

 **NATIONAL ASSOCIATION OF BOND LAWYERS**
THE WORKSHOP: HYBRID 2022
October 12-14, 2022

**PREPARING TO DELIVER THE BOND OPINION:
TAX DILIGENCE AND DOCUMENTATION**

Chair:

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Purchasers of tax-exempt obligations typically rely on the “unqualified opinion” of bond counsel as to the excludability of interest on the bonds from gross income for federal income tax purposes. The tax due diligence performed by bond counsel is a critical foundation for the delivery of the opinion. This panel will explore various approaches to compliance with applicable tax requirements and will engage attendees in a discussion of the due diligence, legal research and analysis, and documentation necessary to support the tax opinion.

I. Overview

The performance of the appropriate level of due diligence coupled with receipt and review of essential documentation is a prerequisite to the issuance of the tax opinion. In conducting tax due diligence, practitioners should keep in mind that:

- The required level of diligence is unique to each transaction
- The due diligence review should be consistent with standards of practice
- Due diligence is an important element in relying upon documentation produced

Due diligence documentation is critical for the following reasons:

- To demonstrate compliance with statutory and regulatory requirements for the issuer's, and any conduit borrower's, statements of reasonable expectations and for certain elections
- To indicate appropriate covenants maintaining the tax-advantaged treatment of the bonds
- To ensure appropriate document retention

A careful process of diligence and documentation will also help issuers and conduit borrowers understand ongoing compliance issues.

II. Tax Opinion and Due Diligence Standards for Bond Counsel

The bond counsel opinion addresses legal consequences but is based upon stated facts and assumptions. Practitioners have a duty to make inquiries with respect to material facts, but there generally is no requirement to audit or independently verify such facts. Reliance on facts, however, must be reasonable and red flags should not be ignored. The factual basis for the opinion is established through tax due diligence and documentation.

As described below, the National Association of Bond Lawyers, the American Bar Association, the Treasury Department and, most importantly, the Internal Revenue Code of 1986, as amended (the "Code"), and the related Treasury Regulations (the "Regulations") provide general guidance with respect to the level of due diligence that may be appropriate in any given transaction.

NABL Model Opinion Standard

Counsel should give an unqualified opinion only if firmly convinced a reasonable, properly briefed court would agree. Due to the lack of judicial precedent in the tax-exempt bond area, the Model Bond Opinion Report (2003) states further that "bond counsel may nonetheless give an unqualified opinion with respect to federal income tax matters if it is firmly convinced that, upon due consideration of the material facts and all of the relevant sources of applicable law on federal income tax matters [described in the report], the Supreme Court would reach the federal income tax conclusions stated in the opinion or the IRS would concur or acquiesce in the federal income tax conclusions stated in the opinion."

ABA Formal Opinion 335

In connection with giving opinions, a lawyer should (1) make inquiry of a client as to relevant facts and receive answers, and (2) assuming answers are not incomplete, suspect or inherently inconsistent, the lawyer may assume facts as related to the lawyer and checked by the lawyer by reviewing such documents as are available.

Circular 230 – Section 10.37 - (Applies to many state or local bond opinions)

In rendering “written advice” a practitioner (i) cannot base such advice upon unreasonable factual or legal assumptions, (ii) may not unreasonably rely on representations, findings, etc., (iii) must consider all relevant facts, and (iv) cannot take into account the potential for audit or possible settlement of issues.

Section 6700 of the Code

Under certain circumstances, a practitioner can be fined for statements with respect to excludability of income from tax if the practitioner knows or has reason to know that the statement is false.

III. Performance of Due Diligence

The tax due diligence process is the key means for obtaining the information needed as bond counsel to be able to render the unqualified bond counsel opinion.

While the general process for conducting due diligence can be somewhat uniform, there are nuances that require the process to be tailored depending on the client and the nature of the transaction.

Key issues to consider **BEFORE** starting the diligence process:

- What is the **type of transaction?** (*e.g.*, governmental bond, qualified 501(c)(3) bond, exempt facility bond, small issue industrial development bond)
- What is the **nature of the client and the project?** (*e.g.*, level of sophistication of client, what is already known, if anything, about the assets being financed, any other available background information, is it a new client or existing client?)
- What is the **best approach for eliciting information?** (*e.g.*, letters, questionnaires, phone calls, conferences or combination thereof)
- What is the **goal** of the process? (takeaway for bond counsel; takeaway for the client)

Due diligence materials and responses can be elicited in many ways, often consisting of a combination of the following:

- Tax Questionnaire – The questionnaire often consists of a list of relevant questions concerning the plan of financing, use of proceeds, actual and expected use and ownership of financed or refinanced facilities, sources of repayment, and status of the borrower. The questionnaire may include a request for back-up documentation such as project lists, economic life calculations, management contracts, leases and tax filings.
- Conduit Borrower Application – Tax-related questions and requests for materials may be included in a conduit borrower’s application to the issuer.

- Informal Information Gathering – This may include such things as e-mail correspondence, review of an issuer's/conduit borrower's website, review of EMMA filings, review of newspaper references, review of other publicly available information, etc.
- Conferences and/or Interviews – This may occur in-person or by phone with relevant parties.
- Role of Post-Issuance Compliance Procedures – Review of post-issuance compliance procedures of the issuer and the conduit borrower and adherence to procedures; drafting/updating procedures may be necessary or advisable.
- Due Diligence Session – A due diligence session for a disclosure document may yield helpful insights that are relevant to tax analysis, such as potential for private business use of financed property and the identities of the various users of the financed property.
- Closing Certificates – Facts and expectations can be confirmed in separate certificates delivered by the issuer and any conduit borrower at closing.

Issues to consider:

- What is the nature of the client (*e.g.*, municipality, 501(c)(3) organization, for-profit entity; frequency of issuances and level of sophistication)?
- Who is performing diligence (first year associate, senior partner, tax specialist)?
- Is there more than one user of the bond-financed property that should be interviewed?
- Does the law firm performing the due diligence have “institutional knowledge” that should be taken into account?
- Due diligence responses are worthless if the responder does not understand the questions being asked.
- A written questionnaire may be easier for the client to complete if it is tailored to the client's situation and does not include “boilerplate” due diligence questions that have already been answered in other contexts (for example, during the due diligence process for the offering document) or are not applicable. Long or duplicative questionnaires may overwhelm or confuse a client.
- While written questionnaires provide a tangible diligence file, they may also lead to inconsistent information and, even when carefully drafted, incorrect answers (due to the responder's misunderstanding of what was asked), which then need to be corrected.
- Conferences may provide a better opportunity to educate the issuer and/or borrower and may result in more accurate responses. (Best practices are typically a combination of written questionnaires and conferences.)
- To what extent should the presence of written post-issuance compliance procedures and adherence to such procedures be taken into account for refundings or otherwise?
- To what extent, if at all, should non-tax diligence be reviewed and taken into account?

- How much “deal knowledge” is appropriate?

Due diligence should begin promptly to ensure there is enough time to conduct an appropriate review and avoid last minute issues or surprises. The due diligence process does not end once the initial responses have been received. Rather, due diligence needs to be performed as the transaction progresses to ensure that transaction changes are properly considered. “Bring down” documentation can be used to back up the attorney’s understanding of the facts.

Drafting tax documentation (tax regulatory agreements, no arbitrage certificates, project certificates) often provides an excellent opportunity to think about the various diligence issues that still need to be addressed. For that reason, (a) it may be helpful to start drafting tax documentation as early as possible during the transaction and (b) the person who is responsible for diligence should also be the person who drafts the tax documentation. This opportunity to conduct diligence is lost when tax documents are not drafted until the hours preceding the closing or when tax documents are drafted by multiple persons or by legal assistants who are not otherwise part of the diligence process.

IV. Documentation

In drafting documentation, the attorney is memorializing the diligence findings, stating the parties’ understanding of the facts and reasonable expectations with respect to future events and setting forth the covenants of the parties, making applicable allocations, designations and elections and setting forth the on-going requirements for maintaining the tax status of the bonds, with the goal of providing proof that the bonds were tax-exempt or otherwise tax-advantaged upon issuance and will retain such status so long as the parties comply with the undertakings contained in such documentation. Documentation takes many forms and usually consists of a combination of the following:

- Tax Certificate, No Arbitrage Certificate or Tax Regulatory Agreement: Tax documents are used to document the requirements for the tax status of the bonds by describing in sufficient detail the past, current and expected uses of the financed (or refinanced) facilities, the use of proceeds of any refunded bonds, non-arbitrage representations and expectations and required designations and elections. Representations in tax documents may change over time, depending on legislative, administrative or other considerations. In conduit transactions, tax documents may include tax documents to which both the issuer and the conduit borrower are parties, and in addition, separate certificates of the conduit borrower, which may address, for example, project representations and use of facilities.
- Third-Party Certifications: Third-party certifications may be attached to the tax documents to serve as the basis for the issuer’s or conduit borrower’s conclusions or representations. Such certifications may include:
 - Appraisals
 - Certificates regarding bond yield, loan yield, need for reserve funds, and weighted average maturity calculations
 - Qualified guarantee provider certificates
 - Qualified hedge provider and advisor certificates
 - Feasibility studies

- Engineering letters (often in the context of the 5-year temporary period under section 1.148-2(e)(2)(ii))
 - Verification reports
 - Issue price certificates
 - Financial advisor certificates
- Bond Documents: Bond documents may include the ongoing covenants necessary to maintain tax status of the bonds. Often such covenants will be included in the bond documents even if they are also included in the tax documents. The bond documents may also include requirements for opinions of bond counsel upon the occurrence of certain events (*e.g.*, interest rate mode changes, release of debt service reserve fund moneys) as well as written procedures of the issuer and conduit borrower, including post-issuance compliance procedures.
 - Rebate Compliance Agreement or Instructions: Rebate compliance agreements or instructions set forth rules and procedures for calculating and paying arbitrage rebate to the United States. These agreements and instructions may not be needed for bond issues where no proceeds remain unspent at closing. Arbitrage rebate requirements may be covered in the general tax certificate or other tax documents. Where a separate agreement or instruction letter is used, the bond trustee may be a party to, or recipient of, periodic rebate computations or reports.

Issues to consider:

- Factual statements may become entwined with legal conclusion. For example, a statement that “the Bonds are not federally guaranteed” typically will not be given any weight by IRS examiners during an examination of the tax issues because of the legal conclusion represented by the statement.
- Verbatim language of Code/Regulations versus “user-friendly” paraphrasing of requirements.
- Avoiding a standardized, “one size fits all” form with all definitions relevant to tax-exempt bond requirements as opposed to a “customized” form with only definitions considered material to the specific transaction.
- Look out for potential inconsistencies between various documents (*e.g.*, materially different sources and uses in the offering document and tax certificate or different project descriptions in offering documents, bond documents and tax documents, including documents for any bonds being refunded).
- Be alert to substance over form. Have the correct parties represented the necessary facts and agreed to take the appropriate future actions? Do the appropriate parties understand their

continuing obligations? Have the parties with actual knowledge reviewed and/or executed the factual certifications?

- The tax documents should be carefully reviewed with the client and the client's legal counsel to ensure the client understands the representations, certifications and statements as well as the client's responsibilities following the closing of the bond issue.

V. Record Retention

The Code provides a general rule for the proper retention of records for federal tax purposes. Under this rule, every person liable for tax imposed by the Code must, among other things, keep such records as are sufficient to establish the amount of gross income, deductions, credits or other matters required to be shown in any return of such information. In the case of tax-advantaged bonds, the issuer and conduit borrower are not typically the parties potentially liable to the federal government for tax (the bondholders are), but the issuer and conduit borrower will have covenanted in the bond documents for the benefit of the bondholders to maintain the tax status of the bonds, and in audits the issuer is treated as the taxpayer. This means the issuer will need to retain sufficient records to support the continuing tax-advantaged status of the bonds, and to prove compliance with the rules for expenditure of proceeds, use of the financed assets and investment of proceeds.

In connection with bond counsel's diligence review, bond counsel will want to ensure that proper recordkeeping procedures are in place such that records supporting the tax status of the bonds are available long enough to be helpful in examinations of the bonds, even many years after the bond issuance date.

Examples of records to be retained include, but are not limited to:

- (i) Basic records and documents relating to the bonds (and any refunded bonds);
- (ii) Documentation evidencing the investment and expenditure of proceeds of the bonds (and any refunded bonds) and expenditure of any qualified equity;
- (iii) Documentation evidencing the use of the project or any component thereof by public and private sources (*e.g.*, copies of management contracts, research agreements, leases);
- (iv) Documentation evidencing all sources of payment or security for the bonds (and any refunded bonds);
- (v) Documentation evidencing compliance with the timing and allocation of expenditures of proceeds of the issue (and any refunded bonds); and
- (vi) Records of all amounts paid to the United States in satisfaction of the rebate requirement for the issue and IRS Forms 8038-T (or successor forms thereto) related to such payments.

VI. Documentation of Elections, Designations and Allocations

Where elections, designations (sometimes also referred to as identifications) or allocations are required, IRS examiners will expect to find them documented in the bond transcript. Certain elections and designations must be made by the issuer on or before the issue date in the issuer's books and records. Failure to make these elections or designations on or before the date the bonds are issued may cause the bonds to lose their tax-advantaged status.

VII. Documentation of Post-Closing Requirements and Change in Use Events

Compliance with federal tax requirements for tax-advantaged bonds does not end once the bonds are issued. Instead, issuers and conduit borrowers must be ready to provide on-going monitoring throughout the term of the bonds to ensure that all continuing requirements are met.

The fundamental post-issuance tax compliance tasks are to:

- (1) document and monitor use of bond proceeds (including use of financed facilities);
- (2) comply with all applicable investment yield restrictions;
- (3) satisfy arbitrage rebate responsibilities; and
- (4) promptly address any changes in use that may adversely affect the tax status of the bonds.

Issuers and conduit borrowers should have effective policies and procedures in place to ensure that these tasks are adequately completed.

Issuers and conduit borrowers should be advised concerning the requirements to document a “change in use” and the timing of certain remedial actions, as applicable. Often a change in use will involve issuance of a favorable tax opinion by bond counsel or special tax counsel. A tax certificate that documents the facts and circumstances of the change in use and the remedial action taken will provide the background necessary for such an opinion and provide a valuable record to show compliance with applicable tax rules.