost two-thirds of issuers said there is a negative impact compared to 28 percent who felt there is not a noticeable effect. This response was shared generally in the same proportions among the various local government organizations. Only 17 percent of issuers who believe an audit creates negative market effects believe the NABL proposal would correct this problem. As one issuer responded, “The proposal helps, but the stigma of an audit remains.”

Figure 2
Survey of NABL Proposal: Impact of Proposal

	Number of Agencies	Percent	Number of organizations			
			Cities	Counties	School Districts	Other
Audits Create Negative Market Impacts:						
Yes	35	65%	10	2	18	5
No	15	28%	6	1	5	3
Unsure-No response	4	7%	1	0	3	0
Total	54	100%	17	3	26	8
If a Negative Market Impact, NABL Proposal Would Resolve it:						
Yes	6	17%	2	0	3	1
No	26	74%	8	1	13	4
Unsure-No response	3	9%	0	1	2	0
Total	35	100%	10	2	18	5
Would Prefer a Settlement Agreement Even if Allowed to Appeal Beyond IRS Appeals Division:						
Yes	21	39%	4	2	12	3
No	15	28%	5	0	6	4
Unsure-No response	18	33%	8	1	8	1
Total	54	100%	17	3	26	8
Would Not Appeal a Negative Judgement For the Following Reasons: (Multiple Choices Possible)						
Court Costs	22	31%	6	3	10	3
Lengthy Court Process/Time	21	29%	6	3	9	3
Outcome Unlikely to Change	24	33%	6	2	13	3
Other	3	4%	3	0	0	0
No Reason Would Prevent Appeal	2	3%	2	0	0	0
Total	72	100%	23	8	32	9
Proposal Would Change Relationship with Bond Counsel:						
Yes	15	28%	4	1	8	2
No	33	61%	10	2	15	6
Unsure-No Response	6	11%	3	0	3	0
Total	54	100%	17	3	26	8

Survey responses were mixed when issuers were asked if they would still prefer to enter into a settlement agreement with the IRS even if they could appeal beyond the IRS appeals division. Thirty-nine percent of issuers said they would still prefer to settle with the IRS rather than appeal an adverse decision, 33 percent were unsure of how they would respond, and 28 percent said they would appeal beyond the IRS Appeals Division. Counties and school districts were more likely to prefer entering into settlement agreements (more than half of these agencies still prefer entering into an agreement) than cities and other government organizations. A number of respondents who were unsure in their responses stated that they would decide this on a case by case basis. Several also stated that it would depend on how an appeal would impact the market for their securities.

When asked what factors would prevent an issuer from appealing an adverse IRS decision, 33 percent of respondents felt the outcome was unlikely to change, 31 percent believe court costs may be prohibitive, and 29 percent felt that they may not be able to invest the time for a lengthy court process. Other reasons offered include the potential negative impact of an appeal on the marketability of an issuer's bonds and if other professionals involved in the transaction were found at fault. Two cities indicated that there were no factors that would deter them from appealing an adverse decision.

One argument that has been raised against the NABL proposal is the potential to "water down" bond counsel's opinion (that is, bond counsel would not need to strive for 100 percent confidence in its opinion on the tax-exempt status of a bond if the issuer bears the tax liability and the bond counsel and issuer agree to an acceptable level of risk-taking with respect to the opinion). CDIAC asked issuers if the NABL proposal would change their relationship with their bond counsel. Sixty-one percent of respondents believe their relationship will remain the same compared to 28 percent who believe the proposal would change their

relationship with their bond counsel. Several respondents felt the law change actually would give them more control in their relationship with their bond counsel because they would bear the direct burden of IRS fines and penalties. One issuer said it would require its bond counsel to assume some of the increased tax liability risk by requiring a larger amount of Errors and Omissions insurance. However, another respondent said that this action likely would lead to higher costs of issuance for the issuer.

CDIAC's survey concluded with asking for additional remarks and comments. Responses varied widely from finding the proposal a reasonable attempt at fixing the system to considering a total waste of time and creating a greater bureaucracy. Several respondents did reiterate that bondholders should not be held liable in the event of an IRS adverse action; however, one respondent felt that seeking a solution through legislation would open up the municipal market to further scrutiny and potentially create a worse situation with respect to federal oversight and regulation.

CDIAC plans to work with other state organizations to gather further input on issuer opinions of the NABL proposal in the coming months, and will use that information along with the survey results reported in this article to evaluate the best potential responses to the proposal. In addition, CDIAC will continue to track any further developments with the NABL proposal and provide updated information to local government issuers in future *DEBT LINE* editions. In the meantime, NABL continues to solicit input from issuers and industry professionals regarding the proposal. It would like to generate further dialog and increase issuer awareness of these and other legal issues that significantly impact the public debt issuance process as part of its goals of providing education and information to public finance practitioners. For further information on the NABL proposal, visit NABL's web site at www.nabl.org.

This Offprint was previously published in DEBT LINE, a monthly publication of the California Debt and Investment Advisory Commission (CDIAC). CDIAC was created in 1981 to provide information, education, and technical assistance on public debt and investment to state and local public officials and public finance officers. DEBT LINE serves as a vehicle to reach CDIAC's constituents, providing news and information pertaining to the California municipal finance market. In addition to topical articles, DEBT LINE contains a listing of the proposed and final sales of public debt provided to CDIAC pursuant to Section 8855(g) of the California Government Code. Questions concerning the Commission should be directed to CDIAC at (916) 653-3269 or, by e-mail, at cdiac@treasurer.ca.gov. For a full listing of CDIAC publications, please visit our website at <http://www.treasurer.ca.gov/cdiac>.

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