



**Section of Taxation**

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October 29, 2009

Hon. Douglas Shulman  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, DC 20224

Re: Comments Concerning Stripping Tax Credits

Dear Commissioner Shulman:

Enclosed are comments concerning stripping tax credits. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Stuart M. Lewis  
Chair, Section of Taxation

Enclosure

cc: Michael Mundaca, Acting Assistant Secretary (Tax Policy), Department of the Treasury  
William Wilkins, Chief Counsel, Internal Revenue Service  
Joshua Odintz, Acting Tax Legislative Counsel, Department of the Treasury  
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AMERICAN BAR ASSOCIATION  
SECTION OF TAXATION

COMMENTS CONCERNING STRIPPING TAX CREDITS

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by George G. Wolf of the Committee on Tax Exempt Financing of the Section of Taxation. Substantive contributions were made by David J. Cholst, Dale S. Collinson, James R. Eustis, John McMaster, Arthur M. Miller, Valerie Pearsall Roberts, and Diane Simons. The Comments were reviewed by Jeremy Spector, Chair of the Committee. The Comments were further reviewed by David Garlock of the Section's Committee on Government Submissions, and by Andrew J. Dubroff, Council Director for the Tax Exempt Financing Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal tax principles addressed by these Comments, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: October 29, 2009

## Stripping Tax Credit Bonds

### Executive Summary

We want first to express our gratitude at the hard work of the Treasury Department and the Internal Revenue Service in developing quick guidance as to many of the provisions of the American Recovery and Reinvestment Act of 2009 (the "ARRA")<sup>1</sup> relating to Qualified Tax Credit Bonds ("QTCBs") and build America bonds ("BABs"). Although provision for stripping tax credits was first enacted in 2008, the ARRA greatly expanded the potential applicability of tax credit stripping. These comments are provided for the purpose of identifying specific points of guidance and suggesting appropriate actions by the Treasury Department to make those types of bonds even more attractive and more useful in providing economic recovery to state and local governments.

These Comments make a number of recommendations for guidance, which are summarized below:

1. Confirm that the tax credit allowance is treated as a cash payment on the credit allowance date.
2. Confirm that the deemed interest income associated with a tax credit pursuant to section 54A(f)<sup>2</sup> is treated as a payment of qualified stated interest.
3. Confirm that, in the case of a separation of the ownership of a qualified tax credit bond and the entitlement to the credit pursuant to section 54A(i)(1), the income associated with the credit entitlement is taken into account in accordance with section 1286 as if the entitlement to the tax credit was a right to a cash payment of interest.
4. Provide specific rules under Regulation section 1.1275-2(c) (the aggregation of debt instruments rule) and section 1286 for certain simple stripping transactions.
5. Provide a rule for redemption of tax credit bonds and the associated tax credit in circumstances in which the tax credits have been stripped from the redeemed bonds.
6. Provide a rule for application of the issue price limitation for Credit BABs in section 54AA(d)(2)(C) when the tax credits are stripped at issuance and the issuer sells a combination of par bonds, zero coupon bonds, and tax credits.

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<sup>1</sup> Pub. L. No. 111-5, 123 Stat. 115.

<sup>2</sup> References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.

## Detailed Comments

**1. The tax credit allowance is treated as a cash payment on the credit allowance date, subject to the limitations in the respective tax credit bond provisions (sections 54(c), 54A(c), and 54AA(c)). Accordingly, the tax credit should be allowed to the person that beneficially owns the bond on the credit allowance date or, in the case of a separation described in section 54A(i)(1), to the person that beneficially owns the instrument evidencing the entitlement to the credit on the credit allowance date. The credit allowance date means, for bonds governed by sections 54 and 54A, March 15, June 15, September 15, and December 15 of each year the bond is outstanding (and the bond maturity or redemption date) and for bonds governed by section 54AA the scheduled interest payment dates for each year the bond is outstanding.**

The rule that the tax credit allowance is treated as a cash payment on the credit allowance date is the rule governing the identity of the person entitled to the benefit of the allowance as a tax payment and, as a corollary, determines the time when an investor obtains that benefit. Although we think the statutory provisions are clear on the point, as described in the discussion below, the rule should also be stated in guidance. As discussed in point 2 below, an investor may be in receipt of interest income with respect to a tax credit even though the investor is not entitled to claim the credit.

### *Discussion*

A. Section 54A(a) provides "[i]f a taxpayer holds a qualified tax credit bond *on one or more credit allowance dates* of the bond during any taxable year, there shall be allowed as a credit . . . ." Section 54A(b)(1) provides "[t]he amount of the credit determined under this subsection with respect to any *credit allowance date* for a qualified tax credit bond is 25 percent . . . ." Section 54A(e)(1) provides "[t]he term '*credit allowance date*' means" March 15, June 15, etc. The Conference Report for the Heartland, Harvest, and Horticulture Act of 2008,<sup>3</sup> which added section 54A, states: "[t]he credit accrues quarterly, is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability."<sup>4</sup> Section 54A(i)(1) provides "[i]n case of any such separation, the credit under this section shall be allowed to the person who *on the credit allowance date* holds the instrument evidencing the entitlement to the credit and not to the holder of the bond."

Section 54AA(a) provides "[i]f 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 . . . ." Section 54AA(b) provides "[t]he amount of the credit determined under this subsection with respect to *any interest payment date* . . . ." Section 54AA(f)(2) provides "[r]ules similar to the rules of subsections (f) . . . and (i) of section 54A shall apply for purposes of the credit allowed under subsection (a)." The Conference Report

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<sup>3</sup> Pub. L. No. 110-246, 122 Stat. 1651.

<sup>4</sup> H.R. Rep. No. 110-627, at 1046 (2008) (Conf. Rep.).

for this provision, which was added by section 1531 of the ARRA, says, "[t]he holder of a taxable governmental bond will accrue a tax credit in the amount of 35% of the interest paid on the interest payment date of the bond during the calendar year."<sup>5</sup>

The policy predecessor to section 54A is section 1397E, which provides a similar credit for "qualified zone academy bonds," so-called "QZABs."<sup>6</sup> Section 1397E(a) provides "[i]n the case of an eligible taxpayer who holds a qualified zone academy bond *on the credit allowance date* of such bond which occurs during the taxable year, there shall be allowed as a credit . . . ." Like QTCBs under section 54A, the credit on QZABs is includible in gross income.<sup>7</sup> Section 1397E(i)(1) provides "The term '*credit allowance date*' means, with respect to any issue, the last day of the 1-year period beginning on the date of issuance of such issue and the last day of each successive 1-year period thereafter." Regulation section 1.1397E-1(e)(1) provides "[a]n eligible taxpayer . . . that holds a qualified zone academy bond *on a credit allowance date* is allowed a tax credit . . . ."

In both sections 54A and 54AA, the statute states that the credit is allowed to the person who "holds" the bond "on" a "credit allowance date" or an "interest payment date," respectively. It is the person who holds the bond on the specified date that is allowed the credit. These words mean that the credit allowance is a cash item—it is allowed entirely to the one holder on that date and not to the various persons who might have held the bond during the quarterly period ending on that date. That is also consistent with the legislative history, which says that the credit "accrue(s) . . . *on the interest payment dates.*" Section 54A's predecessor, section 1397E, was equally direct—the credit is allowed to the person who "holds" the bond "on" a "credit allowance date." Similarly, section 54A(i)(1) provides that the credit is allowed "to the person who *on the credit allowance date holds* the instrument evidencing the entitlement to the credit." Cash treatment is also consistent with the numerous statements in the legislative history to these various provisions that the credit is treated "as if it were a payment of interest." "Payment" is itself a cash concept.

The question of cash versus accrual can arise in three contexts—a bond held by a single holder throughout the period from one credit allowance date to the next; a bond that is sold between credit allowance dates; and a bond that is stripped between credit allowance dates.

If the bond is held by a single holder throughout the period from one credit allowance date to the next, the various credit provisions fairly clearly compel the conclusion that the credit is allowable on the credit allowance date and not ratably over the period between credit allowance dates. For example, if calendar year cash method Taxpayer A holds a QTCB for the entire period December 16, 2009, to March 15, 2010, the entire credit should be allowable on March 15, 2010; the credit should not be

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<sup>5</sup> H.R. Rep. No. 111-16, at 86 (2009) (Conf. Rep.).

<sup>6</sup> Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 226(a), 111 Stat. 788.

<sup>7</sup> I.R.C. § 1397E(j).

allowable 16/90ths<sup>8</sup> in 2009 and 74/90ths in 2010. March 15, 2010, is the "credit allowance date." The taxpayer must hold the bond on that date to be allowed the credit, and there would be no purpose in specifying such dates if the credit was allocated and allowed ratably (or in some other manner) over the period.<sup>9</sup> That result is also consistent with the general understanding that credits can be applied against estimated tax payment liabilities and the rough correspondence of the credit allowance dates to estimated tax payment dates—April 15, June 15, September 15, and December 15 for corporations<sup>10</sup> and April 15, June 15, September 15, and January 15 for individuals.<sup>11</sup>

The cash conclusion is perhaps even clearer in the case of sale of a QTCB between credit allowance dates. If Taxpayer A in the above example sold the bond to Taxpayer B on January 1, 2010, Taxpayer A would not hold the bond on the credit allowance date, hence Taxpayer A would not be allowed any portion of the credit. Instead, Taxpayer B holds the bond on the credit allowance date, hence Taxpayer B is allowed the entire credit, just as Taxpayer B would be entitled to the full actual interest payment on the bond if the bond paid interest quarterly. A's sale price will presumably reflect the pro rated amount of the credit that will be allowable on the ensuing March 15, but A will not be allowed any part of the credit with respect to that date. This treatment is reflected in the Instructions to Form 8912, Credit to Holders of Tax Credit Bonds. (The treatment of the "accrued interest" with respect to the credit allowance (see section 54A(f)) is discussed in point 2 below.)

Finally, if Taxpayer A on January 1, 2010, sells to Taxpayer B only the right to the credit accruing on March 15, 2010, A is not allowed any part of that credit, and it is allowed entirely to B. Section 54A(i)(1) says "[i]n case of any such separation, the credit under this section shall be allowed to the person who *on the credit allowance date* holds the instrument evidencing the entitlement to the credit and *not* to the holder of the bond." This treatment again is entirely consistent with the notion that the allowance of the credit is the equivalent of a payment of cash interest. When an interest coupon is stripped, the holder of the strip is paid the entire amount of the coupon; the coupon interest is not shared among the various parties that might have held the bond or the coupon during its accrual period.

B. Credit BABs present an additional issue because the tax credit is allowed to persons who hold the bonds on an "interest payment date." Fixed rate bonds pay interest of specified amounts on specified dates. If the specified interest is not available on the specified date, the defaulted interest itself accrues interest until paid—sometimes at the same rate, sometimes at the "legal rate," sometimes at a penalty rate.<sup>12</sup> The question is whether the section 54AA credit is allowed with respect to the scheduled interest amounts on the scheduled interest payment dates or with respect to the actual interest

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<sup>8</sup> Based on 30/360 muni day count.

<sup>9</sup> Compare section 54A(b)(4)(providing for proration of the tax credit amount when a bond is outstanding for only part of a quarterly period).

<sup>10</sup> I.R.C. § 6655(c).

<sup>11</sup> I.R.C. § 6654(c).

<sup>12</sup> The same can be said for variable rate bonds, but variable rate bonds are unlikely candidates for Credit BABs.

amounts on the actual interest payment dates.<sup>13</sup> We think it is clear that scheduled payment amounts and dates should control for this purpose.

Section 54AA(a) begins with the phrase: "[i]f a taxpayer holds a build America bond *on one or more interest payment dates* of the bond during any taxable year . . . ." Section 54AA(b) provides: "[t]he amount of the credit determined under this subsection *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) defines the term "interest payment date" as "any date on which the holder of record of the build America bond *is entitled to a payment of interest* under such bond."

The legislative history is somewhat ambiguous on this question. The conference report states—

The holder of a taxable governmental bond will accrue a tax credit in the amount of 35 percent of *the interest paid on the interest payment dates* of the bond during the calendar year. The interest payment date is any date on which the holder of record of the taxable governmental bond *is entitled to a payment of interest* under such bond. . . . The actual credit that a taxpayer may claim is determined by multiplying *the interest payment that the taxpayer receives from the issuer (i.e., the bond coupon payment)* by 35 percent.<sup>14</sup>

Nevertheless, we think the better view is that the credit should be allowed with respect to the scheduled interest amounts on the scheduled interest payment dates.

If the tax credits are automatic on the scheduled interest payment dates, there is very little financial credit risk with respect to the tax credits. Because there currently is no market for Credit BABs, this could be very helpful to the marketing and therefore the viability of these instruments in general.

If the section 54AA tax credits are stripped, the tax credit strip holders will not easily know about payment defaults or delays on the bonds. It will complicate matters to have to keep track of the actual payments on the bonds. Moreover, delayed actual interest payments will be in amounts larger than the scheduled interest payments, so the Treasury would actually be giving out larger tax credits if the tax credits were computed based on actual interest payments.

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<sup>13</sup> A similar question arises with respect to Direct Payment BABs, but the section 6431 credits are not strippable, at least not in the same manner as sections 54A and 54AA credits. Section 54A credits for QTCBs are not paid with respect to interest payments on those bonds, if any, so the issue does not arise.

<sup>14</sup> H.R. Rep. No. 111-16, at 86 (2009) (Conf. Rep.).

**2. The interest income associated with a tax credit pursuant to section 54A(f) is treated as a payment of qualified stated interest (within the meaning of Regulation section 1.1273-1(c) or section 1.1275-5(c)), and is taken into account by a holder in accordance with its method of accounting.**

*Discussion*

Section 54A(f) provides "the credit determined under subsection (a) shall be treated as interest which is includible in gross income." Section 54AA(f)(2) provides "[r]ules similar to the rules of subsections (f) . . . of section 54A shall apply for purposes of the credit allowed under" section 54AA.

Under normal federal income tax accounting, interest on debt obligations is taken into account under the holder's method of accounting. A cash method taxpayer (which includes most individuals) takes "qualified stated interest" ("QSI") income into account as it is received, while an accrual basis taxpayer (which includes most corporations) takes interest into account as it accrues. QSI is interest on a debt obligation that is fixed or determined under a qualified variable rate formula and payable at least annually throughout the term of the instrument.<sup>15</sup> The tax credits allowed to holders of QTCBs are at a fixed rate quarterly throughout the term of the debt instrument. Similarly, the credit allowable to holders with respect to interest on BABs is allowable only with respect to QSI.<sup>16</sup> So the section 54A(f) income associated with these credits should be treated as QSI as well. Guidance should confirm that the section 54A(f) interest income is taken into account under the holder's regular method of accounting.<sup>17</sup>

When a debt instrument is sold between interest payment dates, the amount representing accrued interest is included in the seller's income to the extent not previously included under its method of accounting,<sup>18</sup> and the balance is treated as the amount realized on sale of the debt. This rule appears to be applicable to section 54A(f) interest.<sup>19</sup> Presumably, section 54A(f) income will be reported in the same manner. It would be helpful if the Regulations, the forms, or both confirmed this presumption.

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<sup>15</sup> Reg. §§ 1.1273-1(c), 1.1275-5(e).

<sup>16</sup> It is possible that a BAB eligible for the section 54AA credit could have coupon interest part of which is not QSI, *e.g.*, stepped coupon bonds. However, because the section 54AA credit is not allowed with respect to original issue discount (H.R. Rep. No. 111-16, at 86 (2009) (Conf. Rep.)), the non-QSI portion of the interest would not give rise to a credit. So there should be no section 54A(f) interest income associated with the deemed original issue discount.

<sup>17</sup> See Reg. § 1.1397E-1(f), the interest paid on QZAB is treated as qualified stated interest.

<sup>18</sup> Reg. § 1.61-7(d).

<sup>19</sup> See Form 8912, Credit to Holders of Tax Credit Bonds, Instructions for Line 6; *see also* Instructions for Forms 1099-INT and 1099-OID, Interest Income and Original Issue Discount (the instructions for Box 1 state "[i]nclude in box 1 any accrued interest on bonds sold between interest dates or on a payment date").

**3. In the case of a separation described in section 54A(i)(1), the income associated with the entitlement to the tax credit is taken into account in accordance with section 1286(a) and (b) as if the entitlement to the tax credit were a right to a cash payment of interest.**

*Discussion*

Section 54A(i) provides: "[u]nder regulations prescribed by the Secretary-- (2) In the case of a separation described in paragraph (1), the rules of section 1286 shall apply to the qualified tax credit bond as if it were a stripped bond and to the credit under this section as if it were a stripped coupon." Section 54AA(f)(2) provides: "[r]ules similar to the rules of subsections . . . (i) of section 54A shall apply for purposes of the credit allowed under [section 54AA(a)]."

Section 1286 provides rules for the treatment of stripped bonds and stripped coupons. When ownership of the principal component of a bond (the so-called "principal only" or "PO" piece, although the PO piece may also include retained interest coupons) is separated from ownership of the interest component(s) (the so-called "interest only" or "IO" piece(s)), several tax rules apply. The sale of either the IO piece(s) or the PO piece is treated as if each piece were a newly issued debt instrument issued with original issue discount ("OID"), and its issue price is the purchase price of the new holder or the holder's allocable basis in the piece retained.<sup>20</sup> All taxpayers, whether cash or accrual, take OID into income on an accrual basis. OID is generally the difference between the issue price of a debt instrument and its stated redemption price at maturity. Thus, the respective holders are required to accrue OID on their respective pieces under the normal OID rules. The seller of the stripped piece allocates its basis in the debt instrument between the retained piece and the sold piece in proportion to their respective fair market values,<sup>21</sup> and includes in income interest properly accrued to the date of sale (regardless of its method of accounting).<sup>22</sup>

The statute itself is quite comprehensive in its specification of the treatment of stripped bonds and stripped coupons. The regulations under section 1286 are correspondingly very brief. The only rule of general application<sup>23</sup> is Regulation section 1.1286-1(a), which provides that the de minimis rule of section 1273 applies to the stripped interests (so that if the amount of deemed OID is less than 1/4 of one percent of the maturity amount times the number of whole years to maturity, the OID is treated as zero).

For purposes of analyzing the tax accounting for a tax credit strip, consider first the treatment of sale of a whole bond, whether at or between interest payment dates. Assume, for example, a \$50,000 bond with an annual credit rate of eight percent and a credit entitlement of \$1,000 on March 15. If the \$50,000 bond in the example is sold by

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<sup>20</sup> I.R.C. § 1286(a), (b)(4).

<sup>21</sup> I.R.C. § 1286(b)(3).

<sup>22</sup> I.R.C. § 1286(b)(1).

<sup>23</sup> Reg. § 1.1286-1(b) has a special rule applicable only to stripped mortgage loans.

Taxpayer A to Taxpayer B on December 15, and there has been no change in value of the bond, the sale price would be exactly \$50,000. Taxpayer B will accrue all of the income associated with the credit allowance on March 15 (and subsequent dates if it continues to hold the whole bond). On the other hand, if Taxpayer B purchases the whole bond from Taxpayer A on February 1 at a price of \$50,500, Taxpayer B will be entitled to the \$1,000 credit on March 15 but would accrue only \$500 of income in respect thereto, because Taxpayer B would have a basis in the "credit coupon" of \$500, "as if it were an interest payment on the bond."<sup>24</sup>

If instead the March 15 credit allowance is stripped and sold to Taxpayer B on the immediately preceding December 15, again none of the income associated with that amount has accrued. The purchase price would be approximately \$990, depending on the discounted rate of return reflecting short-term interest rates at the time. In this case, Taxpayer B holds the credit allowance throughout the accrual period, would be entitled to the \$1,000 credit on March 15, and would take into account \$10 of OID income, either accrued over the period December 15 to March 15 or entirely on March 15.<sup>25</sup> Assuming the bond was originally purchased by Taxpayer A at face and there has been no change in value, Taxpayer A will realize no gain or loss on sale of the coupon, but his basis in the bond will be reduced by \$990, which reduction will accrue as OID under the normal rules.

A similar result obtains if Taxpayer B purchases a strip for the March 15 entitlement on March 1 for \$997. In this case Taxpayer B would again be entitled to the entire \$1,000 credit on March 15 but would have only \$3 of OID income in respect of the credit; the balance, \$997, is a recovery of basis. On the seller's side, Taxpayer A in this example recognizes \$835<sup>26</sup> of interest income under section 1286(b)(1), and the remaining \$162 will be subject to the gain/loss calculation under sections 1001 and 1286(b)(3). Assuming the bond was originally purchased at face and there has been no change in value, Taxpayer A will realize no gain or loss on sale of the coupon, but his basis in the bond will be reduced by \$162, which will accrue as OID under the normal rules.

Each subsequent sale of either the PO piece or the IO or stripped credit piece(s) is also treated as a new issuance of an OID instrument with respect to the purchaser of that piece, so each subsequent holder must accrue OID on the instrument purchased. Guidance should confirm that these section 1286 rules apply to accruals under section 54A (i)(2) as they would to true cash coupons.

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<sup>24</sup> See Form 8912, Credit to Holders of Tax Credit Bonds, Instructions for Line 6.

<sup>25</sup> Section 1272(a)(2)(C) excludes short-term debt instruments from the current accrual of OID, while section 1271(a)(3) or (4) will treat the "acquisition discount" on the short-term stripped coupon as ordinary income on "retirement" of the coupon. This discussion ignores that distinction. Presumably because the short-term debt instrument rule is picked up by the general reference to the OID rules in section 1286(a), there was no need to provide for it in regulations. If that is not the case, guidance might clarify whether the short-term rule applies to stripped coupons generally or to stripped tax credit coupons in particular.

<sup>26</sup> \$1000 x 76 days / 91 days.

**4. If a single purchaser acquires on a single day all or a portion of the remaining entitlements to tax credits associated with a bond, the purchaser should be allowed to account for the interest income associated with such tax credit entitlements under Regulation section 1.1275-2(c) (the aggregation of debt instruments rule). A holder of a QTCB or a Credit BAB should not be subject to the rules of section 1286 if it strips and sells the tax credit entitlements solely with respect to credit allowance dates within the seller's taxable year.**

*Discussion*

There is virtually no guidance on whether purchase of a "whole" bond after the "maturity date" of the stripped piece(s) retains the OID characterization, whether reassembly of stripped pieces into a whole bond eliminates OID characterization going forward, whether the holder of a series of strips can account for them under the aggregation of debt instruments rule,<sup>27</sup> or whether a uniform amount of interest retained with its principal after stripping a pro rata portion of each interest coupon retains its character as QSI. We are not requesting general guidance on these topics.

However, it would be useful to confirm that a series of tax credit strips acquired by a single purchaser of a specific bond (or a substantially identical bond (*i.e.*, same CUSIP)) at the same time can be accounted for under the aggregation of debt instruments rule in Regulation section 1.1275-2(c). That section provides "[e]xcept as provided in paragraph (c)(2) of this section, debt instruments issued in connection with the same transaction or related transactions (determined based on all the facts and circumstances) are treated as a single debt instrument for purposes of sections 1271 through 1275 and the regulations thereunder." Such treatment would conform to market practice for regular coupon strips and would simplify reporting.

Another useful rule would be to exclude from the application of section 1286 the separation of ownership of tax credit entitlements for the single taxable year in which the separation occurs. That treatment would apply only to the holder of the principal piece plus any unstripped tax credits or, in the case of Credit BABs, the cash coupon. Instead, the seller would treat the entire sale proceeds as taxable income, without basis offset as generally provided by section 1286(b)(3). Such a rule would achieve essentially the same result as under section 1286, but would be considerably simpler to apply.<sup>28</sup> Another benefit of the proposed rule is that it would prevent the tax credit rights retained by the seller from losing their status as QSI. This rule should be written in a way that permits the seller to repeat the stripping process in successive years.

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<sup>27</sup> Reg. § 1.1275-2(c).

<sup>28</sup> The timing results would be identical if the yield on the stripped credit is equal to the taxpayer's yield on the bond (treating the credit right as fixed interest). If the yield on the stripped credit is lower, as is likely the case in normal interest rate environments (short-term rates lower than long-term rates), the suggested simplification in the rules would result in a faster inclusion in income than under a strict application of the coupon stripping rules.

**5. If a tax credit bond is redeemed prior to its stated maturity date, any tax credits arising after the redemption date of the bond are not allowed. If there has been a separation of any of the entitlements to the tax credits as described in section 54A(i)(1), and not all of the substantially identical bonds are redeemed, an issuer may redeem (and treat as extinguished) a proportionate amount of substantially identical entitlements to such tax credits.**

*Discussion*

Interest on bonds typically ceases to accrue when the bonds mature or are retired, accelerated, or otherwise extinguished. If the right to an interest amount otherwise payable after the extinguishment date of the bond has been stripped and sold, that payment entitlement is referred to an "orphan coupon."

In the limited circumstances in which coupon stripping has been done in the secondary market in the past, two basic approaches have been adopted to deal with potential orphan coupons. The first is simply to avoid the problem by only stripping coupons from bonds that are noncallable (or only stripping pre-call date coupons) and issued by issuers that are regarded as default proof (U.S. Treasury securities) or not subject to bankruptcy (State government bonds). The second approach has been to use a trust to strip the coupons and, in the case of an early retirement of the bonds, to provide for distribution of payments to holders of the principal and interest pieces in accordance with their respective accreted values. That approach has limitations under both securities law (registration requirements) and tax law (trust classification).

The few QTCBs that have been issued to date have provided in their indentures for separation of the credit entitlement from the principal entitlement, and have further provided in their indentures for an accreted value payment in the event the principal is paid before the scheduled maturity date. That approach has generally been thought to avoid both the securities law and tax law issues referenced above. And because QTCBs generally should not default prior to their scheduled maturity date, the orphan coupon issue should not be a practical problem with respect to such bonds.

But the issue may still arise with respect to Credit BABs, for which the entitlement to the credit may be with respect to an interest payment date after the associated bond has been extinguished, and there may be situations in which QTCBs must be retired prior to their stated maturity date.

The correct approach to this problem should be that the allowance of the credits under sections 54A or 54AA should expire when the principal of the associated bond is paid or the payment obligation is extinguished. For the holder of a whole bond, payment or extinguishment of the principal amount would cause interest on the bond to cease to accrue. The holder no longer has made an extension of credit to the borrower and should no longer be entitled to interest, either in the form of coupon interest or the tax credit subsidy.

The same should be true for the holder of a stripped credit coupon on a Credit BAB or a QTCB. The holder of a strip should not attain a greater right to the credit than a holder of a whole bond. The effect of an orphan coupon can be dealt with in the same manner as with QTCBs under current market practice (*i.e.*, with an accreted value payment mechanism in the event of early retirement).

Situations are likely to arise in which tax credit bonds, either QTCBs or Credit BABs, are redeemed but not all of the substantially identical bonds (*i.e.*, bonds with the same CUSIP) are redeemed. If that occurs when some or all of the tax credit entitlements have been stripped from those bonds and substantially identical bonds, it would likely be impossible for the issuer to identify and redeem the tax credits associated with the very bonds that are redeemed. It should be sufficient from the Treasury's perspective that the issuer redeem tax credit entitlements of the same credit entitlement dates and in the same amounts as if those tax credit entitlements were still attached to the redeemed bond.

For example, assume issuer has \$10,000,000 of Credit BABs outstanding with a maturity date of January 1, 2020, and semiannual interest payment dates of January 1 and July 1. The issuer determines to call \$1,000,000 of the January 1, 2020, maturity pursuant to a lottery as provided in the bond indenture. As a result of the certification procedures set out in the indenture, the issuer knows that some of the tax credits associated with the bonds selected by the lottery have been stripped, and which credits have been stripped by date and amount, but because tax credits from other bonds of the January 1, 2020, maturity have also been stripped, the issuer does not know which stripped tax credits were originally associated with the bonds to be redeemed. Therefore the issuer conducts a second lottery to determine which of the stripped credits to redeem together with the bonds. As long as the issuer redeems an amount of credits equal to the credits on the redeemed bonds that would have arisen after the retirement date of the redeemed bonds, the issuer and taxpayers may treat unredeemed credits as associated with unredeemed bonds.

**6. An issuer may separate the ownership of the entitlement(s) to the tax credit(s) at the time of issuance of the tax credit bond. If such separation and sale occurs with respect to tax credits allowed under section 54AA(a), the limitation on issue price of the bond in section 54AA(d)(2)(C) should be determined, at the election of the issuer, on the issue prices of two or more such bonds of the same maturity and issued at the same time plus the tax credit entitlements associated with such bonds in the aggregate (*i.e.*, the issue price of each bond should be treated as meeting the issue price limitation if the issue prices of all of the bonds in the aggregate plus the tax credit entitlements meet the issue price limitation). If any of such bonds are sold without original issue discount without regard to section 1286, such bonds should not be treated as issued with original issue discount.**

#### *Discussion*

Section 54A(i) provides "[u]nder regulations prescribed by the Secretary--(1) There may be a separation (*including at issuance*) of the ownership of a qualified tax

credit bond and the entitlement to the credit under this section with respect to such bond." (Emphasis added.) In addition, 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 section 1273(a)(3)) of premium over the stated principal amount of the bond," presumably to prevent the credit from being claimed with respect to what is economically principal by attaching an above market coupon on the bonds.<sup>29</sup>

Stripping at issuance may take different forms. In one, the issuer may sell (directly or through an underwriter) both the PO piece (including the coupon interest in the case of Credit BABs) and the tax credit pieces separately to investors (including possibly the underwriter). The application of section 1286 to purchasers of tax credit strips sold by the issuer at original issuance should be as described in section 3 above. Likewise, treatment of the issuer that sells stripped tax credits at original issuance should also be straightforward—the issue price of the PO piece and the issue price(s) of the tax credit strips should be aggregated for purposes of the issue price limitation for Credit BABs in section 54AA(d)(2)(C), discussed more below.

In order to achieve the best overall pricing of the bonds, however, the issuer may want to separate the bonds into a combination of full coupon bonds without tax credits, zero-coupon bonds without tax credits, and tax credit strips. The question is—how is the issue price determined in this situation?

For example, an issuer may set out to issue Credit BABs (*i.e.*, bonds eligible for the section 54AA(a) tax credits) on January 1, 2010, with a principal amount of \$1,000x, coupon interest of 5%, and a maturity date of January 1, 2020. At the time of issuance, the issuer could strip the tax credits, sell the principal and interest components of each of the bonds for \$874x and the tax credits for \$126x. The bonds meet the issue price limitation of section 54AA(d)(2)(C).<sup>30</sup> The issuer may instead sell \$741x bonds with a coupon of 6.75% (but with no tax credit) at par,<sup>31</sup> \$259x with a coupon of zero (and no tax credit) at an issue price of \$133x, and the tax credit strips for an amount not in excess of \$126x.<sup>32</sup> Assume the issuer makes an election to aggregate the bonds for purposes of

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<sup>29</sup> Section 1273(a)(3) is the de minimis rule for OID, being 1/4 of one percent of the stated redemption price at maturity times the number of whole years to maturity. For example, a \$1,000 bond with a maturity date 20 years after issuance has a maximum issue price of \$1,050 (\$1,000 plus \$50 (\$1,000 x .0025 x 20)). The same result might have been accomplished by basing the section 54AA credit on the yield on the bond, but that approach would have introduced unwarranted administrative complexity. This issue price limitation also applies to bonds eligible for section 6431 credits ("Direct Pay BABs"), presumably for the same reason. There is no issue price limitation for QTCBs as the credit is based on rates determined by the Treasury Department at the time of issuance of the bond.

<sup>30</sup> In these examples, the right to issue with a de minimis amount of premium is ignored.

<sup>31</sup> The amount of the par bonds sold without credits is calculated so that the stated interest on the par bond at 6.75% is equal to the full amount of the interest that would have been payable on the full \$1,000 principal amount of bonds at 5%. In other words, the principal of the par bonds is  $\$1,000 \times 135\% = \$740.74$ .

<sup>32</sup> This example assumes that the zero-coupon bond will price at the same yield (6.75%) as the coupon bond, which will not be the case in most market environments, but is used to simplify the example. It also

the issue price limitation. Because the aggregate issue price of the par bonds, the zero-coupon bonds, and the tax credits meet the aggregate issue price limitation for all the bonds,<sup>33</sup> all of the bonds should be treated as meeting the issue price limitation.

In this case, the issuer associates all of the coupons for the Credit BABs to a single class of bonds and none of the coupons to the zero-coupon bonds. The total amount of credits will not change (as mentioned, credits are not permitted with respect to OID). The aggregate issue price is still \$1,000x. The tax base is not impaired, but the issuer might get substantially better pricing by selling more traditional par bonds and zero-coupon bonds.<sup>34</sup> Note, we are not suggesting that the coupons on the \$259x zero-coupon bonds are being stripped and attached to the \$741x par bonds, but rather that the issue prices of the bonds for purpose of the issue price limitation should be determined in the aggregate. We recognize that treating the par bonds as issued without OID would not be an obvious interpretation of the statute, but we see no harm in such a rule, and it could greatly benefit issuers.

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assumes that the tax credits will price at their theoretical value, which is unlikely to be true in the real world.

<sup>33</sup> Because of the way the par bond principal was calculated, the coupon rate expressed as the aggregate of the principal amounts of the par bonds and the zero-coupon bonds is five percent.

<sup>34</sup> In fact, there may be more tax compliance because much of the reporting complexity would be shifted entirely to the holders of the tax credit strips.