Internal Revenue Service Guidance Allows
Issuers to Move Forward with Stimulus Act Bond Provisions

Build America Bonds

The IRS released several pieces of guidance related to the most novel municipal bond provision included in ARRA. Issuers and their counsel had been reluctant to issue the new taxable bond option bonds, named Build America Bonds, without IRS and Treasury guidance.

Build America Bonds are public purpose bonds that the issuer elects to issue as taxable bonds with a federal tax credit. The credit goes either to the bondholder or, if the bonds are issued to finance capital expenditures and the issuer so elects, to the issuer as a "refundable credit." The first type of bonds are Build America Bonds (Tax Credit); the second, Build America Bonds (Direct Payment). The credit for either type of bonds is 35 percent of the interest paid to the bondholders. For example, if a state issued a Build America Bond (Direct Payment) bearing interest at a rate of 10 percent, the state would receive a payment from the Treasury Department in an amount equal to 35 percent of each interest payment, so that the state's net borrowing cost would be only 6.5 percent.

Similar to traditional tax-exempt government bonds, there is no federal volume limitation on the amount of Build America Bonds that can be issued, provided they are issued in 2009 or 2010. Nor is there a cap on the amount that the federal government will make in direct payment subsidies.

Build America Bonds (Tax Credit)

A Build America Bond (Tax Credit) will allow the holder a federal tax credit equal to 35% of the interest payable by the issuer. Original issue discount is not treated as a payment of interest for purposes of determining the credit. The interest will be fully taxable. In enacting the provision for Tax Credit bonds, Congress assumed that the bondholder would be willing to accept a lower interest rate than a conventional, taxable market rate, because the bondholder will take into account the tax credit it will also receive. The credit is allowable only to the extent of tax liability, but it may be carried forward to succeeding taxable years.

Permitted uses of Build America Bonds (Tax Credit)

Build America Bonds (Tax Credit) can be used for the same kinds of financing as tax-exempt governmental financings, such as original new money financing, working capital financing, tax and revenue anticipation notes, tax increment financings, tax assessment bonds, and refundings of taxable or tax-exempt debt, including current refundings and advance refundings (subject to the one advance refunding limitation). Proceeds of the Build America Bonds (Tax Credit) may be used to reimburse expenditures paid before the bonds were issued in the same manner as permitted for tax-exempt bonds under a declaration of official intent.

Proceeds of Build America Bonds (Tax Credit) may be used to fund a reasonably required reserve fund, subject to the limits for tax-exempt bonds determined by reference to maximum annual debt service or average annual debt service, with an overall limit of 10 percent of the proceeds. There are no limits on the costs of issuance paid from bond proceeds.

Build America Bonds (Direct Payment)

Build America Bonds that are "qualified bonds" receive a refundable credit in the form of a direct payment from the federal government to the issuer in lieu of tax credits to the bondholder. A qualified bond is a Build America Bond that is issued before January 1, 2011, proceeds of which are used exclusively for capital expenditures, with some exceptions as discussed below. The Direct Payment bond is expected to provide a deeper subsidy to a state or local government issuer, and the focus of this bond on new money financing for capital expenditures reflects Congressional intent to stimulate spending.

Permitted uses of Build America Bonds (Direct Payment)

The tax rules place more limits on the use of proceeds of Direct Payment bonds than apply to Tax Credit or governmental tax-exempt bonds. First, bond proceeds must be used exclusively for capital expenditures, reserve funds, or costs of issuance, not for refundings. In Notice 2009-26 the IRS clarifies that proceeds can be used to reimburse capital expenditures originally paid with "equity" (funds other than proceeds of a borrowing) and identified in a declaration of official intent adopted before the original expenditure or within 60 days after it. The IRS provided a small measure of relief from the "no refunding rule" in cases where a state or local government issued a note or other obligation after February 17, 2009 (the ARRA enactment date), to finance costs that were paid or incurred after that date.

In a further limitation on uses of funds, an issuer can use up to only 2 percent of the proceeds of a Build America Bond (Direct Payment) to finance issuance costs. The IRS guidance clarifies that the proceeds can be used to only fund a debt service reserve fund, restricted to an amount of up to 10 percent of the bonds.

Recovery Zone Economic Development Bonds

ARRA provides state and local governments with enhanced tools to redevelop areas of economic distress through the issuance of Recovery Zone Economic Development Bonds. Recovery Zone Economic Development Bonds are a special form of Direct Payment bonds. The percentage credit rate, and thus the subsidy payment an issuer can elect to receive from the federal government for Recovery Zone Economic Development Bonds, is 45 percent (versus 35 percent for Build America Bonds) of the interest payable to bondholders. Congress has capped the issuance of Recovery Zone Economic Development Bonds at $10 billion, with allocations to be made to states in proportion to job losses between December 2007 and December 2008. The IRS has not yet announced these allocations.

Permitted Uses of Recovery Zone Economic Development Bonds

State and local governments will be able to use the proceeds of Recovery Zone Economic Development Bonds to finance not only capital expenditures for property in a designated

"Recovery Zone," public infrastructure, and construction of public facilities, but also on working capital expenses for job training and educational programs. Congress has given issuers discretion in designating an area a "Recovery Zone," so long as the issuer finds significant unemployment, poverty, rate of foreclosure, and general distress; the area is a federally designated Empowerment Zone or Renewal Community; or the area is distressed due to military base foreclosures.

Evaluating Options: Tax Credit vs. Direct Payment vs. Traditional Tax-Exempt

In some cases, an issuer may have the ability to finance a specific project with Build America Bonds (Tax Credit), Build America Bonds (Direct Payment), or traditional tax-exempt bonds. All three options would be available for new money capital financings, but the Build America Bonds (Direct Payment) and Recovery Zone Economic Development Bonds would not be an option if the purpose of the bond issue included refunding of prior debt or payment of general working capital expenses of the issuer. With the release of the IRS guidance, issuers are seeking comparisons of the options for coming bond issuances.

Generally, a state or local government will receive a greater subsidy with a Direct Payment bond than with a Tax Credit bond. In part, the greater subsidy for Direct Payment bonds results from the fact that the 35 percent of credit rate is applied to the entire amount of a conventional market payment, whereas with a Tax Credit bond, the 35 percent rate is applied only to the reduced interest payment the bondholder will accept in anticipation of realizing the rest of a market rate return through claiming the credit.

Direct Payment bonds can give the issuer the ability to sell its debt to a broader market, providing state and local governments with access to conventional corporate debt markets. Build America Bonds (Direct Payment) should be attractive to investors who may not have been interested in tax-exempt income or a tax credit, given their exemption from federal income taxes, such as pension funds, tax-exempt investors, and foreign investors.

ARRA opened one further option for market access for state and local governments. The statute provides that the tax credit portion of the Build America Bonds (Tax Credit) may be stripped from the principal portion under regulations to be issued by the IRS. The April 3, 2009, notice from the IRS does not provide that guidance but solicits comments on that specific feature to facilitate access to that market. There is a similar authorization, also to be made pursuant to Treasury regulations, for the other forms of tax credit bonds (QZABS, QSCBs, New CREBS, etc.).

Election to issue Build America Bonds or Recovery Zone Economic Development Bonds

Regardless of the type of Build America Bonds to be issued, the issuer must make an affirmative election to issue Build America Bonds or Recovery Zone Economic Development Bonds. The recent IRS guidance states that the issuer should make the election on its "books and records." This requirement should be readily met by putting designation language in the issuer's resolution, indenture, or the bond itself. These elections must be made at issuance and are irrevocable.

Issuers opting to issue Build America Bonds (Direct Payment) or Recovery Zone Economic Development Bonds will need to make a second, separate election to receive the interest subsidy payment from the federal government. The election to issue bonds as Build America Bonds (Tax Credit) can be made for any state or local governmental bonds, other than private activity bonds, if the bond interest would have been excludable from gross income but for the election. The further election to issue the bonds as Build America Bonds (Direct Payment) is allowable only for bonds for capital expenditures (plus reserves and issuance costs), as discussed above. Issuers can make both forms of election on their books and records, subject to updated IRS reporting forms or procedures.

Form 8038-CP - Procedures for receiving federal interest subsidy for Build America Bonds (Direct Payment) and Recovery Zone Economic Development Bonds

The IRS has provided temporary procedures for receiving the subsidy payment for 2009. Although the IRS is accustomed to making refund payments to taxpayers, the statutory characterization of the payments to the issuers of the Direct Payment bonds as a “refundable credit” will require the IRS to take on a rather large, novel role. The IRS has provided procedures for 2009 that will require paperwork from issuers, but the IRS has stated its intention to move to an electronic platform in the future.

New IRS Form 8038-CP is provided for issuers of Direct Payment bonds to claim the federal payments. For fixed-rate bonds, Form 8038-CP must be submitted between 90 and 45 days before the interest payment date At least for 2009, a new form must be filed for each interest payment. The 90-day rule will prevent issuers from being able to file at one time for all future semi-annual payments. Issuers should expect to receive payment within 45 days, thus facilitating timely interest payments to bondholders.

For variable-rate bonds, the issuer is to file Form 8038-CP within 45 days after the last interest payment date of each calendar quarter to receive a single payment covering all the interest payments in the quarter. A separate Form 8038-CP is to be used for each bond issue, whether fixed rate or variable rate. An issuer will be required to file for each interest payment date or quarterly in the case of variable-rate payments.

An issuer can direct payments to itself or to an entity designated to receive the payments on its behalf, such as a trustee or paying agent. Issuers will need to determine the appropriate party, depending in part on whether the payment will be received in time to pay the bondholder, as would be possible with fixed-rate bonds, or received in arrears after the issuer or a credit enhancer has already made the payment to the bondholders.

Form 8038-CP and Notice 2009-26 are designed to implement the statutory characterization of the direct payments as “refundable tax credits.” The direct payments will, of course, be made even though this interest payment does not arise from any issuer tax liability, as a consequence of providing for them as “refundable.” If the government makes a late payment, the issuer would receive interest on those late payments, as with other tax refunds. As with other refund payments, the issuer’s right to the payments can apparently be offset against other payments owed to the federal government and other federal tax payments due from the issuer, such as payroll tax obligations. It is unclear whether offsets would be made if the issuer designated payment to a trustee or paying agent. Form 8038-CP provides for adjusting previous over- or underpayments of the credits in conjunction with the current credit payment to be received.

Future refinement of direct payment procedures and invitation for comments

Notice 2009-26 states that the IRS and Treasury are actively pursuing use of an electronic payment platform similar to that available to state and local governments when they subscribe for U.S. Treasury Securities - State and Local Government Series (SLGS). The IRS has been focused on how it can ensure that payments are made with respect to bond issues that qualify for the direct payments. The IRS notes that any electronic platform would need to include periodic information returns for the bonds at least annually. A post-issuance filing requirement for state and local governments is a departure from requirements associated with tax-exempt bonds, but this ice has already been broken by the requirement for quarterly filings of Form 8038-CP.

The IRS and Treasury have invited comments on the direct payment procedures, including specifically what features should be included in an electronic platform, whether the IRS should provide for uniform interest payments dates (e.g., quarterly) that might not coincide with the interest payment dates for a particular bond issue, whether variable-rate bond payments should be paid on a different frequency, and whether payments should be made solely to issuers and not designated third parties to simplify the process. No deadline is given for submission of comments.

Information reporting requirements at issuance

In keeping the governmental nature of the Build America Bonds and Recovery Zone Economic Development Bonds, each of these bonds will be reported on Form 8038-G. Notice 2009-26 provides instructions on how to mark up the existing Form 8038-G to accommodate these new bond types. Generally, the issuer will check the “Other” box for the type of issuance and state which type of bond -- Build America Bonds (Tax Credit), Build America Bonds (“payment option”), or Recovery Zone Economic Development Bonds (“payment option”). Form 8038-CP uses a different terminology of “payment option” from the term “direct payment” used by the IRS in the notices. In addition, the issuer will now be required to attach a schedule to provide information on the nature of the expenditure, using the such existing categories as “education,” “transportation,” and so on.

Further requirements must be met if the issuer is electing Direct Payment Build America Bonds or Recovery Zone Economic Development Bonds. First, the time for filing is accelerated. Normally, Form 8038-G is to be filed within 45 days of the calendar quarter in which the tax-exempt bond is issued. To file for payment, Form 8038-G must be filed at least 30 days before any claim for credit payments on Form 8038-CP is submitted to the IRS (an exception exists for bonds issued before July 1, 2009).

Secondly, the issuer must attach a debt service schedule. For fixed-rate bonds, the schedule is to include a list of each payment date and, as of each interest payment date, the total interest payable, total principal amount expected to be outstanding, and the credit payment expected to be requested from the IRS, and, finally, the earliest date that bonds can be called for redemption. For variable-rate bonds, the schedule is to list each payment date, the total principal amount expected to be outstanding on each of those dates, and a description of how interest on the bonds is computed.

Financing Public Schools - Tax Credit Bond Allocations

Build America Bonds can be used to finance public schools, but ARRA also provides for school financing through two tax credit bonds: Qualified Zone Academy Bonds (QZABs) and a new category, Qualified School Construction Bonds. These two categories share several requirements and each is subject to volume limits (and maturity limits,) unlike Build America Bonds. On April 3, 2009, the IRS provided allocations for each of these bond categories.

Notice 2009-30 divides the national bond volume cap among the states based on poverty level for Qualified Zone Academy Bonds. The federal statute leaves it to the state to determine how its allocation will be allocated within the state. The total national cap for 2008 was $400 million, which is increased to $1.4 billion for 2009. Unused allocation can be carried forward for two years.

For Qualified School Construction Bonds, Notice 2009-35 divides the $11 billion national bond volume cap for 2009 among the states and the 100 largest school districts based on federal school funding for calendar year 2009. Forty percent of the $11 billion was allocated to the 100 largest school districts for 2009. The U.S. Secretary of Education declined to use his ability to select an additional 25 large local education agencies to share in the local allocation. The remaining 60 percent is allocated to the states and territories, with the states to make further allocations within each state.

The Secretary of the Interior has not announced the allocation of the $200 million volume cap for 2009 set aside for Indian schools under the Bureau of Indian Affairs.

General rules applicable to Tax Credit Bonds for Public Schools

For both the QZABs and Qualified School Construction Bonds, the issuer generally will be required to pay back the principal amount of the bond only. The return to the holder is not interest but a credit against federal tax liability -- both regular tax and AMT. The credit rate and the maximum maturity of these tax credit bonds are established by the Treasury Department, not by the market, as is the case for the Build America Bonds. The rates, maturity, and sinking fund restricted rate are all published daily by the Bureau of Public Debt at www.treasurydirect.gov. Unlike with the Build America Bonds, there is no election for the issuer to receive a direct payment from the federal government. In a change from prior QZAB law, there is no restriction on the type of entity that can be a bondholder. The credits can be passed through and stripped in the same manner as Build America Bonds. Unused credits can be carried forward indefinitely by the holder.

Tax credit bonds are generally subject to arbitrage rebate, but there are several exceptions that essentially permit the issuer to keep its arbitrage if various tests are met. The issuer must spend 100 percent of the bond proceeds, including investment earnings, within three years of the issue date or use any unspent proceeds to redeem bonds. The IRS can extend the three-year period. An issuer can establish a “sinking fund” that accumulates money to pay principal at maturity without having to rebate all the earnings to the federal government, provided the sinking fund is funded no more rapidly than equal installments calculated to build up, with earnings invested at a yield not in excess of the published maximum, to the amount due at maturity.

The amount of proceeds that can be used to pay costs of issuance is limited to 2 percent. Unlike Build America Bonds, no sale proceeds can be used to fund a debt service reserve fund. Both tax credit bonds must be used for elementary and secondary public schools, which generally includes charter schools, and it appears as though the school is not prohibited from having private business use of the facilities, such as a nonqualifying management contract. Davis-Bacon labor standards, requiring generally that prevailing wages must be paid on public works projects, apply to both QZABs and Qualified School Construction Bonds.

Permitted uses of Qualified Zone Academy Bonds

Qualified Zone Academy Bonds can be used to finance renovations and equipment purchases, develop course materials, and train teachers and other personnel at public schools designed to cooperate with businesses to enhance the academic curriculum and increase graduation and employment rates. Public schools are eligible if located in a federally designated Empowerment Zone or Enterprise Community or if at least 35 percent of students enrolled are eligible for free or reduced-priced school lunches. In addition, the school must have written commitments for a 10 percent match from private businesses. Use of proceeds to reimburse qualifying expenditures is permitted, provided reimbursements are made within 18 months of the date the original expenditure is paid.

Permitted Uses of Qualified School Construction Bonds

Qualified School Construction Bonds are new tax credit bonds that can be used for new construction, rehabilitation or repair of public school facilities, the acquisition of land on which a public school facility will be constructed, and equipment. The public school facilities to be financed must be located within the jurisdiction of the issuer and that of the large educational agency that allocates the Qualified School Construction Bond volume cap. Reimbursements must be made within 18 months of the date the original expenditure is paid.

Tax Credit Bonds for Energy Projects

The IRS has provided guidance on the allocation of volume cap for two tax credit bonds available for energy conservation and development of alternative energy sources. In the case of Qualified Energy Conservation Bonds, the IRS provided the allocations to states. For the Clean Renewable Energy Bonds, the IRS provided the procedures for applying for an allocation.

Notice 2009-29 allocates the $3.2 billion volume cap for QECBs among the states. Each state must further reallocate a portion of its volume cap to each large local government, meaning counties and municipalities, with populations of 100,000 or more. In making these required reallocations to large local governments, states must use U.S. Census Bureau population figures released between July 1, 2007, and December 31, 2008. An eligible issuer may issue the Qualified Energy Conservation Bonds based on its own volume cap allocation, or by allocation received through a conduit borrower or other ultimate beneficiary of the tax credit bond issue.

These two tax credit bonds are subject to the same general provisions described above for the school bonds relating to maturity, sinking fund yield restriction, spending schedule, and arbitrage rules, though the tax credit rate will be 70 percent of the published rate. With the reduced credit rate, these energy bonds are likely to be sold at a discount or with supplemental interest coupons.

Permitted Uses of Qualified Energy Conservation Bonds

Proceeds of QECBs must be used for "qualified conservation purposes." Such purposes include a wide range of capital expenditures (such as those incurred for reducing energy use in publicly owned buildings, implementing green community programs, and rural development involving the production of electricity from renewable energy resources) and expenditures with respect to research facilities and grants. Qualified conservation purposes also include certain mass-commuting facilities, demonstration projects, and public education campaigns to promote energy efficiency. For example, proceeds of a Qualified Energy Conservation Bond could be used by a state and local governments to fund grants or revolving loan funds that assist residents and businesses in weatherizing buildings.

An issuer may use up to 30 percent of its allocation for projects that involve a private business. Thus, an issuer can make a direct loan to a private business for any of the qualified purposes. If the issuer makes a loan to a private business to implement a green community program, that loan is not treated as part of the 30 percent private use allocation.

New Clean Renewable Energy Bonds

In Notice 2009-33, the IRS solicits applications for allocations of New Clean Renewable Energy Bonds (New CREBs). Applications must be filed with the IRS by August 4, 2009. Generally, each application must (a) identify the public power provider, governmental body, or cooperative electric company expected to own the qualified renewable energy facility; (b) describe the qualified renewable energy facility constituting the project being financed; (c) describe the amount of CREB volume cap previously allocated to each project and any "related projects" (projects owned by the same entity); (d) list the project location; (e) describe the plan to obtain all necessary federal, state, and local regulatory approvals for the project; (f) contain a detailed description of the financing plan for the project; and (g) specify the dollar amount of the volume cap request for the project.

Once applications are received, the IRS will make the allocation. By statute, New CREBs are to be allocated one-third to state, local, and tribal governments; one-third to public power providers; and one-third to cooperative electric companies. As required by the statute, the IRS will allocate volume cap among the public power applicants based on the proportion of an applicant's request to the total amount requested by all public power applicants. The IRS announced that it will allocate the volume cap among the state, local, and tribal governments and the cooperative electric companies by beginning with the project for which the smallest dollar amount of volume cap has been requested and continuing until the total amount of volume cap set aside for that category of qualified owners has been exhausted or until all applications for that category of qualified owners have been granted, whichever occurs first.

Once allocated, the bonds must be issued within three years.

Permitted Uses of New CREBs

The proceeds of New CREBs can be used by governmental bodies, public power providers, or cooperative electric companies for capital expenditures incurred on one or more qualified renewable energy facilities, including wind, closed-loop biomass, open-loop biomass, solar or geothermal, trash combustion, small irrigation power, landfill gas, and marine and hydrokinetic renewable energy facilities. An issuer can finance its portion of a qualifying facility jointly owned with an investor-owned utility or other entity that is not otherwise permitted to apply for an allocation of CREBs.

Contact our Public Finance Team

ARRA provides a tremendous amount of opportunity for state and local governments, particularly when it is used strategically to complement or leverage other resources its makes available. We are here to answer questions and to provide advice on these important provisions as you figure out how best to take advantage of these opportunities.