WINTER 2004 EDITION HAWKINS DELAFIELD & WOOD LLP

HAWKINS ADVISORY

Major New Rules Affecting Tax Opinions

I. Executive Summary of Selected Aspects

- *Broad New Circular 230 Rules Affecting Tax Opinions.* In December 2004, as an outgrowth of its efforts to control tax shelters, Treasury issued two sets of broad new proposed and final rules under so-called "Circular 230." Circular 230 regulates tax lawyers, accountants, and others who practice before the IRS, with disciplinary sanctions for violations. Historically, Circular 230 focused mainly on tax shelter opinions. Notably, the new Circular 230 rules apply more broadly to regulate the form and substance of Federal tax opinions and Federal tax practice standards generally. (Some view these rules as "Federalizing" legal and ethical standards for Federal tax practice.)

- *Impact of New Circular 230 Rules.* The new Circular 230 rules will have a significant impact on the form and content of Federal tax opinions and Federal tax advice. The new Circular 230 rules will result in more extensive tax documentation, heightened tax due diligence, and increased costs for providing Federal tax advice. The customary practice of providing unqualified opinions regarding the Section 103 tax exemption in the tax-exempt bond area probably will continue, but with expanded supplementary tax documentation in Federal tax certificates and legal memoranda. One area of uncertainty involves how the fairly low threshold for significant Federal tax issues potentially may impact Federal securities law disclosure considerations regarding material disclosure issues.

- *First-Time Application of New Circular 230 Rules to Tax-exempt Bonds.* For the first time, the new Circular 230 rules will apply to opinions regarding Federal tax aspects of tax-exempt bonds (sometimes referred to herein as "tax-exempt bond opinions").

- *Proposed Special Rules for Traditional Tax-exempt Bond Opinions Given at Original Issuance Should Accommodate Unqualified Opinions, But Will Require Expanded Separate Tax Documentation.* The new proposed Circular 230 rules provide a special regime for traditional tax-exempt bond opinions given at original issuance regarding the excludability of the interest on State or local governmental bonds from gross income for Federal income tax purposes under Section 103 of the Internal Revenue Code (the "Code") (sometimes referred to as the "Section 103 tax exemption"). The proposed Circular 230 rules define these opinions given at original issuance as "State or local bond

(Continued on page 3)

IN THIS ISSUE

First Quarter 2005 - Record-Setting Volume

The municipal market achieved record volume levels for the first quarter, according to Thomson Financial. The long-term issuance for the first three months of 2005 was $96.6 billion, 10.9% more than the $87.1 billion issued the previous year. This level of issuance was somewhat unexpected and defied widespread predictions of a slowdown in the market. With interest rates still trending at historically low levels, refundings represented a significant portion of the increase. In addition, some borrowers were thought by market watchers to have advanced their financing plans in anticipation of higher rates later this year in response to recent moves by the Federal Reserve to increase short-term interest rates.

Once again, Hawkins Delafield & Wood LLP ranked first in the underwriters' counsel category, and ranked highly in the bond counsel category as well. The Firm's ranking in the underwriters' counsel category, as well as those of our nearest competitors, is listed below.

NATIONAL RANKINGS - UNDERWRITERS' COUNSEL
JANUARY 1 – MARCH 31, 2005

Rank	Firm	Par Amount ($ millions)
1	**Hawkins Delafield & Wood LLP**	**$3,108.8**
2	Clifford Chance LLP	2,499.0
3	Fulbright & Jaworski LLP	2,171.0
4	Squire Sanders & Dempsey LLP	1,847.6
5	Locke Liddell & Sapp LLP	1,785.2
6	Nixon Peabody LLP	1,701.4
7	Cozen & O'Connor	1,398.1
8	Greenberg Traurig LLP	1,181.0
9	Andrews Kurth LLP	1,176.9
10	Sidley Austin Brown & Wood LLP	1,152.2

Source: Thomson Financial

* * * * *

It's Nice to be Recognized

Hawkins clients were once again nominated for the 2004 "Deal of the Year" award. Like the film industry's Academy Awards or baseball's Hall of Fame, The Bond Buyer's Deal of the Year, while not quite as historic as those other two recognitions, has gained in its short history certain stature within the municipal finance industry. The bureau chiefs and editors of the trade newspaper select just five transactions as finalists from some 60 transactions nominated, a fraction of the thousands of transactions that closed last year (between October 1, 2003 and September 30, 2004). Those nominated are selected using announced criteria, such as innovation, complexity, success with new credits, and turnaround situations, among other factors.

So far, Hawkins clients have been well represented in each competition. In the inaugural event in 2002, Chicago Housing Authority's innovative financing, for which the Firm served as Special HUD Counsel to the underwriters, was a nominee and ultimately took top honors. The Metropolitan Transportation Authority's $13.5 billion refunding was also a finalist.

2003's awards also saw two of the Firm's clients honored: the Erie County Economic Development Authority for an innovative financing for the Buffalo City Schools District was an Honorable Mention; and the top honors went to the State of California Department of Water Resources for its $11.9 billion Power Supply Revenue Bonds. The Firm served as bond counsel on both engagements.

This past year two Hawkins clients were finalists: The Hugh L. Carey Battery Park City Authority for its $1.04 Billion Series A, B & C refunding and new-money transactions, for which the Firm served as Bond Counsel; and the $7.921 billion State of California Economic Recovery Bonds, for which the Firm served as underwriters' counsel. The top honors went to Citizens Property Insurance Corporation of Florida for its $750 million transactions that financed additional property and casualty insurance for hurricane-prone Florida.

We extend our congratulations to our clients and all of the finalists who have received this recognition by their colleagues in the municipal finance industry.

* * * * *

A New Addition to the Skyline

In the ongoing story of New York City's economic recovery since the attacks of 2001, the New York City Industrial Development Agency (NYCIDA) recently closed on a $650 million "Liberty Bond" financing for a high-profile office building on one of the last prominent parcels available near the Times Square Redevelopment area. Hawkins Delafield & Wood LLP served as underwriters' counsel on the transaction to Banc of America Securities LLC and BNY Capital Markets Inc.

The 51-story structure, pictured below, will be known as "The Bank of America Tower at One Bryant Park" and will be developed by One Bryant Park LLC, having Bank of America and an affiliate of The Durst Organization as its members. BofA will lease almost half of the building, which will be a signature location for the bank.

The building is designed by the architectural firm of Cook + Fox and utilizes many energy-saving features. Its radical "Crystal Palace" design recalls the famous exhibition hall that stood on nearby Bryant Park in the mid-19th Century.

The financing structure is just as innovative. The variable rate bonds derive their federal tax exemption from the Liberty Bond program, enacted by Congress to help rebuild New York City after the terrorist attacks of 2001. Liberty Bonds have been used throughout Lower Manhattan, as well as in other parts of the city, to assist developers in rebuilding New York.

Hawkins Delafield & Wood LLP played an instrumental role in the development of the Liberty Bond program. As one of the bond counsels to the NYCIDA, the Firm, together with Winston & Strawn LLP, advised the U.S. Treasury as to elements to be included in the enactment of the Liberty Bond legislation.

* * * * *

Maine Municipal Bond Bank Issues First GARVEE Bond Issue

In December, 2004, the Maine Municipal Bond Bank issued the State of Maine's first GARVEE Bonds. GARVEE is the acronym for Grant Anticipation Revenue Vehicle, which is a program of the United States Department of Transportation, Federal Highway Administration that permits States and authorities to issue bonds for qualified highway projects secured by future federal transportation grants.

Maine's GARVEE bond issue resulted from a pressing need to replace the existing Waldo-Hancock Bridge along U.S. Route 1 and State Route 3 after structural deterioration was discovered. Bridge traffic was restricted to two travel lanes, and plans were quickly put in place to construct a new bridge adjacent to the existing bridge, at a total cost (including demolition of the existing bridge) of approximately $80 million.

In order to provide immediate funding for the construction phase of the new bridge, the State Legislature adopted new legislation establishing a cooperative financing arrangement among various state agencies and instrumentalities. The Maine Municipal Bond Bank, which has an established track record of providing financing for municipalities within the State for various public projects, and is the state instrumentality responsible for issuing bonds for a general pooled loan program, a wastewater state revolving fund and a drinking water state revolving fund, was granted new authority to issue up to $50 million of bonds to finance the Waldo-Hancock Bridge replacement. The Bond Bank was authorized to make the bond proceeds available to the State Department of Transportation ("MaineDOT") for use on the bridge project. Various other governmental departments were involved in the development and approval process. The Bonds are non-recourse to the State of Maine or to the general funds of either the Bond Bank or the State.

As security for the Bonds, MaineDOT pledged all present and future federal transportation grants that it receives to the Bond Bank, which assigned its interests to a trustee for the Bonds, and MaineDOT agreed to cause funds to the extent derived from such grants to be deposited with the Bond Bank (or trustee) prior to the date that payments are due with respect to the Bonds. Actual receipt of federal transportation grant money by MaineDOT is subject to a number of contingencies, including there being a federal law establishing (or extending) the federal aid highway program, federal appropriations of funds to the states, and State of Maine allocation of these funds to MaineDOT. At the time of issuance of the Bonds, the federal aid highway program had only one year of statutory authorization remaining. Moody's and Fitch issued underlying ratings (without bond insurance) of "Aa3" and "AA-", respectively, on the Bonds. A policy of insurance issued by Ambac Assurance Corporation resulted in "Aaa" and "AAA" ratings on the Bonds from Moody's and Fitch, respectively.

The issuance of the bonds by the Maine Municipal Bond Bank permitted the State of Maine, through MaineDOT, to proceed with construction of the new bridge without the need to divert funds from other projects and without the need to pursue the time consuming and uncertain process of obtaining authorization to issue State debt.

This transaction continued the firm's recent experience in helping bring new GARVEE financings to market for States, including Oklahoma in 2004, Rhode Island in 2003 and Colorado, beginning in 2000.

* * * * *

Brookings Institution Publishes Hawkins Attorney

The Brookings Institution recently posted on its website, and has published, a report by Hawkins attorney Rod Solomon that analizes the 1998 federal Quality Housing and Work Responsibility Act and its implementation. The Brookings Institution is one of Washington's oldest and most highly regarded "think tanks," with over 140 resident and non-resident scholars who conduct research, write, and advocate policy on many of the government's most critical issues, such as defense, foreign affairs, and the domestic economy. Housing and urban development are frequent Brookings topics and Rod Solomon's extensive report on the recent evolution of the federal public housing and voucher programs is bound to stimulate thought and discussion within the public housing community in the capital as well as nation-wide. Prior to joining the Firm in our Washington D.C. office in 2003, Rod Solomon was Deputy Assistant Secretary in the office of Public and Indian Housing for the federal Department of Housing and Urban Development. He has held numerous high-level policy positions with housing authorities throughout the country during his more than 30-year career.

Rod Solomon's article can be accessed at the Brookings Institution site: http://www.brookings.edu/metro/pubs/20050124_solomon.htm or by contacting the Firm at (212) 820-9374.

* * * * *

Major New Rules Affecting Tax Opinions

(Continued from page 1)

opinions." The proposed Circular 230 rules try to accommodate the continued practice of giving short-form, unqualified opinions at original issuance, with the major refinement. Specifically, the proposed Circular 230 rules will require expanded tax documentation to be given to issuers separately that addresses all relevant facts, provides legal analysis relating the applicable law to the relevant facts, and evaluates all significant Federal tax issues

(with the term "significant Federal tax issues" defined at a fairly low threshold to include any issues for which the IRS has a "reasonable basis" for a successful challenge).

- *Prospective Effective Date for Proposed Circular 230 Rules for Traditional Tax-exempt Bond Opinions Given at Original Issuance of the Bonds.* The proposed Circular 230 rules for traditional tax-exempt bond opinions regarding the Section 103 tax exemption given at the time of the original issuance of the tax-exempt bonds have a prospective effective date of not earlier than 120 days after the publication of subsequent *final* Circular 230 rules on these State or local bond opinions.

- *Final Circular 230 Rules Affect Post-Issuance Tax-exempt Bond Opinions.* A separate set of final Circular 230 rules applies broadly to defined "covered opinions" and to other written Federal tax advice (including e-mails). Covered opinions include "reliance opinions" which reach a "more likely than not" favorable conclusion on significant Federal tax issues and "marketed opinions" used by third parties (e.g., bondholders). The final Circular 230 rules have an exception to their application for "State or local bond opinions" given at original issuance to which the above-described proposed Circular 230 rules apply. Thus, for tax-exempt bonds, the main area in which the final Circular 230 rules may apply involves post-issuance tax-exempt bond opinions. Examples of such post-issuance opinions include various "no adverse effect" opinions given after the issuance of tax-exempt bonds to address the effects of various actions, such as interest rate mode changes or changes of use of tax-exempt bond financed facilities on the Section 103 tax exemption. The final Circular 230 rules require that covered opinions be reasoned opinions which include within the opinions themselves a discussion of relevant facts, legal analysis relating the law to the facts, and evaluation of significant Federal tax issues. The final Circular 230 rules also impose minimum standards on any written Federal tax advice (including e-mails) that is outside of covered opinions. We caution that the final Circular 230 rules have a broad scope and many complex definitions whose potential application to tax-exempt bond opinions should be considered carefully under the particular circumstances.

- *June 20, 2005 Effective Date of Final Circular 230 Rules.* The final Circular 230 rules are effective on June 20, 2005. Thus, it soon will be important for tax practitioners in the tax-exempt bond area to consider the potential application of these final rules, with particular attention to post-issuance "no adverse effect" opinions.

II. Background

In General. In December 2004, Treasury issued major new rules under "Circular 230" which regulate Federal tax practice before the IRS. These new rules will apply broadly to Federal tax opinions regarding tax-exempt bonds essentially for the first time. These new rules will require expanded tax documentation regarding facts, applicable law, and significant Federal tax issues for tax-exempt bond opinions. These new rules will have a significant effect on Federal tax practice in the tax-exempt bond area.

Historically, two distinct types of Federal tax opinions existed. "*Unqualified opinions*" are opinions with a high degree of certainty which are rendered in a "short form" (i.e., without extensive discussion of legal issues). Public investors in the tax-exempt bond market customarily have demanded unqualified opinions. The National Association of Bond Lawyers ("NABL") has articulated an unqualified bond counsel opinion standard. By comparison, "*reasoned opinions*" are opinions with a lower degree of certainty which are rendered in a longer form with detailed discussion of legal reasoning on material Federal tax issues. Reasoned opinions are more common in the corporate area and in private transactions, particularly in "tax shelters," and often with confidentiality conditions.

Historically, Treasury has regulated general tax practice before the IRS in rules under Circular 230, with particular focus on extensive rules for reasoned tax shelter opinions. Previously, however, longstanding 1984 final rules on tax shelter opinions under Circular 230 contained a complete exception to those rules for tax-exempt bond opinions. A little over a year ago, in December 2003, as part of Treasury's ongoing efforts to control tax shelters, Treasury proposed broad new rules on tax practice under Circular 230, including a proposal, without explanation, to remove the previous exception for tax-exempt bond opinions.

Over the past year, numerous State and local governmental groups urged Treasury and the IRS to continue the historic exception to rules on tax shelters under Circular 230 for tax-exempt bond opinions on the grounds that tax-exempt bonds carry out Congressionally-intended incentives for public infrastructure and they lack characteristics of tax shelters. Further, State and local governmental groups expressed particular concern that the proposed expanded requirements under Circular 230 would increase costs to State and local governments. Moreover, State and local governmental groups urged Treasury and the IRS to accommodate the special characteristics the tax-exempt bond market associated with longstanding practices involving short-form unqualified opinions regarding the Section 103 tax exemption. These short-form, unqualified opinions customarily are supported by tax certificates of varying scope from issuers, conduit borrowers, and other parties.

In December 2004, Treasury and the IRS issued two major sets of rules under Circular 230. These new rules broaden their focus beyond tax shelters to look more generally at mandatory standards of tax practice for all tax practitioners. These new rules omit any reference to the pejorative term "tax shelters." In the introduction to these rules, Treasury and the IRS indicated that a general goal was to promote public confidence in the honesty and integrity of the professionals providing tax advice. In part, these new rules appear to be aimed at promoting high tax practice standards through greater transparency regarding Federal tax issues and more fulsome tax disclosures.

The first new set of rules was final Treasury Regulations on general tax practice under Circular 230, 69 Fed. Reg. 75839 (December 20, 2004) (the "Final General Circular 230 Rules"). The second new set of rules was proposed Treasury Regulations on specially-defined "State or Local Bond opinions" under Circular 230, 69 Fed. Reg. 75887 (December 20, 2004) (the "Proposed Circular 230 Rules"). The IRS will hold a public hearing on the Proposed Circular 230 Rules on March 22, 2005. (In general, Section references herein are to the Proposed Circular 230 Rules and the Final General Circular 230 Rules.)

Effective Dates. The Proposed Circular 230 Rules for State and local bond opinions are proposed to be effective not earlier than 120 days after *final* Treasury Regulations on State or local bond opinions are published subsequently in the Federal Register in the future. Thus, Treasury and the IRS will consider public comments on these proposed rules before they go into effect. The Final General Circular 230 Rules will become fully effective on *June 20, 2005*.

Opinions Rendered at Original Issuance of Tax-exempt Bonds versus Opinions Rendered Post-Issuance. It is important to try to highlight the division in potential application between the Proposed Circular 230 Rules and the Final General Circular 230 Rules for various kinds of tax-exempt bond opinions. In oversimplified terms, the main distinction is that the Proposed Circular 230 Rules apply to tax-exempt bond opinions regarding the Section 103 tax exemption which are rendered at original issuance of tax-exempt bonds whereas the Final General Circular 230 Rules potentially may apply to various post-issuance tax-exempt bond opinions.

In particular, the Proposed Circular 230 Rules are proposed to apply only to defined "State or local bond opinions." As proposed, these State or local bond opinions basically would include only those Federal tax opinions that are rendered at original issuance of tax-exempt bonds regarding the Section 103 tax exemption and certain very limited related Federal tax issues (as contrasted both with post-issuance opinions and opinions which are rendered on the issue date which address most Federal tax issues besides the Section 103 tax exemption).

For tax-exempt bond opinions that are outside of the special definition of State or local bond opinion, the Final General Circular 230 Rules potentially may apply. The application of particular provisions of the Final General Circular Rules depends on whether the particular opinion fits within one of the broad categories of "covered opinions" under those rules, as described further herein. Examples of tax-exempt bond opinions which may be subject to the Final General Circular 230 rules in certain circumstances include opinions that various actions will have "no adverse effect" on the tax-exempt status of the interest on the tax-exempt bonds, opinions, such as: (i) a change of interest rate mode; (ii) a change of use of tax-exempt bond financed facilities; or (iii) amendments of bond documents or other actions allowed under bond documents only with an opinion of bond counsel. Other examples of potentially affected opinions include opinions involving secondary market securitizations of tax-exempt bonds (e.g., synthetic secondary market tender option bond programs in partnership trust structures) and opinions involving arbitrage rebate.

We caution that the Proposed Circular 230 Rules and the Final General Circular 230 Rules have a host of technical definitions which will send different kinds of tax opinions down different paths of technical requirements. One theme of the public comments on the Proposed Circular 230 Rules has been to stress the need to clarify where various kinds of tax-exempt bond opinions fit under the two sets of Circular 230 rules.

Same Tax Practice Standards With More Flexible Written Advice. In the introduction to the Proposed Circular 230 Rules, Treasury and the IRS indicated that the rules reflect a tax policy decision that "practitioners rendering opinions concerning the tax treatment of municipal bonds should be subject to the same professional standards that are applicable to other practitioners." Thus, the Proposed Circular 230 Rules provide the same kinds of mandatory tax practice standards for tax-exempt bond opinions as for other types of tax opinions. The main accommodation to the tax-exempt bond area under the Proposed Circular 230 Rules is greater flexibility on the form of required tax documentation for State or local bond opinions in recognition of the short-form unqualified opinion practice which is customary in the tax-exempt bond market. Basically, the proposed special rules for State or local bond opinions require the same expanded discussion of facts, relevant law, and significant Federal tax issues as is required in longer-form "reasoned" tax opinions for covered opinions, except that, for State and local bond opinions, the Proposed Circular 230 Rules provide flexibility to provide this more extensive tax documentation outside of the short-form opinion itself in separate written advice which is set forth in tax certificates, legal memoranda to issuers, or other documents under prescribed requirements.

III. Summary of Proposed Circular 230 Rules for State or Local Bond Opinions

Introduction. This section briefly summarizes the proposed special rules for State or local bond opinions under Section 10.39 of the Proposed Circular 230 Rules.

Application to Defined State or Local Bond Opinions. Section 10.35(b)(9) defines a "State or local bond opinion" to which the Proposed Circular 230 Rules apply, as follows:

> "State or local bond opinion. Written advice, included in bond offering materials (as defined in §10.39(c)) for the issuance of a State or local bond, is a State or local bond opinion if:
>
> (i) the written advice as to Federal tax matters addressed in the bond offering materials consists only of advice that concerns the excludability of interest on a State or local bond from gross income under Section 103 of the Internal Revenue Code, the application of Section 55 of the Internal Revenue Code (i.e., the alternative minimum tax) to a State or local bond, the status of a State or local bond as a qualified tax-exempt obligation under Section 265(b)(3) of the Internal Revenue Code (i.e., the small issuer bank purchase exception to bank carrying cost nondeductibility), the status of a State or local bond as a qualified zone academy bond under Section 1397E of the Internal Revenue Code, or any combination of the above; and
>
> (ii) the practitioner separately provides the issuer of the bond written advice that satisfies the requirements of §10.39."

Form of Separate Written Advice. In general, a tax practitioner who gives a State or local bond opinion must provide separately to the issuer of the tax-exempt bonds certain prescribed written advice. Section 10.39 provides flexibility on the form of the separate written advice. The required written advice may be set forth in a tax certificate or other documents *included in the transcript of proceedings* for the bonds, or, if no transcript is prepared, in other documents made available to the issuer.

Content of Separate Written Advice. Briefly, the separate written advice provided with a State or local bond opinion must do three things. First, it must address relevant facts, without use of unreasonable assumptions or certifications. Second, it must relate the applicable law to the relevant facts. Third, it must evaluate all "significant Federal tax issues." Each of these three requirements is discussed separately below.

Relevant Facts and Due Diligence. Section 10.39(b)(1) imposes specific requirements and standards on tax practitioners for ascertaining facts relevant to State or local bond opinions. A tax practitioner must use reasonable efforts to ascertain relevant facts. The written advice must identify and consider all relevant facts.

A tax practitioner may not base written advice on unreasonable factual assumptions, representations, statements, or findings. A factual assumption or representation is unreasonable if a practitioner "knows or should know" that it is incorrect or incomplete. Factual assumptions include reliance on projections, financial forecasts, or appraisals. A tax practitioner cannot rely on these things if the practitioner knows or should know that they are incorrect or incomplete or they are prepared by persons who lack the necessary skills or qualifications.

One statement in the introduction to the Proposed Circular 230 Rules on "due diligence" has raised some concerns that it might imply a potentially higher level of "due diligence" than the stated standard would suggest. In the tax-exempt bond area and other areas involving numerous facts in the hands of other parties, it is particularly important for tax practitioners to be able to rely reasonably on certifications from other parties as to factual matters without independent "audit" or verification of those facts. Thus, an important comment on this aspect of the Proposed Circular 230 Rules is to clarify the standard for factual inquiries in a manner similar to previous Circular 230 rules to give tax practitioners positive comfort on the appropriateness of a "certificate-based" practice for factual matters without a need for independent audit or independent verification of facts. Of course, tax practitioners should make further inquiry into represented facts that they know or should know are incorrect or incomplete.

The Proposed Circular 230 Rules impose a "locational" rule that the written advice must identify the factual assumptions and representations "in a separate section." The obvious comment here is that the rules should allow for more flexible and logical organization of facts and legal analysis.

Relating Law to Facts. Section 10.39(b)(2) requires that the separate written advice for State or local bond opinions relate the applicable law to the relevant facts. By its terms, this rule requires that the written advice address all relevant legal analysis in a tax-exempt bond issue without any consideration of the relative settled or unsettled nature of the law under the circumstances.

This proposed rule fails to take into account the particularly large number of legal eligibility rules for tax-exempt bond programs. One major concern with this proposed rule is that it could necessitate an undue amount of legal analysis about straightforward matters. It would be helpful if this rule were amended to target this requirement more narrowly to focus on legal analysis regarding significant Federal tax issues which more properly may warrant highlighting.

One subsidiary rule provides that a tax practitioner may not assume the favorable resolution of a significant Federal tax issue except that the practitioner may rely on certain permitted other opinions. Another subsidiary rule provides that the written advice cannot contain inconsistent legal analysis or conclusions. This latter rule may have an impact on transactions in which the tax

analysis considers alternative favorable tax theories or characterizations of legal effects of a transaction.

Evaluating Significant Federal Tax Issues. Section 10.39 (b)(3) requires that the separate written advice consider all "significant" Federal tax issues that are relevant to the overall conclusion that the interest on the State or local bonds is excludable from gross income for Federal income tax purposes under Section 103 of the Code. The written advice must provide the tax practitioner's conclusion as to the likelihood that a taxpayer will prevail on the merits of each significant Federal tax issue. The written advice must describe the reasons for these conclusions, including the facts and analysis supporting the conclusions. In evaluating significant Federal tax issues, the tax practitioner cannot take into account the possibility that that there will be no IRS audit of an issue, that an issue will not be raised on audit, or that an audit issue will be settled.

Section 10.35 defines the critical term "significant Federal tax issue" to mean a Federal tax issue in which the IRS has a reasonable basis for a successful challenge. Although it is unstated and unclear, this *reasonable basis* standard is thought to be derived from a taxpayer defense standard against accuracy-related penalties under Section 6662 of the Code. Under that provision, Treas. Reg. §1.6662-3(b)(3) defines "reasonable basis," as follows:

> "Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities set forth in §1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard as defined in §1.6662-4(d)(2). (See §1.6662-4(d)(3)(ii) for rules with respect to relevance, persuasiveness, subsequent developments, and use of a well-reasoned construction of an applicable statutory provision for purposes of the substantial understatement penalty.)"

Section 1.6662-4(d)(3)(iii) lists various types of authority that may be taken into account for purposes of these standards. This list includes guidance that is formally regarded as precedent for taxpayers by the IRS (such as the Code, regulations and revenue rulings), but also includes many other types of authority that the IRS generally indicates should not be relied upon by taxpayers and that generally is not regarded as precedential guidance (such as, among others, IRS Private Letter Rulings, IRS "information or press releases," and Joint Committee on Taxation "Bluebooks").

In the context of some other stated Federal tax standards, many tax practitioners view the reasonable basis standard as reflecting a degree of confidence in success of about one in five or a 20% likelihood of success. By comparison, two other Federal tax standards, called the "realistic possibility of success" standard under Section 10.34(d)(1) of Circular 230 and Treas. Reg. §1.6694-2(b) and the "substantial authority" standard under Treas. Reg. §1.6662-4(d)(2), are higher threshold standards which reflect a degree of confidence in success of at least one in three or a 33% likelihood of success.

One fundamental concern with the proposed reasonable basis standard as a threshold for significant Federal tax issues and the attendant more extensive tax documentation requirements under Circular 230 is that this fairly low threshold may tend to blur the differences between a number of less meaningful Federal tax issues. It would be preferable if Treasury and the IRS would raise the threshold for significant Federal tax issues generally from those with a reasonable basis for a successful challenge to those with a realistic possibility of success or with substantial authority to target the heightened Circular 230 regime on more clearly serious Federal tax issues. Unfortunately, however, given that this lower reasonable basis standard for significant Federal tax issues is also in the Final General Circular 230 Rules and that several bar groups recommended previously raising that threshold over the past several years without success, it is doubtful whether Treasury would reconsider raising this threshold.

Absent raising the threshold for finding significant Federal tax issues, it will be very important to develop and clarify the reasonable basis standard for purposes of Circular 230 to the fullest extent possible in light of its heightened importance as a "tollgate" in determining whether many provisions of Circular 230 apply.

Significant Federal Tax Issue Standard, Federal Securities Law Disclosure Issues, and Unqualified Bond Counsel Opinion Standard. One difficult question, unanswerable at this time, about the proposed special regime for separate written advice for State or local bond opinions under Circular 230 is whether this approach ultimately will prove workable in achieving the basic goal of the public finance industry. That goal was to preserve the short form unqualified bond counsel opinions customary in the tax-exempt bond market. One possible effect of the fairly low proposed threshold for significant Federal tax issues under the Proposed Circular 230 Rules, however, is that it may lead to more extensive discussion of possible significant Federal tax issues in documents provided to issuers (e.g., Federal tax certificates or legal memoranda) out of a natural abundance of caution, which, in turn, may raise corresponding Federal securities law disclosure issues regarding whether the more extensively-discussed Federal tax issues are sufficiently material to require disclosure in tax-exempt bond offering documents. In any such analysis, a critical factor is whether the bond opinion executed by bond counsel meets the current standard and retains the unqualified short form (even if the bond offering documents contain an analysis of potential significant Federal tax issues), or whether any such analysis is set forth in the executed bond opinion. If the ultimate result here is that tax-exempt bond offering documents

end up including the bulk of the more extensive tax discussion required to be provided separately to issuers for State or local bond opinions under Circular 230, then this regime may fail to achieve the basic goal and tax-exempt bond opinions may as well be long-form reasoned opinions governed by the Final General Circular 230 Rules.

Another difficult question here is how to reconcile the high NABL standard for unqualified opinions with the fairly low threshold for significant Federal tax issues under the Proposed Circular 230 Rules. The high NABL unqualified opinion standard requires that bond counsel be "firmly convinced" (also characterized as having a "high degree of confidence") that the highest court of the relevant jurisdiction, acting reasonably and properly briefed on the issues, would agree with the opinion. Ordinarily, an unqualified opinion should suggest a conclusion with a high degree of certainty that there are no significant Federal tax issues. At the same time, however, the fairly low threshold for significant Federal tax issues under Circular 230 (i.e., whenever the IRS has a "reasonable basis" for a successful challenge) raises the awkward possibility that there might be cases in which bond counsel might straddle this fence by both giving an unqualified opinion and conceding the possibility of the existence of a significant Federal tax issue for Circular 230 purposes.

It remains to be seen how these difficult issues will work out.

Reliance on Opinions of Others. Section 10.39(d) permits a tax practitioner who gives a State or local bond opinion to rely on an opinion of another practitioner on one or more Federal tax issues, unless the practitioner knows or should know that the other opinion should not be relied upon. In addition, if a tax practitioner relies on the opinion of another practitioner on a significant Federal tax issue, the relying practitioner must identify the other opinion and set forth in the separate written advice the conclusions in the other opinion.

This proposed reliance provision has raised various questions. One question involves the requisite extent of diligence that a tax practitioner must exercise to rely on another opinion. Since the basic purpose of a permissible reliance provision should be to permit the allocation of Federal tax issues among tax experts in particular areas of expertise, hopefully, tax practitioners will be able to rely on other tax experts for Federal tax issues within their expertise without undue undertakings to review that other expertise. Another question involves whether these relied-upon opinions are covered essentially as subsidiary parts of State or local bond opinions or whether these relied-upon opinions themselves separately must satisfy the Final General Circular 230 Rules. One typical area in which questions about the treatment of other relied-upon opinions is the qualified Section 501(c)(3) bond area under Section 145 in which tax practitioners commonly rely on various opinions from Section 501(c)(3) exempt organization experts about the nonprofit exempt status and operations of Section 501(c)(3) conduit borrowers. Thus, for example, a question presented here is whether, in a qualified section 501(c)(3) bond issue, the Section 501(c)(3) status opinion from the borrower's counsel which bond counsel relies on in bond counsel's Section 103 tax exemption opinion may be treated as a subsidiary part of bond counsel's State or local bond opinion or whether, instead, that Section 501(c)(3) status opinion must be treated independently as a covered opinion under Section 10.35 of the Final General Circular 230 Rules. The treatment of relied-upon opinions needs clarification.

IV. Summary of Selected Provisions of Final General Circular 230 Rules

Introduction. This section briefly summarizes selected provisions of the Final General Circular 230 Rules to illustrate certain potential applications to tax-exempt bond opinions. The Final General Circular 230 Rules will apply to certain post-issuance tax-exempt bonds opinions if they fit within the definition of "covered opinions." In addition, certain minimum mandatory standards will apply to any written Federal tax advice (including e-mails) which is outside the definition of "covered opinions" to which more extensive requirements will apply.

Application to Defined Covered Opinions. Subject to a specific exception for State or local bond opinions covered by the Proposed Circular 230 Rules, Section 10.35(b)(2)(i) defines a "covered opinion" broadly to include written advice regarding one or more Federal tax issues arising from one of the following:

(A) certain "listed" tax avoidance transactions under Treas. Reg. §1.6011-4(b)(2);

(B) certain arrangements in which the "principal purpose" is tax avoidance or tax evasion; and

(C) certain arrangements in which a "significant purpose" is tax avoidance or tax evasion if, in the case of such significant purpose arrangements, the written advice is one of the following:

(1) a reliance opinion;

(2) a marketed opinion;

(3) subject to conditions of confidentiality; or

(4) subject to contractual protection (meaning basically contracts to reimburse investors when tax benefits fail to be realized).

Reliance Opinions. Section 10.35(b)(4) defines a "reliance opinion" to mean written advice in which the tax practitioner concludes at a confidence level of more likely than not (a more than 50% likelihood) that one or more significant Federal tax issues would be resolved in the taxpayer's favor.

One way to avoid the more extensive tax documentation rules for covered opinions under the Final General Circular 230 Rules would be to fail to be a reliance opinion. An opinion may fail to be a reliance opinion either because it is given at a confidence level below a

more likely than not level or because it addresses no significant Federal tax issues. Many routine post-issuance "no adverse effect" tax-exempt bond opinions (e.g., involving interest rate mode changes) may fail to be reliance opinions simply because they raise no significant Federal tax issues. Tax practitioners should keep this possibility in mind.

Marketed Opinions. Section 10.35(b)(5) defines a "marketed opinion" to mean written advice in which the tax practitioner knows or has reason to know that the written advice will be used or referred to by a person other than the practitioner (or a person who is a member of, associated with, or employed by, the practitioner's firm) in promoting, marketing, or recommending a partnership or other entity, investment plan, or arrangement to one or more taxpayers.

In the tax-exempt bond area, marketed opinions mainly include opinions that will be given to or used by the bondholders. Some post-issuance tax opinions clearly will be marketed opinions because they are used by the bondholders, some post-issuance tax opinions clearly will not be marketed opinions because they will not be used by bondholders, and the status of some opinions is unclear. For example, it is unclear whether a "no adverse effect" tax opinion obtained by an issuer upon a change of use of a tax-exempt bond financed facility under a general tax compliance covenant will be a marketed opinion if the opinion is required to be given to the bond trustee as a representative fiduciary for the bondholders, but the opinion is not used by the bondholders to make an investment decision. Another theme in public comments on the Final General Circular 230 Rules is to clarify the scope of the marketed opinion definition for various kinds of post-issuance tax-exempt bond opinions.

General Requirements for Covered Opinions. Section 10.35(c) of the Final General Circular 230 Rules requires that tax practitioners who provide covered opinions, including reliance opinions and marketed opinions, generally address relevant facts, relate applicable law to relevant facts, and evaluate and reach conclusions on all significant Federal tax issues in the same extensive manner as described previously herein for State and local bond opinions, with one notable difference in form. Specifically, for covered opinions under Section 10.35, the required tax documentation generally must be included in the tax opinion itself (as contrasted to being provided in the permitted separate written advice for State or local bond opinions given at the time of original issuance of tax-exempt bonds).

Limited Scope Opinions. Section 10.35(c)(3)(v) provides special rules for certain limited scope opinions in which a tax practitioner considers less than all of the significant Federal tax issues in a matter. A tax practitioner may give such a limited scope opinion by meeting the following requirements: (1) the practitioner and the taxpayer must agree to the limited scope for purposes of potential reliance for avoiding tax penalties; (2) the opinion must not be a marketed opinion, a listed transaction, or a transaction with a principal purpose of tax avoidance; and (3) the opinion must include certain prescribed disclosures about compensation and referrals.

For tax-exempt bond opinions, the limited scope opinion provision may be useful for certain post-issuance no adverse effect opinions which are not marketed opinions. One technical problem with the limited scope opinion provision is that it requires the tax practitioner and the taxpayer to agree on the scope limitation. This rule may be unworkable in many circumstances in the tax-exempt bond area if the concept of the "taxpayer" is limited to the bondholders, who often are unknown. It would be helpful if this limited scope opinion rule were expanded to allow issuers of tax-exempt bonds to agree upon the scope limitation instead of the bondholders.

Preliminary Advice Exception. One useful exception to the extensive requirements for covered opinions under the Final General Circular 230 Rules applies to certain preliminary advice. In particular, Section 10.35(b)(2)(ii)(A) excludes written advice from the definition of a covered opinion if it is provided to a client during the course of an engagement in which a tax practitioner reasonably expects to provide subsequent written advice to the client that satisfies the requirements of the Final General Circular 230 Rules.

This preliminary advice exception may be useful in the tax-exempt bond area, particularly in matters involving tax advice during the course of a tax-exempt bond transaction in which the tax advice is expected to culminate in a Section 103 tax exemption opinion at closing. One technical issue is that the preliminary advice exception focuses on tax advice provided to the "client" and, in the tax-exempt bond area, tax advice often is provided more broadly to participants in the working group. It would be helpful if the preliminary advice exception were expanded modestly to include tax advice given to these other persons besides the client.

Opt-Out Disclaimer Provisions. For both reliance opinions and marketed opinions, the Final General Circular 230 Rules provide broad "opt-out" disclaimer options which allow tax practitioners basically to opt out of the more extensive general tax documentation requirements for covered opinions by providing certain prescribed disclaimers. The required disclaimers relate mainly to the inability of taxpayers to rely on these tax opinions to avoid tax penalties.

For reliance opinions, the opt-out provision under Section 10.35(b)(4)(ii) applies if the tax practitioner makes a *prominent disclosure* (as defined below) in the written advice to the effect that it was not intended or written by the practitioner to be used and it cannot be used by the taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer. For marketed opinions, the opt-out provision under Section 10.35(b)(5)(ii) applies to written advice (other than advice about listed transactions or advice with a principal purpose of tax avoidance) if the tax practitioner makes a prominent disclosure in the

written advice to the effect that: (1) the advice was not intended or written by the practitioner to be used and it cannot be used by the taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer; (2) the advice was written to support the promotion or marketing of the transactions or matters addressed by the written advice; and (3) the taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

The disclaimed tax penalty protection referred to here relates mainly to the so-called "accuracy-related" tax penalties, such as the substantial understatement of tax penalty under Section 6662 of the Code and the related fraud penalty under Section 6663 of the Code. In general, taxpayers may assert defenses against these accuracy-related penalties under Section 6664 of the Code if they can show that they had "reasonable cause" for a tax position and they acted in good faith. Tax opinions, among other things, may be used by taxpayers to establish this *reasonable cause* defense to the accuracy-related tax penalties. In the introduction to the Final General Circular 230 Rules, Treasury and the IRS indicated that they intend to amend the regulations under Treas. Reg. §1.6664-1 to clarify that a taxpayer may not rely upon tax opinions that include the above-described opt-out disclaimers to establish the reasonable cause and good faith defense to the accuracy-related penalties.

Prominent Disclosures. Under Circular 230, an item that is required to be "prominently disclosed," such as the disclosures for the opt-out disclaimer provisions, must be set forth in a separate section at the beginning of the written advice in a bold typeface that is larger than any other typeface used in the written advice. One mildly amusing practical technology question here is how to address these larger typeface requirements with various Blackberry e-mail devices.

Comment on Possible Use of Opt-Out Disclaimers in the Tax-exempt Bond Area. In the general tax area, it appears that one common approach that many firms may use in a wide range of circumstances to avoid the more extensive tax documentation requirements for covered opinions under the Final General Circular 230 Rules will be to use the opt-out disclaimers against tax penalty protection. Some tax practitioners believe that these opt-out disclaimers will become commonplace, particularly for e-mails and more discrete tax advice, to remove doubt about the potential application of various Circular 230 rules. The possible use of opt-out disclaimers for various tax-exempt bond opinions to avoid the more extensive tax documentation requirements under Circular 230 warrants further study and serious consideration. One key question here will be the extent to which investors in the tax-exempt bond market will accept these opt-out penalty disclaimers in various circumstances.

Mandatory Minimum Standards for Written Tax Advice (Including E-mail). Section 10.37 of the Final General Circular 230 - Rules imposes certain mandatory minimum standards on written Federal tax advice (including e-mails), including written advice that meets an exception to the definition of a covered opinion. This provision aims largely to impose minimum standards on written Federal tax advice that otherwise uses an opt-out provision to avoid the general requirements for covered opinions. The mandatory minimum standards on written Federal tax advice include the following:

> (1) a tax practitioner may not rely on unreasonable factual or legal assumptions or unreasonable representations, statements, or findings;
>
> (2) a tax practitioner may not fail to consider all relevant facts that the practitioner knows or should know; and
>
> (3) a tax practitioner may not take into account the possibility that a tax return will not be subject to an IRS audit, that an issue will not be raised on audit, or that an issue will be settled.

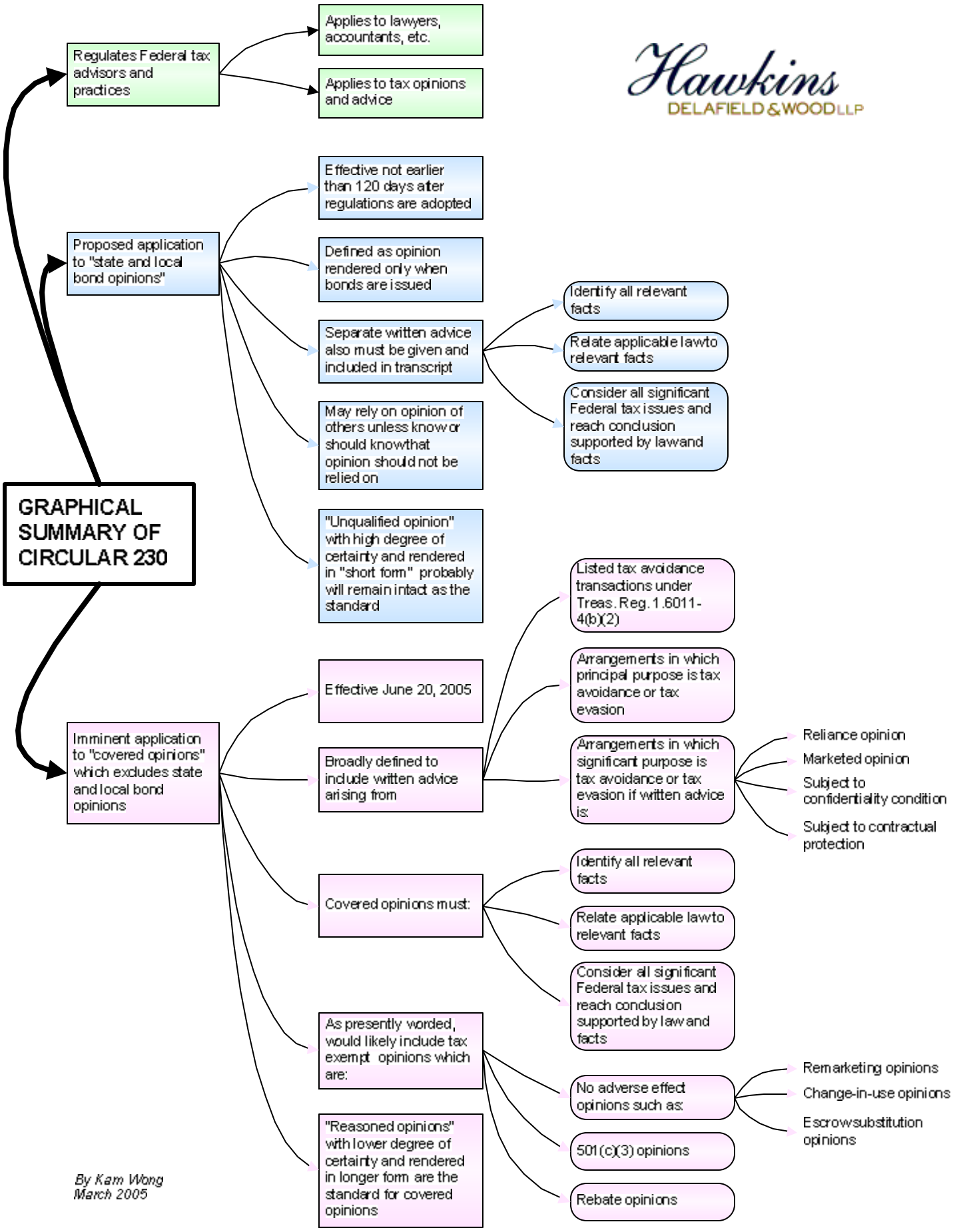
Unlike the rules for covered opinions under Section 10.35 and the rules for State or local bond opinions under Section 10.39, both of which require comparable extensive tax documentation regarding facts, relating law to facts, and evaluation of significant Federal tax issues, the mandatory minimum standards for written tax advice under Section 10.37 do not impose any specific tax documentation requirements for facts, applicable law, and significant Federal tax issues.

The determination of whether a tax practitioner complies with the mandatory minimum standards under Section 10.37 is based on all the facts and circumstances, including the scope of the legal engagement and the specificity of the tax advice sought. For a tax opinion that a tax practitioner knows or has reason to know will be used by third parties, the determination of whether the tax practitioner complies with the mandatory minimum standards under Section 10.37 will be based on a heightened standard of care because of the greater risk caused by the practitioner's lack of knowledge of the taxpayer's particular circumstances.

Sanctions. Section 10.52 provides that a tax practitioner may be censured, suspended, or disbarred from practice before the IRS for willfully violating the rules under Circular 230 or for recklessly or through gross negligence violating certain rules under Circular 230, including, among others, the rules for covered opinions under Section 10.35 and, when they become final, the rules on State or local bond opinions under Section 10.39.

Supervisory Responsibilities and Procedures. Section 10.36 imposes significant supervisory responsibilities and sanctions on tax practitioners who have (or share) principal authority and responsibility for overseeing a firm's Federal tax practice. These responsible tax practitioners must take reasonable steps to ensure that the firm has adequate procedures in effect for all members, associates, and

(Continued on page 12)



By Kam Wong
March 2005

Major New Rules Affecting Tax Opinions

(Continued from page 10)

employees for purposes of complying with the rules on covered opinions under Section 10.35, and, when they become final, the rules on State or local bond opinions under Section 10.39. Any such responsible tax practitioner will be subject to discipline for failing to comply with these requirements if: (1) the tax practitioner willfully, recklessly, or through gross incompetence does not take reasonable steps to ensure that the firm has adequate procedures to comply with Section 10.35 or Section 10.39, as applicable, and one or more individuals who are members of, associated with, or employed by the firm are, or have, engaged in a pattern or practice, in connection with their practice with the firm, of failing to comply with Section 10.35 or 10.39, as applicable; or (2) the tax practitioner knows or should know that one or more individuals who are members of, associated with, or employed by the firm are, or have, engaged in a pattern or practice, in connection with their practice at the firm, that does not comply with Section 10.35 or Section 10.39, as applicable, and the practitioner willfully, recklessly, or through gross incompetence fails to take prompt action to correct the noncompliance.

Aspirational Best Practices. Section 10.33 of the Final General Circular 230 Rules provides non-mandatory, aspirational best practices for advisors on Federal tax issues. In general, tax advisors should provide clients with the highest quality representation concerning Federal tax issues by adhering to best practices. These best practices include the following:

(1) The tax advisor should communicate clearly with the client regarding the terms of the engagement. For example, the advisor should have a clear understanding with the client regarding the form and scope of the advice.

(2) The tax advisor should establish the facts, determine which facts are relevant, evaluate the reasonableness of assumptions and representations, relate the applicable law to the relevant facts, and arrive at a conclusion supported by the law and the facts.

(3) The tax advisor should advise the client regarding the import of the conclusions reached, including, for example, whether a taxpayer may avoid accuracy-related penalties under the Code if the taxpayer acts in reliance on the advice.

(4) The tax advisor should act fairly and with integrity in practice before the IRS.

(5) Tax advisors with responsibility for overseeing a firm's Federal tax practice should take reasonable steps to ensure that the firm's procedures for all members, associates, and employees are consistent with the above-described best practices.

Conclusion. These new Circular 230 rules will have a major impact on tax practice generally and will have a particularly significant impact on tax practice in the tax-exempt bond area. For questions regarding the new rules on tax practice under Circular 230, please feel free to contact the author of this article, tax partner John J. Cross III of our Washington, D.C. office, whose phone number is 202-682-1487 and whose e-mail is jcross@hawkins.com. In addition, of course, please feel free to contact any of our other tax partners.

John J. Cross III
jcross@hawkins.com

* * * * *

About Hawkins Advisory

The Hawkins Advisory is intended to provide occasional general comments on new developments in Federal and State law and regulations which we believe might be of interest to our clients. Articles in the Hawkins Advisory should not be considered opinions of Hawkins Delafield & Wood LLP. The Hawkins Advisory is not intended to provide legal advice as a substitute for seeking professional counsel; readers should not under any circumstance act upon the information in this publication without seeking specific professional counsel. Hawkins Delafield & Wood LLP will be pleased to provide additi onal details regarding any article upon request.

Additional copies of this issue of the Hawkins Advisory may be obtained by calling or writing any attorney in the Firm.

Hawkins
DELAFIELD & WOOD LLP
est. 1854

New York
67 Wall Street
New York, NY 10005
Tel: (212) 820-9300

Newark
One Gateway Center
Newark, NJ 07102
Tel: (973) 642-8584

Hartford
185 Asylum St.
Hartford, CT 06103
Tel: (860) 275-6260

Washington
601 Thirteenth St., N.W.
Washington, D.C. 20005
Tel: (202) 682-1480

Los Angeles
633 West Fifth St.
Los Angeles, CA 90071
Tel: (213) 236-9050

San Francisco
One Embarcadero Center
San Francisco, CA 94111
Tel: (415) 486-4200

Sacramento
1121 L St.
Sacramento, CA 95814
Tel: (916) 326-5200