Bond Case Briefs

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What Happens When the IRS and Issuer Agree to Disagree?

My last blog post was about how, as a result of a change in the Internal Revenue Code (the "Code"), the IRS will be altering the manner in which it audits many partnerships (and limited liability companies that are taxed as partnerships under the Code). In a nutshell, for tax years beginning on or after January 1, 2018, the IRS may assess a tax deficiency against certain partnerships rather than flowing the taxable income adjustment at the partnership level through to the individual partners and then collecting the additional tax from each individual partner. This change in the Code was deemed to be a revenue raiser due to the increased efficiency in assessing the tax against the partnership rather than the individual partners. This streamlined partnership audit process is similar to the IRS being permitted to settle an IRS audit involving tax-exempt bonds with the issuer or conduit borrower rather than having to assess a tax deficiency against the various bondholders and collecting the tax from each individual bondholder. This got me thinking . . . what happens if the issuer or conduit borrower and IRS cannot agree to a resolution when the IRS believes the tax-exempt bonds are taxable?

As you know, the IRS treats the issuer as the "taxpayer" when it begins an audit of tax-exempt bonds even though the bondholders will ultimately be the "taxpayers" if the tax-exempt bonds become taxable. For example, under IRS guidelines, the IRS sends the information document requests ("IDRs") to the issuer of the tax-exempt bonds and is authorized to reach a settlement with the issuer. In addition, it is the issuer of the tax-exempt bonds that has the ability to either (a) request a technical advice memorandum ("TAM") from the IRS national office with respect to one or more issues relating to the tax-exempt bonds, or (b) after receiving a proposed adverse determination from the IRS agent, request that the matter be referred to the IRS' Office of Appeals ("Appeals"). Although the goal of Appeals is to settle cases with the Appeals' officer acting as an independent reviewer, sometimes the parties cannot agree. If settlement attempts at Appeals between the IRS agent and issuer are unsuccessful, the IRS will issue a final adverse determination that the tax-exempt bonds are now taxable. If the IRS has not already done so, around the same time that the IRS issues the final adverse determination, the IRS will contact the trustee for the subject bonds and request the names and address of all bondholders thereof.

Once the final adverse determination is made that the tax-exempt bonds are taxable, the issuer no longer has any rights in the audit process. Rather, the IRS will begin treating the bondholders as the "taxpayer" from that point until final resolution of the tax controversy. In general, the IRS has three years from the date that a bondholder filed his or her income tax return reporting tax-exempt interest to assess a tax on the now allegedly taxable interest. The IRS will assess this tax by sending each bondholder a statutory notice of deficiency that is oftentimes referred to as a "90 Day Letter." The 90 Day Letter sent to each bondholder will set forth the basis for the tax deficiency and will also set forth the amount of tax, interest and penalties owed by such bondholder. The bondholder will have 90 days to respond by filing a petition challenging the assessment in the U.S. Tax Court. In the alternative, the bondholder could pay the assessed tax, interest and penalties due, but then file a claim for refund. At this point, the bondholder could attempt to reach a settlement with the IRS, although there is no formal procedure in place to do so. The incentive for both the bondholder and IRS to settle, however, would be to avoid the costly litigation process discussed below.

After the bondholder's refund is denied by the IRS (which it presumably would be), the bondholder could then file a claim for refund in the U.S. district court with jurisdiction over his or her tax residence or in the U.S. Court of Federal Claims located in Washington D.C. If the bondholder was to lose at the district court or Tax Court, the bondholder could appeal to the appropriate U.S. Court of Appeals. Similarly, if the bondholder was to lose at the U.S. Court of Federal Claims, he or she could appeal to the U.S. Court of Appeals for the Federal Circuit, which is also located in Washington D.C. If the bondholder then loses at the appellate level, the bondholder could appeal to the U.S. Supreme Court. However, as you know, the U.S. Supreme Court could decide not to hear the case (i.e., by denying the taxpayer's writ of certiorari), thus affirming the appellate court's decision.

Assuming that the bondholder hires legal counsel to help navigate the above-described litigation, the process could become very costly for the bondholder even if he or she ultimately wins the case. This bondholder-by-bondholder litigation process would also be very expensive for the IRS. Accordingly, it is a good thing that the vast majority of tax controversies involving tax-exempt bonds are settled by the issuer and IRS before a final adverse determination is issued by the IRS. This is because the issuer has a very strong incentive to settle with the IRS so that the marketplace does not react negatively the next time the issuer wants to issue tax exempt bonds. In addition, from the IRS' standpoint, it is far more efficient to settle with the issuer than to pursue each bondholder. Therefore, thankfully, it is very rare for the IRS and issuer to agree to disagree.

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