

John Trofa,
Practice Group Leader
trofa@chapman.com
312.845.3777

Andrea G. Bacon
bacon@chapman.com
312.845.3817

Ryan D. Bjerke
bjerke@chapman.com
801.536.1426

Nancy A. Burke
burke@chapman.com
312.845.2953

James C. Burr
burr@chapman.com
801.536.1447

Rose E. Gallagher
gallaghe@chapman.com
312.845.3732

H. Craig Hall
hall@chapman.com
801.536.1414

Eric T. Hunter
ehunter@chapman.com
801.536.1441

Charles L. Jarik
jarik@chapman.com
312.845.3795

Buzz Larsen
larsen@chapman.com
312.845.3473

William M. Libit
libit@chapman.com
312.845.2981

James E. Luebchow
luebchow@chapman.com
312.845.3726

Robert W. Ollis, Jr.
ollis@chapman.com
312.845.3806

Gisele Rainer
rainer@chapman.com
415.278.9050

Richard J. Scott
scott@chapman.com
801.536.1401

Christopher F. Walrath
walrath@chapman.com
312.845.3483

Recent IRS Notice – Direct Payment Subsidy Option for Certain Qualified Tax Credit Bonds and Build America Bonds

On April 26, 2010, the Internal Revenue Service (the “IRS”) released Notice 2010-35, Direct Payment Subsidy Option for Certain Qualified Tax Credit Bonds and Build America Bonds (the “Notice”). The Notice applies to bonds issued after March 18, 2010 and may be relied upon by issuers and taxpayers pending the promulgation and effective date of future administrative or regulatory guidance. The Notice provides guidance related to certain qualified tax credit bonds, direct pay build America bonds and recovery zone economic development bonds.

I. Certain Qualified Tax Credit Bonds

The Notice provides, among other things, the following guidance relating to (i) information reporting for direct pay tax credit bonds, including direct pay tax credit bonds authorized under the Hiring Incentives to Restore Employment (HIRE) Act, and “pure” tax credit bonds (*i.e.*, tax credit bonds that provide tax credits to owners of the bonds), (ii) subsidy payment procedures for direct pay tax credit bonds and (iii) reimbursements using proceeds of direct pay tax credit bonds:

Information Reporting For Tax Credit Bonds

- The Notice states the IRS intends to publish on or before June 25, 2010, new IRS Form 8038-TC, Information Return for Tax Credit Bonds and Specified Tax Credit Bonds. This form applies to both direct pay tax credit bonds and “pure” tax credit bonds.
- For direct pay tax credit bonds, Form 8038-TC must be filed with the IRS at least 30 days before the first Form 8038-CP is filed to request the subsidy payment for an interest payment date for that issue. For direct pay tax credit bonds with interest payment dates prior to September 1, 2010, the form may be filed less than 30 days before filing the first Form 8038-CP (discussed further below). A debt service schedule is to be attached to the Form 8038-TC for both fixed rate and variable rate bonds.

Subsidy Payment Procedures for Direct Pay Tax Credit Bonds

- The Notice states that the IRS intends to publish on or before June 25, 2010, a revised Form 8038-CP, Return for Credit Payments to Issuers of Qualified Bonds, to take into account direct pay tax credit bonds. The Form 8038-CP is the form used by issuers of direct pay tax credit bonds (as well as other types of direct pay bonds) to request subsidy payments with respect to an interest payment date on a direct pay tax credit bond.

- Issuers of direct pay tax credit bonds are required to use the revised form on and after its release date. As a result, any Form 8038-CP completed before the new form is released that has not been submitted to the IRS cannot be used to request subsidy payments.
- A separate Form 8038-CP must be filed with respect to each interest payment date for an issue of direct pay tax credit bonds.
- For fixed rate bonds, an issuer must file a Form 8038-CP at least 45 days and no more than 90 days before the applicable interest payment date with respect to the bonds.
- In general, for variable rate bonds, subsidy payments will be paid quarterly on a reimbursement basis for interest paid by the issuer during the quarter that includes 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 Form 8038-CP is the 45th day after the last interest payment date within the quarterly period for which reimbursement is requested. If, however, the issuer knows the interest payment amount at least 45 days prior to the interest payment date, Form 8038-CP may be filed within the same time frame as fixed rate bonds.

Limitation on Bond Premium

- For purposes of determining subsidy payments on a direct pay tax credit bond, a rule similar to the prohibition against the issuance of a build America bond with more than a de minimis amount of premium, as discussed below, applies to direct pay tax credit bonds. Generally, the de minimis premium for a bond means a premium no greater than .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 (or if earlier, the optional redemption date that results in the lowest yield on the bond).
- The definition of "issue price" applicable to tax-exempt bonds applies for this purpose. In general, the issue price of a maturity of bonds for which a bona fide public offering is made is determined as of the sale date based on reasonable expectations regarding the initial public offering price. The issue price of bonds may not exceed their fair market value as of the sale date.
- The Treasury Department and the IRS are reviewing the definition of issue price and expect to address any further limitations or special rules in future prospective administrative or regulatory guidance.

Treatment of Original Issue Discount

- For purposes of determining refundable subsidy payments on a direct pay tax credit bond, original issue discount ("OID") (whether paid upon accrual, bond redemption, at maturity or otherwise) is not treated as a payment of interest. For example, all payments on a bond that does not provide for the payment of interest at least annually are treated as OID and no subsidy payments will be made with respect to such bond.

Preissuance Accrued Interest

- For purposes of determining subsidy payments on a direct pay tax credit bond, preissuance accrued interest is not taken into account. For this purpose, the term "preissuance accrued interest" means the portion of the stated interest on the bond paid by the issuer that is allocable to interest accrued prior to the issue date of the bond.

Original Expenditures, Short-Term Interim Financing and Reimbursements

- Direct pay tax credit bonds issued to reimburse otherwise eligible expenditures for qualified purposes that were paid or incurred after March 18, 2010 and that were financed originally with temporary short-term financing issued after March 18, 2010 will not be treated as a refunding issue (tax credit bonds cannot be issued for refunding purposes).
- Issuers may use proceeds of direct pay tax credit bonds to reimburse otherwise eligible expenditures for qualified purposes. In applying the rules under Section 54A of the Code relating to reimbursement of eligible expenditures for qualified purposes, the reimbursement rules under the tax-exempt bond provisions generally apply.

II. Direct Pay Build America Bonds and Recovery Zone Economic Development Bonds

The Notice provides the following guidance with respect to direct pay build America bonds (i.e., build America bonds for which an issuer is entitled to receive payments equal to thirty-five percent of the interest payable on each interest payment date) and recovery zone economic development bonds:

Form 8038-CP

Issuers of direct pay build America bonds and recovery zone economic development bonds are required to submit Forms 8038-CP to request subsidy payments with respect to interest payable on a bond on an interest payment date.

- As indicated above, the Notice states the IRS intends to publish on or before June 25, 2010, a revised Form 8038-CP, Return for Credit Payments to Issuers of Qualified Bonds.
- Issuers of qualified build America bonds and recovery zone economic development bonds are required to use the revised form on and after its release date. As a result, as with direct pay tax credit bonds, any Form 8038-CP completed before the new form is released that has not been submitted to the IRS cannot be used to request subsidy payments.

Limitation on Bond Premium

- For a bond to qualify as a build America bond, the bond cannot be issued with more than a de minimis amount of premium. As discussed above, generally, the de minimis premium for a bond means a premium no greater than .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 (or, if earlier, the optional redemption date that results in the lowest yield on the bond).
- The definition of "issue price" applicable to tax-exempt bonds applies for this purpose. In general, the issue price of a maturity of bonds for which a bona fide public offering is made is determined as of the sale date based on reasonable expectations regarding the initial public offering price. The issue price of bonds may not exceed their fair market value as of the sale date.
- As mentioned above, the Treasury Department and the IRS are reviewing the definition of issue price and expect to address any further limitations or special rules in future prospective administrative or regulatory guidance.

Treatment of Original Issue Discount

- For purposes of determining subsidy payments on a direct pay build America bond, OID (whether paid upon accrual, bond redemption, at maturity or otherwise) is not treated as a payment of interest. For example, all payments on a bond that does not provide for the payment of interest at least annually are treated as OID and no subsidy payments will be made with respect to such bond.

Preissuance Accrued Interest

- For purposes of determining subsidy payments on a direct pay build America bond, preissuance accrued interest is not taken into account. As with direct pay tax credit bonds, the term “preissuance accrued interest” means the portion of the stated interest on the bond paid by the issuer that is allocable to interest accrued prior to the issue date of the bond.

John Trofa is the Practice Group Leader for the Chapman and Cutler LLP National Public Finance Group and can be reached at 312.845.3777 or trofa@chapman.com. For additional information on the matters described in this issue of the National Public Finance Bulletin, please contact your regular Chapman and Cutler LLP attorney or visit us at chapman.com.

National Public Finance Bulletin editors: Christi Jacobsen, 801.536.1409 or jacobsen@chapman.com, and Brandon Johnson, 801.536.1407 or bjohnson@chapman.com.

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