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Dear Messrs. Scott and Louthan and Ms. Harrigal:

We are writing to share concerns about and make proposals with respect to the enforcement program of the Internal Revenue Service in the tax-exempt bond area.

NABL continues to support a vigorous, fair enforcement program. NABL believes that such a program promotes the integrity of the tax-exempt market and assures the efficiency of the interest rate subsidy. However, unique characteristics of the tax-exempt market have allowed the enforcement program to produce unintended consequences. Before outlining NABL's suggestions, it may be helpful to amplify why this is so.

Characteristics of the Tax-Exempt Market

Conferring tax-exemption on the interest of state or local government bonds is intended to provide a subsidy to governmental issuers through an interest rate lower than the rate otherwise available in the conventional taxable markets. In general, the spread between taxable and tax-exempt interest rates should reflect the marginal income tax rate in order for the intended subsidy to be efficient.

If an investor in fixed-rate bonds buys with fear that the bonds will not be tax-exempt for their entire term, then the risk of taxability will be factored into the interest rate. It will be higher than the rate otherwise expected in light of the marginal income tax rate, thereby reducing the efficiency of the subsidy.

If an investor in fixed rate bonds buys at an interest rate that properly reflects the spread between taxable and tax-exempt rates, but receives notice later that the tax-exempt status of the bonds

is in question, then the resale price in the secondary market is likely to be adversely affected. At that point the investor must either hold bonds with a diminished value, or sell at a loss. Such experiences no doubt affect pricing by the investor in its next purchase of bonds.

Many bonds in the tax-exempt market are issued with a variable rate - for example, a rate that changes weekly. The investors in this debt will buy, or continue to hold, at tax-exempt rates reflecting the marginal income tax rate only if they believe that the interest they receive will continue to be tax-exempt. If they receive notice that the tax-exempt status of variable rate bonds is in question, the interest rate can be expected to rise dramatically on the next repricing date.

Most tax-exempt bonds are sold in a public offering. The disclosure requirements of that market, including Rule 15c2-12 and the general antifraud provisions, dictate that investors in the initial and secondary market receive information material to their decision to buy or sell bonds. If that information relates to tax-exempt status, the information may affect market price as suggested above.

Although the enforcement initiative has identified some examples of non-compliance, we believe that the great majority of tax-exempt debt complies with the applicable rules and deserves to realize the full subsidy intended by Congress for tax-exempt financing. It is also important to recognize that, in addition to rules relating to basic eligibility for tax-exempt financing, there are very technical requirements of the Internal Revenue Code and regulations as well. Those requirements may be missed by an issuer acting in good faith to finance a project that otherwise is well within the boundaries of eligibility. It may be appropriate for such issuers to take remedial action or to pay a penalty commensurate with the transgression, but these issuers should otherwise realize the full subsidy intended by Congress.

State and local government issuers of tax-exempt debt deserve due process in an enforcement proceeding. In this respect they are no different from regular taxpayers who also deserve due process. However, an issuer that wishes to challenge the preliminary adverse result of an enforcement proceeding must face not only the enforcement proceeding itself, but also the disclosure requirements and market effects outlined above in order to pursue that challenge. Under those circumstances, it is difficult to afford the issuer due process in that challenge, no matter how fair or streamlined the challenge proceeding may be. The interest rate effect may simply be too big a price to pay.

The Resulting Problem With the Enforcement Program

The unintended consequences of the enforcement program can be summarized as follows. First, an audit proceeding that challenges the tax-exempt status of bonds will, when disclosed to the market, affect the market price of bonds. It will affect the market price even before the enforcement proceeding is concluded. It will affect the market price even though the issuer may ultimately prevail in the proceeding. The effect with variable rate bonds will be an increase in the interest rate. The effect with fixed rate bonds will be a reduction in value of the bonds to the holder and/or a loss of liquidity. Second, the market effect of pending audit proceedings makes it difficult, or impossible, for an issuer to pursue its "case" with due deliberation. There is tremendous pressure to conclude a proceeding quickly in order to minimize market impact. Even if the Service creates or implements streamlined and fair appeals procedures, the pressure to conclude the audit will remain so long as the market effect continues.

It is fundamentally unfair for an issuer to be penalized by an adverse effect on the market for its bonds just because an audit is pending. It is contrary to the public policy supporting the tax-exempt bond program for the subsidy to be diminished or eliminated by the threat of an audit proceeding. It is fundamentally unfair for an issuer to be deprived of the ability to fully and fairly determine its legal positions because it cannot risk the market effect of

a pending audit while it challenges a preliminary adverse determination.

Educating the market about the meaning and likely outcome of an enforcement proceeding could help alleviate the concerns of investors and the impact on the market. The introductory audit letters proposed by Mark Scott are a positive step in the education process. These letters may help determine which audit proceedings must be disclosed to the market in the initial stages and may help the market understand the initial purpose of the audit if it is disclosed.

It would also help to educate the market about the likelihood that the bondholder will actually be called upon to pay any penalty that may result from the audit. Representatives of the Service have acknowledged that the overwhelming majority of audit proceedings end with no penalty, or a penalty paid only by the issuer. This practical experience indicates that it is rare for the investor to be harmed. If the market could be convinced that the experience to date is a safe indicator of future results, it would help. But it would not cure the problem. The current premise of the enforcement program - that bonds may be declared taxable - is a serious enough threat to the investor that education is not likely to eliminate the concern of the investor.

The closing agreement guidelines proposed by the American Bar Association would also take a positive step toward improvement of the enforcement program. These guidelines have several constructive features: they provide a ceiling on the amount of the penalty that an issuer could be required to pay; they provide for a reduction of the penalty when the mistake or failure of the issuer was made after the issuer exercises due diligence; and if the mistake or failure relates only to a portion of the bond proceeds, they restrict the penalty to the portion of the bond proceeds that was misspent. These constructive features should be retained in the enforcement program guidelines. However, NABL also has significant concerns about the ABA proposal. The type of mistake or violation covered is quite limited. Only a few categories of misspent proceeds are addressed. We are also concerned about the dichotomy between the penalty for pre-audit and post-audit discovery of the mistake or violation. We also believe that the concept of taxpayer exposure is appropriate for some, but not all, types of violations. Most important, we believe that a closing agreement program must have a broader scope or purpose.

NABL believes that the enforcement program must support the confidence of investors in the continued tax-exempt status of their bonds. It must effectively eliminate the risk that the investor will be penalized. It must allow issuers the ability to have a fair proceeding to challenge a preliminary adverse determination. We believe the enforcement program can achieve these goals.

NABL's Proposal

NABL proposes that the enforcement program should establish the following principles:

1. As a general rule, the issuer, not the bondholder, will pay any required penalty when a mistake or violation occurs. For a conduit financing, the conduit borrower will pay the penalty. The Service will not attempt to impose a penalty on the bondholder if the bondholder has purchased tax-exempt bonds in good faith. Receipt by the bondholder of an approving opinion of bond counsel should establish a presumption of good faith.

2. The program should cover all possible violations. Some types of violations can be specifically identified and a maximum penalty specified for those violations. For violations not specifically identified with a maximum penalty, a framework for establishing the penalty or remedy should be established.

3. The program should specify the maximum penalty for as many classes or types of violations as possible so that issuers will be encouraged to voluntarily report

noncompliance. Issuers will not have the confidence necessary to report violations if the penalty exposure is unknown.

4. The remedy or penalty for noncompliance must properly reflect the nature and extent of the violation. There are numerous factors that may justify a penalty less than the maximum specified or some other action not requiring a penalty. These factors include:

   (a) the good faith effort of the issuer to comply with the applicable rules;

   (b) basic eligibility of the issuer's project for financing despite violation of collateral requirements;

   (c) the economic benefit derived by the issuer from noncompliance;

   (d) the amount of proceeds misspent;

   (e) the issuer's lack of experience in tax-exempt financing;

   (f) the complexity of the financing or the controlling authority;

   (g) the difficulty of discovering noncompliance by the issuer;

   (h) the occurrence of events beyond the issuer's control;

   (i) the issuer's lack of knowledge of the violation or the need for corrective action; and

   (j) the issuer's voluntary reporting of a violation prior to discovery on audit.

   We continue to believe strongly that it is not appropriate to specify a more stringent maximum penalty for discovery of a violation during audit.

5. No single approach, such as calculation of taxpayer exposure, can provide a penalty that is appropriate for all violations. In some cases, a simple monetary fine, rather than taxpayer exposure, will be appropriate. In many cases, payment of money may be the inappropriate remedy. Creative ways to achieve the federal policy objective of increased issuer compliance need to be explored. Various types of alternate penalties or remedies should be available in order to make the penalty appropriate, including restitution of any economic benefit improperly obtained, allocation of an issuer's own funds to offset the amount of proceeds improperly spent (similar to current change in use remedial actions), a penalty equal to the amount of income tax that would have been payable with respect to the portion of the bonds misspent, a requirement that the issuer adopt procedures to insure against future similar violations, and restriction of an issuer's access to the tax-exempt market for some period.

These principles can be incorporated in enforcement procedures and in closing agreement guidelines. We are prepared to develop our plan in detail before we present it for your consideration. Toward that end we are looking forward to working with all of you (and your colleagues) in the months to come with a view toward improving the enforcement process in the tax-exempt bond area. We also intend to address other matters in future communications with you that are related to enhancing compliance, including pre-issuance guidance and alternative dispute resolution.

We encourage and welcome your participation.

NATIONAL ASSOCIATION OF BOND LAWYERS

By:____
J. Hobson Presley, Jr., President

By:____
Neil P. Arkuss, Chairman of Task Force on Alternative Dispute Resolution

cc: Stephen J. Watson, Esq.
NABL Board of Directors