

Part III - Administrative, Procedural and Miscellaneous

Build America Bonds and Direct Payment Subsidy Implementation

Notice 2009-26

SECTION 1. PURPOSE

This Notice provides guidance on the new Build America Bonds under § 54AA of the Internal Revenue Code (“Code”) and the implementation plans for the refundable credit payment procedures for these bonds. This Notice includes guidance on the modified Build America Bond program for Recovery Zone Economic Development Bonds under § 1400U-2 of the Code. This Notice provides guidance on the initial refundable credit payment procedures, required elections, and information reporting. This Notice solicits public comments on the refundable credit payment procedures for these bonds. This Notice is intended to facilitate prompt implementation of the Build America Bond program and to enable state and local governments to begin issuing these bonds for authorized purposes to promote economic recovery and job creation.

SECTION 2. RELEVANT PROVISIONS

2.1 Introduction.

Section 1531 of Title I of Division B of the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009) (enacted February 17, 2009) (“ARRA”), added § 54AA to the Code, authorizing state and local governments, at their option, to issue two general types of Build America Bonds as taxable governmental bonds with Federal subsidies for a portion of their borrowing costs. The subsidies take the form of either tax credits provided to holders of the bonds or refundable tax credits paid to state and local governmental issuers of the bonds. Build America Bonds have different levels of Federal subsidies and program requirements depending on the particular type of bond.

The first type of Build America Bond provides 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 taxable governmental bonds (net of the tax credit), which represents a Federal subsidy to the state or local governmental issuer equal to approximately 25 percent of the total return to the investor (including the coupon interest paid by the issuer and the tax credit). This type of Build America Bond will be referred to in this Notice as “Build America Bonds (Tax Credit).”

The second type of Build America Bond provides a Federal subsidy through a refundable tax credit paid to state or local governmental issuers by the Treasury Department and the Internal Revenue Service (“IRS”) in an amount equal to 35 percent

of the total coupon interest payable to investors in these taxable bonds. This type of Build America Bond will be referred to in this Notice as “Build America Bonds (Direct Payment).” The level of the 35 percent Federal interest subsidy on Build America Bonds (Direct Payment) is deeper than the corresponding approximately 25 percent Federal interest subsidy on Build America Bonds (Tax Credit).

In addition, § 1401 of ARRA, which added § 1400U-2 of the Code, provides for a third type of Build America Bond (Direct Payment) known as “Recovery Zone Economic Development Bonds,” which provides for a deeper Federal subsidy through a refundable tax credit paid to state or local governmental issuers in an amount equal to 45 percent of the total coupon interest payable to investors in these taxable bonds. This type of Build America Bond will be referred to in this Notice as “Recovery Zone Economic Development Bonds (Direct Payment).”

2.2 Build America Bonds (Tax Credit).

Section 54AA(d) defines the term Build America Bond to mean any 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 (but for § 54AA) be 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.

In general, 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 (“tax-exempt governmental bonds”) 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. Similarly, Build America Bonds (Tax Credit) may not be issued for any purposes for which tax-exempt governmental bonds could not be issued under § 103 (e.g., prohibited second advance refunding issues or pension annuity issues).

Section 54AA(a) provides that if a taxpayer holds a Build America Bond 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 § 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 is 35 percent of the amount of interest payable by the issuer with respect to such date. Section 54AA(e) provides that the term “interest payment date” means any date on which the holder of record of the Build America Bond is entitled to a payment of interest under such bond. Accordingly, 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. See H. R. Conf.

Rep. 111-16, 111th Cong., 1st Sess. (February 12, 2009) (“ARRA Conference Report”) at 594; see also *id.* at 593, n. 146 (original issue discount is not treated as a payment of interest for purposes of determining the credit).

Section 54AA(c)(1) provides that the credit allowed under § 54AA(a) 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. See ARRA Conference Report at 593.

Section 54AA(d)(2)(A) provides that, 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 under §§ 54AA(a) or § 6431.

Section 54AA(d)(2)(B) provides that, for purposes of applying the arbitrage restrictions under § 148, the yield on a Build America Bond 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. See ARRA Conference Report at 593.

Section 54AA(d)(2)(C) provides that a bond shall not be treated as a Build America Bond if the issue price has 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 bond. See ARRA Conference Report at 593. This restriction applies to both Build America Bonds (Tax Credit) and Build America Bonds (Direct Payment).

Section 54AA(f)(1) provides that, for purposes of the Code, interest on any Build America Bond shall be includible in gross income. 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). Briefly, the referenced provisions under § 54A treat credits as interest includable in gross income, provide special rules for S corporations and partnerships, provide special rules for regulated investment companies and real estate investment trusts, and authorize the Department of the Treasury to promulgate regulations to allow for “stripping” (which is the separation of the ownership of these bonds and the associated tax credits under principles based on § 1286).

Section 54AA(h) grants to the Department of the Treasury broad regulatory authority to prescribe such regulations and other guidance as may be necessary or

appropriate to carry out the provisions for Build America Bonds under § 54AA and the refundable credit provisions for these bonds under § 6431.

2.3 Build America Bonds (Direct Payment).

Section 54AA(g) authorizes Build America Bonds (Direct Payment) that meet the definition of “qualified bonds” to receive a refundable credit under § 6431 in lieu of tax credits under § 54AA and imposes different program requirements. Section 54AA(g)(2) defines the term “qualified bond” to mean a bond that is issued as part of an issue that meets the following requirements: (1) the bond is a Build America Bond; (2) the bond is issued before January 1, 2011; (3) 100 percent of the excess of (i) the available project proceeds (as defined in § 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 § 150(a)(3)) with respect to such issue, are to be used for capital expenditures; and (4) the issuer makes an irrevocable election to have this subsection apply.

In determining a reasonably required reserve fund for purposes of this provision, the rules under § 148(d)(2) apply. Accordingly, a Build America Bond (Direct Payment) will be an arbitrage bond if the amount of the sale proceeds of such an issue that is part of any reserve or replacement fund exceeds 10 percent of the proceeds. As such, the interest on such bond would not be tax-exempt under § 103 and thus would not be a qualified bond for purposes of this provision. ARRA Conference Report at 596, n. 150.

The eligible uses of proceeds and types of financing for Build America Bonds (Direct Payment) are more limited than for Build America Bonds (Tax Credit). In general, Build America Bonds (Direct Payment) may be issued to finance governmental purposes for which tax-exempt governmental bonds (excluding private activity bonds under § 141) could be issued under § 103, but – pursuant to § 54AA(g)(2)(A) – the excess of available project proceeds over amounts in a reasonably required reserve fund may be used to finance only capital expenditures (as defined in Treas. Reg. § 1.150-1(b)), as contrasted with working capital expenditures. See ARRA Conference Report at 594, n. 147. For this purpose, an eligible financing of capital expenditures includes a reimbursement of capital expenditures under the reimbursement rules contained in Treas. Reg. § 1.150-2. By contrast, Build America Bonds (Direct Payment) generally may not be issued to refinance capital expenditures in “refunding issues” (as defined in Treas. Reg. § 1.150-1). Further, for this purpose, 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 the effective date of ARRA, and such reimbursement will not be treated as a refunding issue under Treas. Reg. §§ 1.150-1(d) or 1.150-2(g).

Section 6431(a) provides that, for Build America Bonds (Direct Payment) issued before January 1, 2011, the issuer of such bond shall be allowed a credit with respect to

each interest payment under such bond which shall be payable by the Secretary. Section § 6431(b) provides that the Department of the Treasury shall pay (contemporaneously with each interest payment date under such bond) to the issuer of such bond (or to any person who makes such interest payments on behalf of the issuer) 35 percent of the interest payable under such bond on such date. Section 6431(d) provides that the term “interest payment date” means each date on which interest is payable by the issuer under the terms of bonds. The ARRA Conference Report indicates that the payment by the Secretary is to be made either in advance or as reimbursement. ARRA Conference Report at 595.

The amount of refundable credit that a state or local governmental 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 (or 45 percent in the case of Recovery Zone Economic Development Bonds (Direct Payment)). See ARRA Conference Report at 594 and n. 148 (original issue discount is not treated as a payment of interest for purposes of calculating the refundable credit under this provision).

Section 6431(c) states that for purposes of the arbitrage investment restrictions under § 148, the yield on Build America Bonds (Direct Payment) is reduced by the credit allowed under this section. Accordingly, 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 § 6431. See ARRA Conference Report at 595.

2.4 Recovery Zone Economic Development Bonds (Direct Payment).

Section 1401 of ARRA added § 1400U-2 to the Code to authorize state and local governments to issue Recovery Zone Economic Development Bonds (Direct Payment). These bonds are treated as qualified bonds for purposes of § 6431 and they have a deeper refundable credit subsidy than Build America Bonds (Direct Payment) equal to 45 percent of the total coupon interest payable to investors in these taxable bonds.

In particular, § 1400U-2(b) defines the term “recovery zone economic development bond” to mean a bond that is issued as part of an issue that meets the following requirements: (1) the bond is a Build America Bond; (2) the bond is issued before January 1, 2011; (3) 100 percent of the excess of (i) the available project proceeds (as defined in § 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 § 150(a)(3)) with respect to such issue, are to be used for one or more “qualified economic development purposes” (as defined in § 1400U-2(c)); and (4) the issuer designates such bond for this purpose.

The Treasury Department and the IRS expect to issue separate guidance on Recovery Zone Economic Development Bonds (Direct Payment), including guidance on the allocation of the \$10 billion national bond volume cap for these bonds under § 1400U-1.

SECTION 3. SCOPE AND APPLICATION OF REFUNDABLE CREDIT PROCEDURES FOR BUILD AMERICA BONDS

3.1 Refundable Credit Implementation Plans for 2009.

(a) In General. The IRS and the Treasury Department plan to implement the initial refundable credit payment procedures for 2009 for Build America Bonds (Direct Payment) and Recovery Zone Economic Development Bonds (Direct Payment) as promptly as possible to enable state and local governments to begin issuing these bonds for authorized purposes to promote economic recovery and job creation. The IRS and the Treasury Department expect that an IRS form for requesting the Federal share of interest on these bonds, new IRS "Form 8038-CP, *Return for Credit Payments to Issuers of Qualified Bonds*," will be available on the IRS website on or about the date of release of this Notice. The IRS will be prepared to accept such forms for processing by May 1, 2009, and the IRS and Treasury Department will be prepared to make timely payments with respect to interest payment dates beginning on or after July 1, 2009, as further described below.

In particular, the initial refundable credit procedures will require an issuer to submit a Form 8038-CP to request payment of the amount of the credit within a prescribed time before or after each applicable interest payment date, depending on whether the bonds are fixed rate bonds or variable rate bonds, as described below. Issuers should expect to receive requested payments within 45 days of the date that a processible Form 8038-CP is filed with the IRS. See § 6611(g).

When credit payments are made, the IRS will send the payments to the requested recipient's "last known address," as that phrase is defined and determined under Treas. Reg. § 301.6212-2 and Rev. Proc. 2001-18, 2001-1 C.B. IV, or any successor guidance. In the case of credit payments sent to a person other than the issuer, the last known address may not be the address the issuer provided on the Form 8038-CP. The instructions to the Form 8038-CP will provide instructions on how an issuer or trustee can verify and update the address of record.

(b) Fixed Rate Bonds. In general, for fixed rate bonds, upon receipt of a timely filed Form 8038-CP requesting payment of the credit, such amount will be paid on a contemporaneous basis by the applicable interest payment date. For fixed rate bonds, the due date for an issuer to file a Form 8038-CP, *Return for Credit Payments to Issuers of Qualified Bonds*, is the 45th day before the applicable interest payment date with respect to the bonds. This return, however, may not be filed earlier than the 90th day before the relevant interest payment date.

(c) Variable Rate Bonds. In general, for variable rate bonds, 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 bonds, the due date for an issuer to file a Form 8038-CP, *Return for Credit Payments to Issuers of Qualified Bonds*, is the 45th day after the last interest payment date within the quarterly period for which reimbursement is requested.

3.2 Future Development and Refinement of Refundable Credit Payment Procedures.

The IRS and the Treasury Department plan to actively pursue refining the refundable credit payment procedures for Build America Bonds (Direct Payment) and Recovery Zone Economic Development Bonds (Direct Payment) for 2010 and thereafter to achieve as workable and efficient a system as possible that is consistent with all necessary and appropriate compliance safeguards. In this regard, the IRS and the Treasury Department plan to study the feasibility of moving these direct payment procedures to an electronic platform similar to that used by the Bureau of Public Debt to make recurring electronic payments on U.S. Treasury securities, such as U.S. Treasury Securities of the State and Local Government Series (“SLGs”) with which state and local governments are familiar. The IRS and the Treasury Department expect that any development or usage of an electronic platform for these direct payment procedures will include ongoing compliance safeguards that involve periodic information returns on these bonds at least annually.

3.3 Tax Character and Procedural Framework for the Refundable Credit.

In general, the refundable credits for Build America Bonds under § 6431 are payments that are treated as overpayments of tax. In this regard, § 1531(c)(5) of ARRA adds a reference to Build America Bond provisions under § 6431 as a conforming amendment to § 6401(b)(1) regarding amounts treated as overpayments. Similarly, § 1531(c)(4) of ARRA adds a reference to the provisions under § 6431 to § 6211(b)(4)(A) regarding treatment of erroneous payments of credits as negative amounts of tax or deficiencies. Accordingly, 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 also apply to credit payments with respect to Build America Bonds under § 6431. Pursuant to the broad legislative regulatory authority under § 54AA(h) to prescribe such regulations and other guidance as may be necessary or appropriate to carry out the Build America Bond provisions under § 54AA and the refundable credit provisions under § 6431, the IRS and the Treasury Department will consider the potential need to develop any special rules to adapt or tailor the procedural framework implementing these provisions.

SECTION 4. ELECTIONS TO ISSUE BUILD AMERICA BONDS

Subject to updated IRS reporting forms or procedures, an issuer of Build America Bonds (Tax Credit), Build America Bonds (Direct Payment), and Recovery Zone Economic Development Bonds (Direct Payment) should make the elections required by §§ 54AA(d) or (g) to issue the applicable bonds on its books and records on or before the issue date of such bonds.

SECTION 5. INFORMATION REPORTING FOR BUILD AMERICA BONDS

5.1 Build America Bonds (Tax Credit).

Subject to updated IRS information reporting forms or procedures, an issuer of Build America Bonds (Tax Credit) must report the issuance of the bonds on IRS Form 8038-G, *Information Return for Tax-Exempt Governmental Obligations*. Issuers of these bonds with an issue price of less than \$100,000 should file a Form 8038-G in accordance with the instructions contained in this Notice instead of filing an IRS Form 8038-GC, *Information Return for Small Tax-Exempt Governmental Bond Issues, Leases and Installment Sales*. Issuers should check Line 18, "Other", on the form and insert "Build America Bond (tax credit)" on the line provided. Issuers must attach a separate schedule that indicates the type of bond issue that would normally be entered on Lines 11 to 18, i.e., education, health and hospital, transportation, public safety, environment (including sewage bonds), housing, utilities or other (with description for "other" category).

5.2 Build America Bonds (Direct Payment) and Recovery Zone Economic Development Bonds (Direct Payment).

Subject to updated IRS information reporting forms or procedures, an issuer of Build America Bonds (Direct Payment) or Recovery Zone Economic Development Bonds (Direct Payment) must report the issuance of the bonds on IRS Form 8038-G, *Information Return for Tax-Exempt Governmental Obligations*. The Form 8038-G with respect to an issue must be filed with the IRS at least 30 days before the first Form 8038-CP is filed to request payment with respect to an interest payment date for that issue, except that, for bonds issued before July 1, 2009 only, such Form 8038-G may be filed less than 30 days before the filing of the first Form 8038-CP provided the form 8038-G is filed separately from and prior to the filing of Form 8038-CP. Issuers should not attach a Form 8038-G to a Form 8038-CP. Issuers of these bonds with an issue price of less than \$100,000 should file a Form 8038-G in accordance with the instructions contained in this Notice instead of filing a Form 8038-GC, *Information Return for Small Tax-Exempt Governmental Bond Issues, Leases and Installment Sales*.

An issuer of Build America Bonds (Direct Payment) must check Line 18, "Other", on the form and insert "Build America Bond (payment option)" on the line provided. An issuer of Recovery Zone Economic Development Bonds (Direct Payment) must check

Line 18, "Other", on the form and insert "Recovery Zone Economic Development Bond (payment option)" on the line provided. Issuers must attach a separate schedule that indicates the type of bond issue that would normally be entered on Lines 11 to 18, i.e., education, health and hospital, transportation, public safety, environment (including sewage bonds), housing, utilities or other (with description for "other" category).

In addition, issuers of these bonds must attach a schedule to the Form 8038-G which contains the information described below for the bond issue.

(1) For fixed-rate bonds, attach a complete debt service schedule, titled "Fixed Rate Bond – Debt Service Schedule," that provides a list of each interest payment date, the total interest payable on such date, the total principal amount of bonds expected to be outstanding on such date, the credit payment expected to be requested from the IRS on such date, and the earliest date that bonds can be called.

(2) For variable rate bonds, attach a debt service schedule, titled "Variable Rate Bond – Debt Service Schedule," that provides a list of each interest payment date, the total principal amount of bonds expected to be outstanding on such date, and a description of how interest on the bonds is computed.

SECTION 6. REQUEST FOR COMMENTS

The IRS and the Treasury Department solicit public comment on all aspects of the direct payment procedures for Build America Bonds, including, without limitation, 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 these payments. The IRS and the Treasury Department solicit specific public comment on the following aspects of these direct payment procedures: (1) whether consideration should be given to employing an electronic platform to make these payments similar to that used for SLGs and what particular features would be important to making such a platform workable; (2) whether consideration should be given to a different frequency or approach to the payment of variable rate bonds; (3) whether consideration should be given to making these direct payments solely to issuers, rather than including third parties designated by issuers, to simplify the process; and (4) whether consideration should be given to imposing uniform interest payment dates (e.g., quarterly on January 1, April 1, July 1, and October 1) to improve the efficiency of the program.

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 Office of Associate Chief Counsel (Financial Institutions and Products), Re: Notice 2009-26, CC:FIP:B5, Room 3547, 1111 Constitution Avenue, NW, Washington DC 20224. Comments that are submitted will be made available to the public.

SECTION 7. EFFECTIVE DATE

The effective date of this Notice is April 3, 2009. This Notice provides interim guidance. This Notice applies to Build America Bonds, including Recovery Zone Economic Development Bonds, issued after February 17, 2009.

SECTION 8. PAPERWORK REDUCTION ACT

The information collection contained in this Notice has been approved by the Office of Management and Budget (OMB) in accordance with the Paperwork Reduction Act (44 U.S.C. chapter 35) under control number 1545-2143. Under the Paperwork Reduction Act, an agency may not conduct or sponsor and a person is not required to respond to a collection of information unless it displays a valid OMB control number.

The collections of information in this Notice are in Section 5. The information is required in order to inform the Treasury Department and the IRS of expected future direct payments on Build America Bonds. This information will be used to determine the expected amount of future direct payments on Build America Bonds. The collections of information are mandatory. The likely respondents are state or local governmental issuers of Build America Bonds.

We estimate the total number of respondents to be 1,000 and the total annual responses to be 5,000. We estimate it will take 3 hours to comply. Estimates of the annualized cost to respondents for the hour burdens shown are not available at this time.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and return information are confidential, as required by 26 U.S.C. 6103.

SECTION 9. DRAFTING INFORMATION

The principal authors of this Notice are Carla Young and Timothy Jones of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this Notice, contact Ms. Young or Mr. Jones at (202) 622-3980.