Lesson 10

Build America Bonds

Overview

Purpose

This lesson introduces the student to build America bonds ("Build America Bonds") authorized by § 54AA.

Objectives

At the end of this lesson, you will be able to:

- Identify the general requirements for and characteristics of all Build America Bonds
- Differentiate Build America Bonds (Direct Pay) from Build America Bonds (Tax Credit) and Recovery Zone Economic Development Bonds

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Overview, Continued

Contents

This lesson contains the following topics:

Section 1

Introduction

Statute

The American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009) (enacted February 17, 2009) ("ARRA"), added Section 54AA to the Code, which authorized state and local governments to issue "build America bonds" ("Build America Bonds") in lieu of issuing traditional tax-exempt obligations from February 17, 2009 through December 31, 2010.

Why is this important?

State and local governments borrowed more than $181 billion through the issuance of 2,275 separate issues of Build America Bonds by December 31, 2010. Issues of Build America Bonds will be outstanding for decades after 2010. In addition, Congress may authorize Build America Bonds to be issued in the future.

Definition

A Build America Bond is a federally taxable state or local governmental bond (excluding a private activity bond under § 141) that meets the following requirements:

(1) the interest on such bond would be (but for Section 54AA) excludable from gross income under § 103;
(2) the bond is issued before January 1, 2011; and
(3) the issuer makes an irrevocable election to have § 54AA apply to the bond.

See § 54AA(d).

Taxable Interest

Unlike traditional tax-exempt obligations, interest on Build America Bonds is federally taxable to bondholders. State and local governmental issuers that choose to issue federally taxable Build America Bonds instead of tax-exempt bonds are allowed federal subsidies for a portion of their borrowing costs. The subsidies take the form of either tax credits provided to holders of the bonds ("Build America Bonds (Tax Credit)") or refundable tax credits paid directly to state and local governmental issuers of the bonds ("Build America Bonds (Direct Payment)").

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Limited Period for Issuance of Build America Bonds

ARRA only authorized the issuance of Build America Bonds during the period commencing on February 17, 2009 (the effective date of ARRA) through December 31, 2010.

For bonds that were structured as a "draw-down" loan under Treas. Reg. § 1.150-1(c)(4)(i) or a commercial paper program under Treas. Reg. § 1.150-1(c)(4)(ii), only those draws or commercial paper that were funded before January 1, 2011 and for which interest began to accrue for Federal income tax purposes before January 1, 2011 may qualify as Build America Bonds. See § 4 of Notice 2010-81, 2010-50 I.R.B 825, November 23, 2010.

Irrevocable Election

An issuer of Build America Bonds must make the irrevocable election required by §§ 54AA(d) or (g) to issue such bonds as Build America Bonds on the issuer's books and records on or before the issue date of the bonds. See § 4 of Notice 2009-26, 2009-16 I.R.B. 833, April 3, 2009.

Not Federally Guaranteed

For purposes of the restrictions against federal guarantees of tax-exempt bonds under § 149(b), a Build America Bond is not treated as federally guaranteed by reason of the credit allowed under § 54AA(a) or § 6431. See § 54AA(d)(2)(A).

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De Minimis Premium Limitation

Build America Bonds must be issued with not more than a de minimis amount (determined under rules similar to the rules of § 1273(a)(3)) of premium over the stated principal amount of the bonds. For purposes of applying this limitation on bond premium, the definition of "issue price" applicable to tax- exempt bonds under Treas. Reg. § 1.148-1(b) applies. Section 1273(a)(3) and§ 1.1273-1(d) provide rules for determining a de minimis amount for a bond, which generally means .25 percent of the stated redemption price at maturity of the bond multiplied by the number of complete years from the bond's issue date to its maturity date. In addition, the rules in Treas. Reg. § 1.163-13(e)(3) (relating to an issuer's determination of bond issuance premium in certain circumstances) will apply to determine a bond's payment schedule and maturity date. Under Treas. Reg. § 1.163-13(e)(3)(i), in the case of a bond subject to certain contingencies, the rules in Treas. Reg. § 1.1272-1(c) (other than § 1.1272-1(c)(3) (relating to mandatory sinking funds)) will apply to determine the bond's payment schedule and maturity date. See § 6.2 of Notice 2010-35, 2010-19 I.R.B. 660, April 26, 2010.

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De Minimis Premium Limitation - Hypotheticals

County of Alpha issued a 17 year Build America Bond at a premium. How much premium over the stated principal amount of the bond was permissible?

What if the bond is callable by the County at par after 10 years?

- The County will be treated as if it called the bond on the first call date if calling the bond on the first call date would produce the lowest yield on the bond. If so, the County would determine if the premium is de minimis based on <u>a 10-year maturity date</u> rather than a 17-year maturity date (10 years times .25% equals 2.5% of permissible premium).

What if the bond is callable by the County at any time under a "make whole" call option, which requires the County to pay a call premium in an amount that preserves the bond's original yield to maturity?

- The County's exercise of that call option generally will not produce a lower yield and the call option will be disregarded in determining whether the bond premium is de minimis (17 years times .25% equals 4.25% of permissible premium).

See § 6.2 of Notice 2010-35

Information Reporting

To satisfy the information reporting requirements of § 149(e), issuers of Build America Bonds were originally required to report information about their Build America Bonds on IRS Form 8038-G, *Information Return for Tax-Exempt Governmental Obligations* regardless of whether the issue price was less than $100,000. On its release, issuers of Build America Bonds were required to file IRS Form 8038-B, *Information Return for Build America Bonds and Recovery Zone Economic Development Bonds.*

Section 2

Build America Bonds (Direct Pay)

In General

Build America Bonds (Direct Payment) provide a Federal subsidy through a refundable tax credit paid directly to state or local governmental issuers by the Treasury Department and the IRS under § 6431 in lieu of any credit otherwise allowable to bondholders under § 54AA, in an amount equal to 35 percent of the total coupon interest payable to investors in the bonds. The amount of refundable credit that an issuer may claim with respect to a Build America Bond (Direct Payment) is determined by multiplying the interest payment that is payable by the issuer on an interest payment date (i.e., the bond coupon interest payment) by 35 percent. See § 2.3 of Notice 2009-26.

Original Issue Discount

Original issue discount is not treated as a payment of interest for purposes of calculating the refundable credit. See § 2.3 of Notice 2009-26.

Pre-issuance Accrued Interest

Pre-issuance accrued interest, which is the portion of the stated interest on any Build America Bonds (Direct Payment) paid by the issuer that is allocable to interest accrued prior to the issue date of the bond (as defined in § 1.150-1(b)), is not taken into account for purposes of determining refundable credit payments under § 6431. See § 6.5 of Notice 2010-35.

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Eligible Uses of Proceeds

The eligible uses of proceeds for Build America Bonds (Direct Payment) are more limited than the permissible uses of proceeds for Build America Bonds (Tax Credit) and for tax-exempt bonds generally. Build America Bonds (Direct Payment) must be issued to finance governmental purposes for which tax-exempt governmental bonds (excluding private activity bonds under § 141) could be issued under § 103. In addition, pursuant to § 54AA(g)(2) each Build America Bond (Direct Payment) must be a "qualified bond." A qualified bond means any Build America Bond issued as part of an issue if 100% of the excess of available project proceeds (defined in § 54A(e)(4) as the sale proceeds of an issue less not more than two percent of such proceeds used to pay issuance costs plus investment proceeds thereon) over the amounts in a reasonably required reserve fund are to be used to finance capital expenditures (as defined in Treas. Reg. § 1.150-1(b)), as contrasted with working capital expenditures. See § 2.3 of Notice 2009-26. Build America Bonds may not be used to refinanced capital expenditures in a refunding issue (as defined by Treas. Reg. 1.50-1)

Reasonably Required Reserve

In determining a reasonably required reserve fund for purposes of § 54AA(g), the rules under § 148(d)(2) apply to Build America Bonds (Direct Payment). Generally, an issue of Build America Bonds (Direct Payment) will be arbitrage bonds if the amount of the sale proceeds of the issue that is part of any reserve or replacement fund exceeds 10 percent of the proceeds. As such, the interest on such Build America Bonds (Direct Payment) could not be Federally tax-exempt under § 103 and thus, such bonds would not be qualified bonds for purposes of § 54AA(g). See § 2.3 of Notice 2009-26.

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Reimbursable Expenditures

An eligible financing of capital expenditures includes a reimbursement of capital expenditures under the reimbursement rules contained in Treas. Reg. § 1.150-2. Similarly, Build America Bonds (Direct Payment) may be used to reimburse otherwise-eligible capital expenditures under Treas. Reg. § 1.150-2 that were paid or incurred after the effective date of ARRA and that were financed originally with temporary short-term financing issued after February 17, 2009, and such reimbursement will not be treated as a refunding issue under Treas. Reg. § 1.150-1(d) or § 1.150-2(g). See § 2.3 of Notice 2009-26.

Overpayments of Tax

In general, the refundable credits paid to issuers with respect to Build America Bonds (Direct Payment) under § 6431 are payments that are treated as overpayments of tax for Federal tax purposes. Rules relating to overpayments of tax, such as credits against liabilities in respect of an internal revenue tax and offsets under § 6402, interest on overpayments of tax under § 6611, and limitations on credits or refunds of overpayments of tax under § 6511 apply to credit payments with respect to Build America Bonds (Direct Payment). See § 3.3 of Notice 2009-26.

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Refundable Credit Procedures

In general, the Secretary will pay an issuer the refundable credits due to the issuer with respect to interest on fixed rate Build America Bonds (Direct Payment) upon receipt of the issuer’s timely filed Form 8038-CP *Return for Credit Payments to Issuers of Qualified Bonds* requesting payment of the credit. Section 6431 provides that the Secretary must make the payment on a contemporaneous basis with the applicable interest payment date. The ARRA Conference Report indicates that the payment by the Secretary may be made either in advance or as a reimbursement. See § 2.3 of Notice 2009-26.

For fixed rate Build America Bonds (Direct Payment), the due date for an issuer to file a Form 8038-CP is the 45th day before the applicable interest payment date with respect to the bonds. However, Form 8038-CP may not be filed earlier than the 90th day before the related interest payment date. See § 3.1(b) of Notice 2009-26.

For variable rate Build America Bonds (Direct Payment), upon receipt of a timely filed Form 8038-CP requesting payment of the credit, such amount will be paid quarterly on a reimbursement basis for interest paid by the issuer during the quarter, including the interest payment date with respect to which the return requesting payment relates. For variable rate Build America Bonds (Direct Payment) the due date for an issuer to file a Form 8038-CP is the 45th day after the last interest payment date within the quarterly period for which reimbursement is requested. See § 3.1(c) of Notice 2009-26

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Bond Yield

For purposes of the arbitrage investment restrictions under § 148, the yield on Build America Bonds (Direct Payment) is reduced by the credit allowed. Issuers should calculate the yield on Build America Bonds (Direct Payment) for purposes of the arbitrage rules by applying the rules contained in § 148 and the regulations thereunder, but by reducing the amount of interest paid on the bond by the amount of credit payments received pursuant to Section 6431. See § 2.3 of Notice 2009-26.

Section 3

Build America Bonds (Tax Credit)

In General

Build America Bonds (Tax Credit) provide a Federal subsidy through Federal tax credits to investors in the bonds in an amount equal to 35 percent of the total coupon interest payable by the issuer on such bonds.

Eligible Uses of Proceeds

Build America Bonds (Tax Credit) may be issued to finance any governmental purpose for which tax-exempt governmental bonds (excluding private activity bonds under § 141) could be issued under § 103 and must comply with all requirements applicable to the issuance of tax-exempt governmental bonds. Accordingly, Build America Bonds (Tax Credit) may be issued to finance the same kinds of expenditures (e.g., capital expenditures and working capital expenditures) and may involve the same kinds of financings (e.g., original new money financings, current refundings, and one advance refunding) as tax-exempt governmental bonds. Build America Bonds (Tax Credit) may not be issued for any purposes for which tax-exempt governmental bonds may not be issued under § 103 (e.g., prohibited second advance refunding issues or pension annuity issues). See § 2.2 of Notice 2009-26.

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Tax Credits

Section 54AA(a) provides that if a taxpayer holds a Build America Bond (Tax Credit) on one or more interest payment dates of the bond during any taxable year, there shall be allowed as a credit against the tax imposed by chapter 1 for the taxable year an amount equal to the sum of the credits determined under Section 54AA(b) with respect to such dates. Section 54AA(b) provides that the amount of the credit determined with respect to any interest payment date for a Build America Bond (Tax Credit) is 35 percent of the amount of interest payable by the issuer with respect to such date. An "interest payment date" is any date on which the bondholder is entitled to a payment of interest on such bond. The tax credit that a taxpayer may claim with respect to a Build America Bond (Tax Credit) is determined by multiplying the interest payment that a bondholder is entitled to receive from the issuer (i.e., the bond coupon interest payment) by 35 percent.

Effect of Sequestration on State and Local Govt Filers

Pursuant to the requirements of the Balanced Budget and Emergency Deficit Control Act of 1985, as amended, refund payments to certain state and local government filers claiming refundable credits under section 6431 of the Internal Revenue Code applicable to certain qualified bonds are subject to sequestration. This means that refund payments processed on or after October 1, 2013 and on or before September 30, 2014 will be reduced by the fiscal year 2014 sequestration rate of 7.2 percent and refund payments processed on or after October 1, 2014 and on or before September 30, 2015 will be reduced by the fiscal year 2015 sequestration rate of 7.3 percent irrespective of when the amounts claimed by an issuer on any Form 8038-CP was filed with the IRS. The sequestration reduction rate will be applied unless and until a law is enacted that cancels or otherwise impacts the sequester, at which time the sequestration reduction rate is subject to change. These reductions apply to Build America Bonds, Qualified School Construction Bonds, Qualified Zone Academy Bonds, New Clean Renewable Energy Bonds, and Qualified Energy Conservation Bonds for which the issuer elected to receive a direct credit subsidy pursuant to section 6431.

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Limitations and Carryforward Allowance

Section 54AA(1) provides that the credit allowed for any taxable year shall not exceed the excess of (1) the sum of the regular tax liability (as defined in § 26(b)) plus the tax imposed by § 55, over (2) the sum of the credits allowable under part IV of subchapter A of chapter 1 (other than subpart C and subpart J). Section 54AA(c)(2) provides that if the credit allowable under § 54AA(a) exceeds the limitation imposed by § 54AA(c)(1) for such taxable year, such excess shall be carried to the succeeding taxable year and added to the credit allowable under § 54AA(a) for such taxable year (determined before the application of § 54AA(c)(1) for such succeeding taxable year). Unused credit may be carried forward to succeeding taxable years.

Stripping Credits

Under § 54AA(f)(2), rules similar to the rules of § 54A(f), (g), (h), and (i) shall apply for purposes of the credit allowed under § 54AA(a). Section 54A authorized the Treasury Department to promulgate regulations to allow for "stripping," which is the separation of the ownership of the bonds and the associated tax credits under principles based on § 1286.

Bond Yield

Section 54AA(d)(2)(B) provides that for purposes of applying the arbitrage restrictions under § 148, the yield on a Build America Bond (Tax Credit) shall be determined without regard to the credit allowed under § 54AA(a). Accordingly, issuers should calculate the yield on Build America Bonds (Tax Credit) for purposes of the arbitrage rules by applying the rules contained in § 148 and the regulations thereunder without an adjustment for the tax credit taken by bondholders.

Section 4

Recovery Zone Economic Development Bonds

In General

Section 1400U-2 provides for another type of Build America Bonds known as "Recovery Zone Economic Development Bonds." Recovery Zone Economic Development Bonds are treated as a qualified bond for purposes of § 6431 and provide a deeper Federal subsidy in an amount equal to 45 percent of the total coupon interest. All Recovery Zone Economic Development Bonds are "Direct Payment" bonds.

Similarities to Build America Bonds (Direct Payment)

Recovery Zone Economic Development Bonds under § 1400U-2 are a third type of Build America Bonds. Recovery Zone Economic Development Bonds are comparable to Build America Bonds (Direct Payment), except that they provide for a deeper Federal subsidy through a refundable tax credit paid to State or local governmental issuers in an amount equal to 45 percent (rather than 35 percent) of the total coupon interest payable to investors in the bonds and they have different program requirements regarding eligible uses of proceeds for qualified economic development purposes within recovery zones, as described further below.

Volume Cap

An issuer of Recovery Zone Economic Development Bonds was required to receive an allocation of volume cap in order to issue the bonds. Under § 1400U-1, the annual national recovery zone economic development bond volume cap limitation was $10,000,000,000. The volume cap allocated among the States and counties and large municipalities within the States was based on relative declines in employment in 2008 and more fully described in Notice 2009-50.

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Eligible Uses of Proceeds

Under Section 1400U-2, each Recovery Zone Economic Development Bond must meet the following requirements: (1) the bond is a Build America Bond; (2) the bond must have been issued after February 17, 2009 and before January 1, 2011; (3) 100% of the excess of (i) the available project proceeds (as defined in Section 54A to mean sale proceeds of such issue less not more than two percent of such proceeds used to pay issuance costs plus investment proceeds thereon), over (ii) the amounts in a reasonably required reserve fund (within the meaning of Section 150(a)(3)) with respect to such issue, are to be used for one or more "qualified economic development purposes" (as defined in Section 1400U-2(c)); and (4) the issuer must designate such bond as a Recovery Zone Economic Development Bond.

Qualified Economic Development Purposes

Under § 1400U-2(c), "qualified economic development purposes" are expenditures for purposes of promoting development or other economic activity in a "recovery zone," including — (1) capital expenditures paid or incurred with respect to property located in such recovery zone, (2) expenditures for public infrastructure and construction of public facilities, and (3) expenditures for job training and educational programs.

Recovery Zones

A "recovery zone" is (1) any area designated by the issuer as having significant poverty, unemployment, rate of home foreclosures, or general distress, (2) any area designated by the issuer as economically distressed by reason of the closure or realignment of a military installation pursuant to the Defense Base Closure and Realignment Act of 1990, and (3) any area for which a designation as an empowerment zone or renewal community is in effect. See § 1400U-1(b).

Summary

Review of Lesson 10

This purpose of this lesson was to introduce the student to Build America Bonds:

- All Build America Bonds, including Recovery Zone Economic Development Bonds, were issued between February 17, 2009 and December 31, 2010.
- Issuers of Build America Bonds (Direct Payment) are entitled to receive refundable credit payments directly from the Treasury Department equal to 35 percent of interest on such bonds.
- Proceeds of Build America Bonds (Direct Payment) may only be used to pay costs of issuance, to fund a reasonably required reserve and for capital expenditures.
- Holders of Build America Bonds (Tax Credit) are entitled to tax credits equal to 35 percent of the interest on such bonds, which credits may not exceed tax liability in a tax year, but unused credits may be carried forward to subsequent tax years.
- Proceeds of Build America Bonds (Tax Credit) may be used to pay any costs or for any purposes for which proceeds of tax-exempt governmental bonds may be used.
- Issuers of Recovery Zone Economic Development Bonds are entitled to receive refundable credit payments directly from the Treasury Department equal to 45 percent of interest on such bonds.
- Proceeds of Recovery Zone Economic Development Bonds may be used to pay costs of issuance, to fund a reasonably required reserve and for qualified economic development purposes within designated recovery zones.

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Summary, Continued

Preview of Lesson 11

Lesson 11 discusses private activity bonds as described in § 141. The term "private activity bonds" will be defined and the tests for distinguishing governmental bonds from private activity bonds will be explored. Additionally, lesson 11 will examine those private activity bonds used to finance certain activities that are considered by Congress to be "qualified" private activity bonds, thus permitting exclusion of the interest to holders of the bonds.