Hunton & Williams
Client Alert

April 2009

IRS Guidance on Build America Bonds

On February 17, 2009, President Obama signed into law the Stimulus Act, officially entitled the American Recovery and Reinvestment Tax Act of 2009 ("ARRTA"). Among many initiatives, ARRTA provides state and local governments with a number of new financing tools and incentives that should stimulate public sector capital projects while also improving the vitality of the public finance debt sector. As part of the effort in this area, ARRTA significantly expands existing tax-credit bond programs available to state and local governments and introduces new programs. One such new program allows issuers to deliver governmental bonds (not private activity) as **taxable tax-credit bonds** in lieu of traditional bonds with tax-exempt interest. These bonds are known as **Build America Bonds** ("BABs") and may be issued at least through December 31, 2010. BABs are codified in Sections 54AA and 1400U-2 of the Internal Revenue Code of 1986, as amended (the "Code").

On April 3, 2009, the IRS issued Notice 2009-26 (the "April 3 Notice") to provide interim guidance on BABs to enable state and local governments to begin using the program. This alert provides a general overview of BABs and summarizes the guidance provided by the April 3 Notice.

Overview of BABs

BABs are state and local **governmental (not private activity) bonds** that could be issued as tax-exempt bonds but which the issuer elects to treat as taxable under Section 54AA of the Code.

Tax Credit BABs and Direct Payment BABs

Section 54AA provides for two general types of BABs. The first operates as a traditional tax-credit bond and **provides the bondholder with a federal income tax-credit equal to 35 percent of interest paid on the bond** ("Tax Credit BABs"). These credits are applied on an annual basis. If a bondholder lacks sufficient tax liability in any year to fully utilize that year's credit, the unused credit may be carried forward for use in succeeding taxable years. The amount of the credit must be treated as income to the holder and this somewhat reduces the actual credit benefit (the IRS estimates it should be considered as a "25 percent credit").

The second type of BABs ("Direct Payment BABs") operates under a unique structure resulting from the issuer's election to receive payment from the federal government in lieu of the bondholder receiving a tax-credit. In this scenario, the IRS makes **direct payments to the issuer in an amount equal to 35 percent of interest paid on the bond**. These payments are

Contacts

District of Columbia

Andrew R. Kintzinger
(202) 955-1837
akintzinger@hunton.com

William H. McBride
(202) 778-2242
wmcbride@hunton.com

Georgia

Douglass P. Selby
(404) 888-4207
dselby@hunton.com

Caryl Greenberg Smith
(404) 888-4025
carylsmith@hunton.com

North Carolina

William H. McBride
(919) 899-3030
wmcbride@hunton.com

Mary Nash K. Rusher
(919) 899-3066
mnrusher@hunton.com

Texas

J. Nicholson Meindl
(214) 468-3358
nmeindl@hunton.com

Virginia

Christopher G. Kulp
(804) 788-8742
ckulp@hunton.com

John D. O'Neill, Jr.
(804) 788-8406
joneill@hunton.com

Robert Dean Pope
(804) 788-8438
dpope@hunton.com

referred to by the IRS as “refundable credit payments” or “direct payments.”

Section 1400U-2 — Recovery Zone Economic Development Bonds

In addition to the two types of BABs provided for in Section 54AA of the Code, ARRTA also created a third type — Recovery Zone Economic Development Bonds (“RZEDBs”). RZEDBs are codified in Section 1400U-2 and, like Direct Payment BABs, provide for payments to the issuer. RZEDBs receive a higher subsidy than Direct Payment BABs **(45 percent instead of 35 percent of the interest paid)**; however certain other requirements must be met for RZEDB issuance. In particular, there are limitations on the use of proceeds including that the projects financed must be in **“recovery zones”** — generally defined by ARRTA as areas that have been economically depressed for certain reasons; the projects that are financed with RZEDBs must be constructed by contractors paying **Davis-Bacon wages;** and issuers of RZEDBs must receive a portion of an **overall national volume cap** for these bonds. The April 3 Notice deferred the delivery of rules for such cap allocations to a later date. Accordingly, while the procedures for RZEDBs will no doubt be similar to those set forth for other BABs, we focus what follows on the first two types of BABs and anticipate a subsequent client alert on RZEDBs when more information is available.

IRS Guidance

The April 3 Notice provides **interim guidance** on the Build America Bond Program to enable state and local governments to begin using the program prior to the issuance of IRS regulations. Particular topics addressed in the April 3 Notice include eligible types of projects and financings, initial implementation of the direct payment procedures for Direct Payment BABs, elections to use the program and information reporting requirements for the program.

Eligible Types of Projects and Financings

The basic definition of a “Build America Bond” provided in Code Section 54AA requires that (1) the bond qualify as a governmental bond under Section 103 of the Code (and not be a private activity bond), (2) the bond be issued before January 1, 2011, (3) the issuer makes an irrevocable election and (4) the initial issue price does not have more than a de minimis amount of premium over the stated principal amount of the bond. A Tax Credit BAB need not satisfy any other requirements and therefore may be used for any purpose for which a tax-exempt financing is generally available, **including refundings** (there were some early public comments indicating that BABs could not be used for refunding purposes but this suggestion has been clearly set aside for Tax Credit BABs). There is no volume cap limitation for this type of BAB. Any state or local government may issue Tax Credit BABs in 2009 and 2010 for projects for which governments may otherwise issue tax-exempt government bonds. Note also the requirements are on a “bond by bond” basis. Therefore an issuer can designate a portion of an issue, or even just a portion of a maturity, as BABs and have the rest be issued on a tax-exempt basis. Issue splitting may become common, since some analysts have pointed out the 35 percent credit may produce more beneficial net interest rates for longer maturities in a normal yield curve environment.

In addition to meeting the foregoing requirements for Tax Credit BABs, Direct Payment BABs may be used to finance **only new money issues** for which 100 percent of available project proceeds are used for capital expenditures (net of amounts placed in a reasonably required reserve fund). There is no volume limitation for Direct Payment BABs. The 2 percent cost of issuance limitation on Direct Payment BABs is the first application to governmental bonds of a rule which has been applicable to most private activity bonds for many years.

Applicability of Tax-Exempt Financing Rules; Information Reporting

Despite their taxable status, all BABs are subject to certain rules applicable to traditional tax-exempt financings. (*i.e.*, registration, reimbursement, rebate and arbitrage). For arbitrage purposes under Section 148 of the code, the yield on a Tax Credit BAB is calculated without regard to the tax credit amount. The yield on Direct Payment BABs, however, is reduced by the direct payment amount.

Issuers of all BABs must report the issuance of the bonds on IRS Form 8038-G, *Information Return for Tax-Exempt Governmental Bonds,* even if the issuer would otherwise file Form 8038-GC. Issuers of BABs must check Line 18 of Form 8038-G, “Other,” and note “Build America Bond (tax credit)” or “Build America Bond (payment option)” on the line provided. In addition, issuers of BABs must attach a separate schedule that indicates the type of bond issue (education, health and hospital, transportation, public safety, environment, housing, utilities or other) as well as a debt service schedule including expected credit payments if it is a Direct Payment BAB.

Implementation of Direct Payment Procedures

While Tax Credit BABs need no further issuer procedure for the holder credits given, the April 3 Notice provides that issuers of Direct Payment BABs must file a new form with the IRS — Form 8038-CP — to receive their payments. **For fixed rate bonds, a Form 8038-CP must be filed in advance of each interest payment date. For variable rate bonds, a Form 8038-CP must be filed quarterly.** Note that the following described procedures are stated to pertain to tax year 2009 only and may change with additional IRS guidance. In addition there are special rules for issues closed before July 1, 2009, which are not discussed herein.

For fixed rate bonds, a Form 8038-CP is due not more than 90 days before and not less than 45 days prior to each interest payment date. Federal payments are to be made on or about the interest payment date. For variable rate bonds, a Form 8038-CP is due 45 days after the last interest payment date within the quarterly period for which reimbursement is requested. Federal payments are to be made in a single amount aggregating all amounts due for that quarter.

Miscellaneous Provisions

In addition to the foregoing, we have noted the following information arising from ARRTA, the April 3 Notice, Form 8038-CP, or the Instructions therefor:

- The calculation of the 35 percent amount should **not** take into account any original issue or market discount — it relates to stated interest only.
- Credits on BABs may be stripped and resold separately, but not until the IRS produces regulations on that subject.
- Interest payments on BABs will not be subject to state income tax unless and until a state changes its laws on that subject.
- Direct payments are made to an issuer or its designee (trustee, paying agent, etc., if the payments are pledged) at the "official address" for the recipient. Such address may or may not be the one shown on the Form 8038-CP and therefore caution is warranted in confirming such facts.
- Separate Forms 8038-CP are required for each issue of bonds, even if they are issued on the same date or have identical interest payment dates.

Development of Market for Taxable Municipal Securities Uncertain

With the market for taxable municipal bonds largely undeveloped, issuers and their advisers face a challenge in determining whether use of BABs will produce total debt service savings compared to traditional tax-exempt offerings. Only time and actual transactions will supply the answer. In the meantime we believe our clients should be aware of the possibilities and alert to the concepts involved. The rules for BABs allow an issuer to make the decision as to whether to issue bonds as BABs at the very last minute so their use should be considered for all **or a portion** of any traditional governmental bond issue right up to the day of pricing.

Request for Comments

In addition to providing guidance on BABs, the April 3 Notice also solicits public comment on the direct payment procedures. The IRS is interested in comments regarding efficient methods to make such direct payments, workability and ease of usage for state and local governments, ongoing compliance safeguards, and the tax procedural framework for the payments. All comments should be submitted in writing and can be emailed to notice.comments@irscounsel.treas.gov (include "Notice 2009-26" in the subject line) or mailed to the Office of Associate Chief Council (Financial Institutions and Products), Re: Notice 2009-26, CC:FIB:B5, Room 3547, 1111 Constitution Avenue, NW, Washington DC 20224. All submitted comments will be made available to the public. Hunton & Williams LLP may be submitting comments or participating in comments sent by others. If you wish to forward any comments through us, please contact any of the attorneys listed.