

Department
of the
Treasury

Internal
Revenue
Service

Office of
Chief Counsel

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Application of Section 7602(c),
Notice of Contact of Third Parties, Upon Incorporation
Subject: to the Bond Examination Program Cancellation Date: into the CCDM

Purpose

The purpose of this Notice is to advise Chief Counsel attorneys on the application of I.R.C. § 7602(c), Notice of Contact of Third Parties, to the Bond Examination Program.

In General

For purposes of complying with the advance notification and recordkeeping requirements of section 7602(c), the general rules are (1) that a bondholder will not be treated as a taxpayer until a preliminary determination has been made to pursue the specifically identified bondholder for assessment or collection of past due taxes; and (2) that the issuer will be treated as "the taxpayer" with respect to a bond issue.

Discussion

Section 7602(c) provides that an officer or employee of the Internal Revenue Service may not contact any person other than the taxpayer with respect to the determination or collection of the taxpayer's liability without providing advance notice that such contacts may be made. The Service is required to keep a record of persons contacted and to provide such record to the taxpayer both on a periodic basis and upon the taxpayer's request. There are three statutory exceptions to these requirements: (1) if the taxpayer has authorized the contact; (2) if the Secretary determines for good cause shown that giving the taxpayer notice would jeopardize collection of any tax or ... involve reprisal against any person"; or (3) with respect to any pending criminal investigation. Section 7602(c)(3).

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In interpreting section 7602(c), the Service has adopted an approach that balances taxpayers= business and reputational interests with third parties= privacy interests and the Service=s responsibility to administer the internal revenue laws effectively. This balancing approach is more fully explained in the preamble to the proposed regulations, which were issued on January 2, 2001. See Prop. Treas. Reg. ' 301.7602-2, 66 Fed. Reg. 77 (Jan. 2, 2001).

Bondholder

While bondholders may ultimately be liable for internal revenue taxes upon the completion of an investigation to determine the tax status of a bond issue, disputes regarding the tax status of a bond issue are generally resolved at the issuer level with the bond issuer or another party to the transaction. Accordingly, the proposed regulations provide that contacts made to determine the tax status of a bond issue are not initially contacts that are made ~~with respect to~~ the determination of the tax liability of bondholders so as to require the advance notice or a record of persons contacted to be sent to bondholders. See Prop. Treas. Reg. ' 301.7602-2(c)(3).

A bondholder is treated as a taxpayer, however, under section 7602(c) when a preliminary determination has been made to pursue the specifically identified bondholder for assessment or collection of past due taxes.^{1/} Thus, bondholders should be treated as taxpayers for the purpose of section 7602(c) when three events occur: (1) the bondholders are specifically identified by name; (2) the audit of the issuer has progressed to the point that specific issues that would effect the individual bondholder's liability have been identified; and (3) a preliminary determination has been made to pursue those issues further. Once all three of these events occur, the advance notice and recordkeeping requirements of section 7602(c) must be met with respect to the identified bondholders.

Issuers

Information sought in determining the tax status of a bond issue is not "with respect to the determination or collection" of the issuer=s tax liability and, thus, issuers are not covered by the literal language of section 7602(c). In some respects, however, an issuer's reputation may be affected by a tax status investigation. Congress was concerned with protecting the taxpayer's reputational interest. See S. Rep. No.105-174 at 77 (April 22, 1998) (Third party contacts "may have a chilling effect on taxpayer's business and could damage taxpayer's reputation in the community"). There is a good argument that the real party in interest in a tax status bond investigation is the issuer. Thus, the underlying purpose of the advance notice and recordkeeping requirements of section 7602(c) are generally better served by treating the issuer as the taxpayer and providing the issuer with the advance notice and a record of persons contacted.^{2/}

^{1/} For purposes of section 7602(c), bondholders do not include mutual funds or other trusts or companies holding the bonds in street name.

^{2/} Form Letter 3164 H (DO) may be used for providing issuers with advance notice that contacts with third parties may be made. Alternatively, Form 12180, Third Party Contact Authorization Form, may be used to obtain authorization from the issuer prior to contacting third parties.

This approach is consistent with other areas of tax administration where the issuer is treated as the taxpayer with respect to the bond issue. See Section 5.4.0 of IRM 7.6.2, Exempt Organizations Examination Procedures Handbook (issuers are to be treated as taxpayers with respect to the bond issue for purposes of disclosure, technical advice requests, and appeals); Disclosure Guide for Tax-Exempt Bond Examination; section 3.20 of Rev. Proc. 99-35, 1999-41 I.R.B. 301 (Administrative Appeal of Proposed Adverse Determination of Tax-Exempt Status of Bond Issue). It is important to note, however, that a bond examination is not an examination of the bond issuer, but of the municipal financing arrangement, and the issuer's records are only reviewed to the extent they are relevant to the examination of the municipal bond transaction. Thus, irrespective of the Service's treatment of the issuer for section 7602(c)'s notice provisions, they are not generally the taxpayer under other provisions of the Internal Revenue Code.^{3/}

Accordingly, although in most instances the issuer should be treated as the taxpayer for purposes of section 7602(c), a careful review of the facts and circumstances surrounding such examination may reveal an extreme situation where balancing the taxpayer's business and reputational interests with third parties' privacy interests and the IRS' responsibility to administer the internal revenue laws effectively would justify not treating the issuer as the taxpayer.

Other Situations

1. Conduit Borrowers

Private activity bonds may be issued to finance privately-owned or operated facilities. Generally, such financings involve a single conduit borrower, usually an individual, corporation or charitable organization, that is the primary beneficiary of the debt issuance. If the examination of the bond issuance uncovers a problem with the bond, the conduit borrower may have a liability, independent from the bondholders, pursuant to the provisions of section 150(b). Accordingly, in the case of private activity bonds, the conduit borrower should be treated as the taxpayer for purposes of the third-party notification and recordkeeping requirements when a preliminary determination is made to examine the conduit borrower for purposes of determining the conduit borrower's liability under section 150(b).

^{3/} For instance, where the bond issuer is served a John Doe summons to identify unknown investors, or a summons to examine records, the bond issuer is not a taxpayer for purposes of the provisions governing the issuance of summonses. Sections 7602-7609. Also, if the bond transaction fails to comply with the tax laws, the issuer would not be liable for any taxes, would not be assessed for past due taxes resulting from the determination, and would not be subject to collection proceedings or actions. Sections 6201-6344.

