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November 20, 2009

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

Re: Comments on Build America Bonds

Dear Commissioner Shulman:

Enclosed are comments on Build America Bonds. 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,

A handwritten signature in black ink, appearing to read "Stuart M. Lewis".

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  
Eric San Juan, Deputy Tax Legislative Counsel, Department of the Treasury  
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**AMERICAN BAR ASSOCIATION  
SECTION OF TAXATION**

**COMMENTS ON BUILD AMERICA BONDS**

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 Perry E. Israel of the Committee on Tax Exempt Financing of the Section of Taxation. Substantive contributions were made by Michela Daliana, Charles C. Cardall, Ramiro M. Carbonell, Michael I. Diamond, Marc A. Feller, Carol Duane Olson, Robert Price, Maxwell Solet, Gary Walsh, and Patti T. Wu. The Comments were reviewed by Jeremy Spector, Committee Chair. The Comments were further reviewed by Clifford M. Gerber of the Section’s Committee on Government Submissions and by Andrew J. Dubroff, Council Director, for the 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: November 20, 2009

## Executive Summary

These Comments have been prepared in response to Notice 2009-26<sup>1</sup> and Notice 2009-50<sup>2</sup> and to assist the Department of the Treasury (the “Treasury”) and the Internal Revenue Service (the “Service”) in preparation of guidance on Build America Bonds (“BAB”). We want first to express our gratitude at the hard work of the Treasury and the Service in developing quick guidance as to many of the provisions of the American Recovery and Reinvestment Act of 2009 (the “ARRA”)<sup>3</sup> relating to BAB and “Recovery Zone Bonds.” These comments are provided for the purpose of identifying areas of uncertainty and suggesting appropriate actions by the Treasury to make these types of bonds more attractive and useful in providing economic recovery to municipalities.

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

1. Clarify that the special rule relating to “issue price” contained in Regulation section 1.148-1(b) applies to BABs.
2. Clarify that original issue premium and discount are determined on a maturity-by-maturity basis for BABs.
3. Clarify that BABs and tax-exempt bonds are not part of the same issue for tax purposes.
4. Clarify that BABs and qualified tax credit bonds are not part of the same issue for tax purposes.
4. Clarify that BABs and taxable bonds that are neither BABs nor qualified tax credit bonds are not part of the same issue for tax purposes.
5. Provide guidance that the remedial action rules described in Regulation section 1.141-12 and Revenue Procedure 79-5<sup>4</sup> will generally apply to BABs.
6. Clarify that BABs are not included in the amount of bonds issued by a “qualified small issuer” under section 265(b)<sup>5</sup> or in the amount of tax-

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<sup>1</sup> 2009-16 I.R.B. 833 (April 20, 2009).

<sup>2</sup> 2009-26 I.R.B. 1118 (June 29, 2009).

<sup>3</sup> Pub. L. No. 111-1, 123 Stat. 115.

<sup>4</sup> 1979-1 C.B. 485.

<sup>5</sup> References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.

exempt bonds held by a bank for purposes of the section 265(b) *de minimis* rule.

7. Confirm that tax-exempt bonds may be used to refund BABs.
8. Confirm that pre-issuance accrued interest is not included in calculating the subsidy to be paid on BABs.
9. Develop credit-stripping rules for tax credit BABs (along with rules for qualified tax credit bonds) as expeditiously as possible.
10. Amend Circular 230 to exclude opinions with respect to BABs and related matters from the definition of covered opinions to be consistent with the treatment of State and local bond opinions.
11. Clarify that “available project proceeds” does not include earnings on a reasonably required reserve fund after the end of the project period.
12. Clarify that, for purposes of defining a “reasonably required reserve fund,” the federal subsidy is not taken into account to reduce annual debt service.
13. Clarify the meaning of “capital expenditure” for purposes of BABs.
14. Provide guidance to the effect that the rules of Regulation section 1.148-6 relating to the allocation of gross proceeds to expenditures also apply to BABs.
15. Confirm that the reimbursement rules of Regulation section 1.150-2 apply with respect to BABs and simplify the limitations on reimbursements provided in Notice 2009-26.
16. Provide further guidance with respect to the ability to use direct payment BABs for gas or electric prepayments.
17. Clarify that “look-through” rules will be applied with respect to determining the useful life of assets financed through grants.
18. Clarify who is a “paid preparer” under section 6694 for purposes of Form 8038-CP, *Information Return for Credit Payments to Issuers of Qualified Bonds*.
19. Confirm that a pledge of subsidies received from direct payment BABs to tax-exempt bond issues will not result in a “federal guarantee” under section 149(b).
20. Confirm that an issuer may, within the context of the statutory framework, designate its entire jurisdiction as a recovery zone.

21. Confirm that states may provide for a mechanism for Recovery Zone volume cap to be transferred from one jurisdiction to another and specify any specific requirements relating to the waiver of Recovery Zone volume cap.
22. Provide safe harbor limits for maturities of Recovery Zone Economic Development Bonds (“RZEDBs”) used for job training.
23. Clarify the application of the Davis-Bacon rules to RZEDBs.
24. Confirm that the “general public use” requirement as applied to Recovery Zone Facilities Bonds (“RZFBs”) is deemed to be met.
25. Confirm that a functionally related and subordinate rule also applies to assets that may be financed with RZFBs.

We recognize that this list is fairly extensive and may, because of its length, result in a delay in guidance. At the same time we appreciate the need for timely guidance on a number of these matters. Accordingly, the following is a list of the items we view as being of a higher priority:

- Definition of issue;
- Issue price;
- Federal guarantee;
- Remedial actions;
- Definition of available project proceeds;
- Debt service reserve fund sizing;
- Guidance regarding capital expenditures;
- Clarification of the reimbursement rules; and
- Application of Circular 230 exclusion.

## Introduction

Section 1531 of ARRA added sections 54AA and 6431. These sections provide for a new type of tax credit bond, the BAB. Qualifying BABs will result in either a tax-credit allowed to the holder of the BAB on specified dates (“Tax Credit BABs”) or, at the option of the issuer, a direct payment subsidy for certain BABs, when the federal government makes payments to the issuer equal to the amount of credit that would otherwise be allowed (“Direct Payment BABs”). In addition, section 1401 of ARRA adds sections 1400U-1 and 1400U-2, which provide that, for a certain type of Direct Payment BAB (called a Recovery Zone Economic Development Bond or “RZEDB”), the direct payment subsidy to the issuer is an amount greater than the otherwise allowed subsidy would be for Direct Payment BABs.

In general, BABs are bonds that meet the following requirements:

1. The bonds are not “private activity bonds.”<sup>6</sup>
2. The interest on the bonds would, except for the application of the BABs rules, otherwise be excludable from federal gross income under section 103.<sup>7</sup>
3. The BABs are issued prior to January 1, 2011.<sup>8</sup>
4. The issuer makes an irrevocable election to have the bonds treated as BABs.<sup>9</sup>
5. The bonds do not have issue prices with more than a *de minimis* amount of original issue premium, determined under rules similar to the rules of section 1273(a)(3).<sup>10</sup>

To qualify as Direct Payment BABs, two additional requirements apply:

1. All of the “available project proceeds,” as defined in section 54A, of the issue, less available project proceeds held in a reasonably required reserve fund, within the meaning of section 150(a)(3), and

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<sup>6</sup> I.R.C § 54AA(d)(1).

<sup>7</sup> I.R.C § 54AA(d)(1)(A).

<sup>8</sup> I.R.C § 54AA(d)(1)(B).

<sup>9</sup> I.R.C § 54AA(d)(1)(C).

<sup>10</sup> I.R.C § 54AA(d)(2)(C).

costs of issuance not in excess of two percent are to be used for capital expenditures.<sup>11</sup>

2. The issuer makes an irrevocable election to have the bonds treated as Direct Payment BABs.<sup>12</sup>

To qualify as RZEDBs, the requirements applicable to BABs and the following three additional requirements generally apply:

1. All of the available project proceeds, as defined in section 54A, of the issue, less available project proceeds held in a reasonably required reserve fund, within the meaning of section 150(a)(3), are to be used for one or more qualified economic development purposes.<sup>13</sup>
2. The issuer designates the bonds as RZEDBs.<sup>14</sup>
3. The maximum aggregate face amount of bonds that are designated by any issuer cannot exceed the amount of RZEDB limitation allocated to such issuer under section 1400U-1.<sup>15</sup>

For this purpose, “qualified economic development purpose” means expenditures for the purposes of promoting development or other economic activity in a recovery zone, including capital expenditures paid or incurred with respect to property located in a recovery zone, expenditures for public infrastructure and construction of public facilities, and expenditures for job training and educational purposes.<sup>16</sup>

The various provisions relating to BABs and RZEDBs raise a number of interpretative issues. These Comments discuss several issues and suggest resolution of those issues. In addition, the Comments also address a few questions relating to Recovery Zone Facilities Bonds or “RZFBs,” which were created by section 1400U-3 (also added by ARRA), when those questions overlap with questions related to RZEDBs.

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<sup>11</sup> I.R.C. § 54AA(g)(2)(A).

<sup>12</sup> I.R.C. § 54AA(g)(2)(B).

<sup>13</sup> I.R.C. § 1400U-2(b)(1)(A).

<sup>14</sup> I.R.C. § 1400U-2(b)(1)(B).

<sup>15</sup> I.R.C. § 1400U-2(b)(2).

<sup>16</sup> I.R.C. § 1400U-2(c).

## Issues relating to BABs generally

**Application of General Tax-Exempt Bond Rules.** For a bond to qualify as a BAB, it must initially be an obligation that, but for section 54AA and an election by the issuer, would qualify as a tax-exempt bond other than a private activity bond.<sup>17</sup> The rules relating to tax-exempt bonds apply in determining whether the BAB would otherwise qualify as a tax-exempt bond. The applicable rules include the issuer qualification tests of section 103, the private activity bond tests of section 141, the arbitrage rules of section 148, the miscellaneous requirements set forth in section 149, and, to the extent applicable, the definitions contained in section 150. Those sections, and the related Regulations and other related guidance issued by the Treasury and the Service, must be analyzed to determine whether the bond would otherwise be a tax-exempt bond. Many of the tests are applied by looking at the entire issue of which the bond is a part.<sup>18</sup> Accordingly, the definition of issue contained in Regulation section 1.150-1(c) is applicable for this purpose. As discussed below, we recommend that guidance clarify that rules relating to tax-exempt bonds are applicable to BABs not only for purposes of determining whether the BABs would otherwise be tax-exempt bonds, but also for other purposes.

*a. Issue Price and Original Issue Premium.* Assuming that the bond would otherwise be treated as a tax-exempt governmental bond, various other tests must be met, including a requirement that the issue price of the bond not include more than a *de minimis* amount of premium (as determined under rules similar to section 1273(a)(3)). Questions have arisen as to how issue price is to be determined.

In particular, the general tax rules for determining issue price, contained in sections 1273 and 1274, state that, for publicly offered debt instruments not issued for property (*i.e.*, those sold for money), the issue price is “the initial offering price to the public (excluding bond houses and brokers) at which price a substantial amount of such debt instruments was sold.”<sup>19</sup> The Regulations state that, for each debt instrument that is part of the same issue, the issue price “is the first price at which a substantial amount of the debt instruments is sold for money.”<sup>20</sup> The Regulations further provide that, for debt instruments issued on or after March 13, 2001, two or more debt instruments are part of the same issue if they have the same credit and payment terms, are issued pursuant to the same plan or a part of a single transaction or series of related transaction, and are issued within a period of 13 days beginning on the date the first debt instrument is issued to a person other than a bond house, broker, or similar persons acting as an underwriter,

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<sup>17</sup> I.R.C. § 54AA(d)(1).

<sup>18</sup> *See, e.g.*, I.R.C. § 141(a)(1) (a private activity bond is any bond that is part of an *issue* that meets the applicable tests).

<sup>19</sup> I.R.C. § 1273(b)(1).

<sup>20</sup> Reg. § 1.1273-2(a)(1).

placement agent, or wholesaler.<sup>21</sup> Thus, under the general rule, bonds that have the same maturity, interest rate, and other payment terms and are sold at the same time by the issuer (so-called “substantially identical bonds”) will be treated as having the same issue price, based upon the initial offering price to the public at which a substantial amount of such bonds are sold. The Regulations and other guidance do not define substantial amount, but we understand that practitioners commonly use ten percent as a guideline.

This rule is slightly modified for purposes of applying the tax-exempt bond rules. Regulation section 1.148-1(b) provides, in relevant part, first that ten percent is a substantial amount (resolving the ambiguity about what constitutes as substantial amount) and second that “the issue price 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.” Thus, for purposes of applying the tax-exempt bond rules, issue price for each substantially identical bond is determined at the sale date based upon reasonable expectations if the bonds are offered in a bona fide public offering (presumably at that price).<sup>22</sup>

Application of the special rule for tax-exempt bonds may give a different result for issue price than would be obtained by using the general rule contained in section 1273. Because of the special nature of BABs, which are otherwise very similar to other municipal debt, we recommend that the special rule for issue price contained in Regulation section 1.148-1(b) be made applicable to BABs. We believe that this produces a conclusion that issue price is to be determined separately for each group of substantially identical BABs and that, for BABs that are offered to the public in a bona fide offering, the issue price of substantially identical BABs will be determined at the sale date based upon reasonable expectations. Moreover, as provided in Regulation section 1.148-1(b), the issue price will not change if part of the issue is later sold at a different price or if none of the BABs are actually sold at the bona fide offering price.<sup>23</sup>

We also read the requirement that a BAB may not have an issue price that includes more than a *de minimis* amount of original issue premium to mean that original issue premium is determined by looking at each group of substantially identical BABs

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<sup>21</sup> Reg. § 1.1275-1(f)(1).

<sup>22</sup> Questions have arisen in the tax-exempt bond context as to whether actual information concerning the sales of bonds to the public after the sale date may affect issue price by, for example, allowing one to determine whether the expectations as of the sale date were reasonable. These comments do not address those questions.

<sup>23</sup> There have been several reports of agents examining Electronic Municipal Market Access (or “EMMA”) data to determine whether the bonds in an issue of BABs were sold with more than a *de minimis* amount of original issue premium. These reports have raised concerns among practitioners and issuers of BABs that the examining agents may not be applying the reasonable expectations test set forth in Regulation section 1.148-1(b) and may conclude that the bonds do not qualify for BAB status because of factors beyond the control of the issuers. The recommended application of the special rule for tax-exempt bonds would alleviate such concerns.

that otherwise meet the definition of “issue” contained in Regulation section 1.1275-1(f)(1). Accordingly, for each group of various BABs sold at the same time that might otherwise be treated as part of the same issue under Regulation section 1.148-1(c), an original issue premium with respect to one maturity of the BABs may not be offset by an original issue discount with respect to another maturity of the BABs. If this reading is correct, we suggest that guidance confirm the reading.

*b. Single Issue Question.* When determining whether a bond is a private activity bond or whether it meets the requirements relating to bearing tax-exempt interest, it is often important to identify the bonds that are part of the same “issue.” Regulation section 1.150-1(c) provides guidance in this matter, stating that, generally, bonds are part of the same issue if they are sold at substantially the same time, sold pursuant to the same plan of financing, and reasonably expected to be paid from the same source of funds. In addition, the Regulations provide that taxable and tax-exempt bonds are not part of the same issue, although the issuance of tax-exempt bonds in a transaction involving taxable bonds may constitute an abusive arbitrage device or a device to avoid other limitations in sections 103 and 141-150.<sup>24</sup>

Because BABs are ultimately taxable bonds, they generally would not be thought to be part of the same issue as tax-exempt bonds that are sold by the same issuer at the same time, pursuant to the same plan of financing, and payable from the same source of funds. The question has arisen, however, as to whether BABs need to be analyzed together with tax-exempt bonds sold and issued at the same time to determine whether they would be treated as tax-exempt governmental bonds that would be eligible for a BABs election. In theory, if the BABs were analyzed together with other bonds issued at the same time, bonds might be treated as tax-exempt that would not otherwise be treated as tax-exempt. For example, suppose a proposed issue of BABs of \$50 million is to be sold at the same time as \$50 million of other bonds. If the BABs and the other bonds were treated as a single issue for purposes of the private activity bond test, it would theoretically be possible for 100% of the proceeds of the BABs and 80% of the proceeds of the other bonds to be used for governmental purposes. If so, all the bonds together would not be treated as private activity bonds (since only ten percent of the proceeds would be used for private purposes). On a standalone basis, however, the other bonds would be viewed as meeting the test and accordingly being private activity bonds. Similarly, if the bonds are part of the same issue, 80% of the BABs and 100% of the other bonds could be used for governmental purposes, but on a standalone basis would have ambiguous results under the private activity bond test. Additionally, if bonds intended to be Direct Payment BABs are treated as part of the same issue as tax-exempt bonds, the use of proceeds of the tax-exempt bonds could cause the Direct Payment BABs to fail the requirement that 100% of the proceeds be used for capital expenditures. These results all appear to be anomalous and inconsistent with the policy of encouraging BABs, and we recommend that it be made clear that BABs and tax-exempt bonds are never part of the same “issue” for tax purposes.

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<sup>24</sup> Reg. § 1.150-1(c)(2).

It is also a long-standing practice to use taxable bonds to pay for expenditures that cannot be financed with tax-exempt bonds, leaving only qualifying uses to be funded with the tax-exempt bonds. We expect to see similar uses of taxable debt, including qualified tax credit bonds under section 54A, in connection with the issuance of BABs. Such an approach could result in the bonds intended to be BABs inadvertently failing one or more of the BABs tests. We recommend that guidance clarify that BABs and taxable bonds that do not receive a federal tax subsidy should never be part of the same “issue” for tax purposes. Similarly, we recommend that guidance clarify that BABs and qualified tax credit bonds are never part of the same “issue.” Our recommendations would provide for analysis of the BABs on a standalone basis and prevent a gaming of the tax rules designed to subvert the intention of the tax-exempt bond rules and the BABs rules or to result in an artificial calculation of yield for purposes of rebate.

*c. Remedial Actions.* For tax-exempt bonds, if the issuer takes actions after the bonds are issued that, if expected at the time the bonds were issued, would have caused those bonds to be taxable, those actions will result in the bonds being treated as taxable. The tax law makes some provision allowing for remedial action in certain cases. Specifically, Regulation section 1.141-12 provides several alternative actions that may be taken in appropriate cases to preserve the tax-exempt status of the bonds. Similarly, Revenue Procedures 79-5<sup>25</sup> and 81-22<sup>26</sup> provide a corrective action that may be taken with certain excess proceeds.

For purposes of determining whether the BABs would otherwise be treated as tax-exempt governmental bonds, we believe the remedial actions provided for tax-exempt bonds should generally apply. However, with respect to other rules relating to BABs (for example the requirement that 100% of the available project proceeds (less amounts deposited into a reasonably required reserve) be used for capital expenditures), it is unclear whether these or similar remedial action rules apply. We believe there is no policy reason to allow for remedial actions with respect to only certain of the BABs rules and urge that guidance provide that the remedial actions described in Regulation section 1.141-12 and Revenue Procedures 79-5 and 81-22 will apply to BABs for purposes of all the BABs rules.<sup>27</sup> Thus, for example, if Direct Payment BABs were issued with an expectation<sup>28</sup> that 100% of the proceeds would be used for capital

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<sup>25</sup> 1979-1 C.B. 485.

<sup>26</sup> 1981-1 C.B. 692.

<sup>27</sup> Defeasance of the bonds is one of the permitted remedial actions under Regulation section 1.141-12. There is a special rule in Regulation section 1.1001-3(e)(5)(ii)(B)(1) that prevents defeasance of a tax-exempt bond from being a significant modification in certain cases. Consistent with the requirement that BABs must first qualify as tax-exempt bonds before an election may be made to treat them as BABs, we recommend that guidance clarify that the special reissuance rule also applies to BABs to prevent a defeasance from causing reissuance of the BABs and potential disqualification if the reissuance is after December 31, 2010, and a realization event to the holders of the BABs.

<sup>28</sup> The language of section 54AA(g)(2) uses the terminology “are to be used,” which suggests some sort of reasonable expectations test, similar to the language of section 141(b)(1). It seems appropriate

expenditures and if capital expenditures were exhausted with proceeds still remaining, the issuer should be allowed to redeem the BABs or defease them to their first optional call date.<sup>29</sup>

An additional remedial action, unlike any available to tax-exempt bonds, might be developed specifically for BABs. This might allow an issuer to identify on a form provided by the Service the portion of the BABs that no longer qualify for the subsidy and to receive a reduced subsidy reflecting only the amount of the remaining bonds that qualify as BABs.

**Section 265.** Section 265(b)(3) and (b)(7) provide that tax-exempt bonds issued by certain “small issuers” will not be subject to the complete disallowance of interest expense for financial institutions that hold them and that financial institutions may hold up to two percent of their assets in tax-exempt bonds issued in 2009 and 2010 without resulting in a complete disallowance of interest expense. Because BABs must otherwise qualify as tax-exempt bonds, absent the election, the question arises whether BABs will count against either limit. We believe a literal reading of the statute indicates that BABs will not be so counted, because the interest paid on the BABs is included in gross income<sup>30</sup> and the limitations in section 265(b)(3) and (b)(7) only apply to bonds the interest on which is tax exempt. However, for avoidance of doubt in the marketplace, we believe this analysis should be confirmed.<sup>31</sup>

**Refunding of BABs.** Because BABs must be issued in 2009 or 2010, if the BABs are to be refunded after that, they may not be refunded with new BABs. However, we read the rules as allowing tax-exempt bonds to be used to refund BABs if the general tax-exempt bond requirements are met. Again, for the avoidance of doubt in the marketplace, we believe this result should be confirmed.<sup>32</sup>

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to provide a post-issuance compliance regime for BABs similar to that of tax-exempt bonds, but with the caveat that the same types of corrective actions should be made available.

<sup>29</sup> Some accommodation in the remedial action rules may be required to address the fact that many BABs issued to date have been issued with complete call protection (*i.e.*, the issuer does not have a right to call the BABs for redemption).

<sup>30</sup> See I.R.C. § 54AA(f)(1).

<sup>31</sup> The effect of Regulation section 1.1397E-1T(i)(5) is that both Qualified Zone Academy Bonds, as defined in section 54E(a), and tax exempt bonds are counted for purposes of determining the size limitations for the “small issuer” rebate exception under section 148(f)(4)(D). This rule is aimed at a very specific arbitrage exception, however, and the policy behind it should not require that BABs be treated as tax-exempt bonds for purposes of section 265.

<sup>32</sup> There is some concern that the establishment of an escrow to defease BABs in the context of an advance refunding may cause a reissuance of the BABs pursuant to Regulation section 1.1001-3(c)(4). There is a special rule that prevents such a reissuance for tax-exempt bonds in Regulation section 1.1001-3(f)(6), and we recommend that the Treasury consider extending that relief to BABs as well.

**Accrued Interest.** The credit allowable with respect to a BAB is based on the amount of interest payable by the issuer with respect to each interest payment date.<sup>33</sup> Questions have arisen as to whether a credit is allowable with respect to the payment of any pre-issuance accrued interest on a BAB. Informal advice has been provided that pre-accrued interest is not included in determining the amount of the subsidy. We suggest that this informal advice be confirmed in written guidance.

**Stripping of Credits.** Section 54AA(f)(3) provides, inter alia, that credit stripping rules like those to be developed with respect to other tax credit bonds under section 54A(i) are to apply to BABs (presumably to Tax Credit BABs). We suggest that this guidance be issued as expeditiously as possible.<sup>34</sup>

**Circular 230.** A “State or local bond opinion” is excluded from the definition of “covered opinion” for purposes of Circular 230.<sup>35</sup> A State or local bond opinion is a written advice that addresses the excludability of interest on a State or local bond under section 103 and related and ancillary matters. In addition, a State or local bond opinion includes an opinion as to the status of a Qualified Zone Academy Bond under section 1397E and related and ancillary matters.<sup>36</sup> Accordingly, it appears that as currently written, Circular 230 would apply to any tax opinions delivered with respect to BABs.<sup>37</sup> As a covered opinion, a BABs opinion then would have to meet the requirements of section 10.35 generally. For the same reasons that State or local bond opinions, including Qualified Zone Academy Bond opinions under section 1397E, are excluded from the definition of covered opinion, we recommend that opinions with respect to BABs and related and ancillary matters also be excluded from the definition of covered opinion.

#### **Issues relating to Direct Payment BABs only.**

**Available Project Proceeds.** Section 54AA(g)(2) requires that 100% of the excess of the amount of available project proceeds (as defined in section 54A) over the amount of such proceeds deposited into a reasonably required reserve fund (within the meaning of section 150(a)(3)) be used for capital expenditures. Section 54A(e)(4) defines “[a]vailable project proceeds” to mean the excess of the proceeds from the sale of

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<sup>33</sup> I.R.C. § 54AA(b).

<sup>34</sup> We also suggest that guidance be provided with respect to credit stripping for qualified tax credit bonds under section 54A.

<sup>35</sup> Circular 230 § 10.35.

<sup>36</sup> It seems appropriate to modify this exclusion to include all bonds subject to section 54A.

<sup>37</sup> It is possible, of course, that any such opinions would avoid status as covered opinions by including the disclaimers discussed in 10.35(b)(4) and (b)(5). However, when an opinion is used in connection with the marketing of BABs, such as a Tax Credit BAB, such disclaimers may not be acceptable.

an issue over the issuance costs financed by the issue (up to two percent of such proceeds) and the proceeds from the investment of the excess. This results in an effective limit of two percent of the proceeds of the BABs on the amount of proceeds of an issue of Direct Payment BABs that may be used to pay costs of issuance.<sup>38</sup>

Earnings on the proceeds appear to include earnings on proceeds deposited into the reasonably required reserve, although arguably these earnings are not included under section 54AA(g)(2) because section 54AA(g)(2)(A)(ii) excludes amounts deposited in the reserve fund from the amounts that must be spent on capital expenditures. For tax-exempt bonds, proceeds subject to the private use tests include earnings on sale proceeds deposited into a reasonably required reserve or replacement fund, but only to the extent that those earnings accrue during the “project period.”<sup>39</sup> “Project period” means the period that begins on the date the bonds are issued and ends on the date the project financed with the bonds is placed in service (with an election available for bonds that finance more than one project).<sup>40</sup> We recommend that a similar rule be adopted with respect to “available project proceeds” for purposes of determining whether the 100% rule is met for Direct Payment BABs. In addition, it we recommend that the guidance acknowledge that earnings on proceeds do not include amounts that must be rebated.

The reference to section 150(a)(3) that is included in section 54AA(g)(2)(A)(ii) does not provide any definition of “reasonably required reserve fund.” Notice 2009-26 does, however, describe this reference as incorporating at least the ten percent limit on reasonably required reserve funds set forth in section 148(d)(2). This reading seems appropriate because the BABs must otherwise qualify as tax-exempt bonds and would not qualify if the requirements of section 148(d) were not satisfied. We recommend that all of the rules relating to reasonably required reserve funds for governmental tax-exempt bonds (generally contained in Regulation section 1.148-2(f)) be applied to BABs for purposes of determining the amount of available project proceeds. In addition, given that the subsidy payments may be offset by other amounts owed the federal government and that the issuer may decide not to pledge the subsidy payments to the repayment of the BABs, we recommend that “debt service,” for the purpose of applying the rules contained in Regulation section 1.148-2(f), be clarified to mean the gross debt service on the BABs, without taking into account a reduction for the subsidy payments.

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<sup>38</sup> Arguably, the costs of issuing bonds should be treated as a capital expense amortized over the life of the bond issue and could be financed without regard to any two percent limitation. *See, e.g.,* Rev. Rul. 77-234, 1977-2 C.B. 39 (costs of issuance are a capital expenditure and must be taken into account in determining whether the \$10 million capital expenditures limit for small issue industrial development bonds has been exceeded). (The conclusion of Rev. Rul. 77-234 seems consistent with Regulation sections 1.263(a)-4 and -5.) This result, however, seems contrary to the intent of Congress in specifically referring to “available project proceeds.”

<sup>39</sup> Reg. § 1.141-1(b).

<sup>40</sup> *Id.*

**Capital Expenditures.** The requirement that 100% of the available project proceeds (less amounts deposited in a reasonably required reserve fund) be used for capital expenditures raises several questions.<sup>41</sup>

First, we believe that whether expenditures are “capital expenditures” should be determined under general federal tax principles. Such a rule would be consistent with, for example, Regulation section 1.150-1(b), and we suggest that this Regulation should apply.

The “capital expenditure” definition is somewhat muddled by the so-called *de minimis* exceptions of Regulation section 1.148-6(d)(3)(ii). This list of exceptions is intended to clarify that certain types of “working capital expenditures” may be treated in the same fashion as capital expenditures for purposes of the allocation of gross proceeds to expenditures. For example, one of the exceptions refers to issuance costs, but as discussed above,<sup>42</sup> Revenue Ruling 77-234 concludes that issuance costs are capital expenditures; thus there is no apparent need for the exception. Similarly, a payment for a qualified guarantee typically gives rise to an asset that appears to be a capital expenditure under general federal tax principles.<sup>43</sup> Guidance should be issued to clarify the scope of the definition of “capital expenditures” for this purpose. At the least, it should clarify that amounts spent for a qualified guarantee are capital costs and that the *de minimis* exceptions of Regulation section 1.148-6(d)(3)(ii), including the allowances for interest on the BABs for some period past the placed-in-service date of the financed projects, apply in determining whether 100% of the proceeds have been spent on capital expenditures.

For purposes of determining what expenditures have been made with proceeds, we recommend that guidance provide that the rules of Regulation section 1.148-6, relating to the allocation of gross proceeds to expenditures, will also apply to BABs, giving the issuers of BABs the same flexibility relating to allocations afforded by those Regulations. Adoption of this approach would mean that “expenditures” made with bond proceeds for purposes of determining whether the bonds would otherwise qualify as tax-exempt governmental bonds will be consistent with “expenditures” of available project proceeds used in determining whether the 100% capital expenditures rule is met for BABs.

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<sup>41</sup> We note that the 100% rule does not leave any room for error. We recommend that some allowance be made for *de minimis* expenditures for other than capital purposes.

<sup>42</sup> See footnote 23.

<sup>43</sup> Potentially, a portion (relating to the construction period) of the cost of the bond insurance, which functions as a proxy for interest or a carrying charge, should be capitalized into any assets constructed with the bond proceeds. The remainder, however, appears to be a capital cost amortized over the life of the contract of insurance. See Reg. § 1.263(a)-4(b)(1), -4(c)(1)(iii).

Similarly, the Regulations relating to reimbursement allocations<sup>44</sup> should apply to BABs. These Regulations would be applicable for purposes of determining whether the bonds are governmental tax-exempt obligations in any event. We see no policy reason for not applying these Regulations for purposes of determining whether the 100% capital expenditure test has been met. This appears to be the approach taken in Notice 2009-26, although some confusion has arisen from the discussion of reimbursement in Notice 2009-26, which limits the ability to use Direct Payment BABs to refinance temporary short-term financing issued after the effective date of ARRA to reimbursement expenditures made after the effective date of ARRA. Although we agree that any temporary short-term financing should have to be issued after ARRA to be eligible to be taken out with a Direct Payment BAB, we do not see any policy reason to restrict the ability to use the short-term financing to make reimbursement allocations to reimbursement expenditures made after ARRA. There is also some confusion as to whether capital expenditures paid from the issuer's general funds (*i.e.*, not from short-term financing) may be reimbursed from BABs pursuant to the general reimbursement rules of Regulation section 1.150-2, regardless of whether the original expenditure was paid prior to the effective date of ARRA. Although Notice 2009-26 provides that eligible financing of capital expenditures includes a reimbursement of capital expenditures under the rules contained in Regulation section 1.150-2, without regard to the effective date of ARRA, the ensuing discussion in the Notice focuses solely on short-term financings and expenditures made after the effective date of ARRA. We do not believe that Notice 2009-26 was intended to redefine what constitutes a new money financing, including reimbursement of an issuer's own funds under the reimbursement rules. However, the discussion of short-term capital financing has resulted in some confusion. Thus, even if the limitations on reimbursement of expenditures made from short-term financings are not removed, we recommend that they be clarified to expressly not apply with respect to reimbursements of expenditures paid from the issuer's general funds.

Questions have also arisen as to whether expenditures for gas or electric prepayments, such as those provided for in section 148(b)(4) and Regulation section 1.148-1(e)(2)(iii) should be treated as capital expenditures. Because of the uncertainty as to the conclusion and the large amounts of bonds involved, we recommend that further guidance be issued with respect to this question.

Finally, questions have arisen regarding use of BABs proceeds to make grants to unrelated persons for their own capital purposes. There is no clear statement under current law regarding the capital or working capital status of bonds issued to provide money for grants for capital purposes. Many bond counsel "look through" to the use of the proceeds by the grantee to determine whether the bonds were issued for capital purposes. Historically, this "look through" approach has been used to determine compliance with the safe harbors set forth in Regulation section 1.148-1(c)(4)(i)(B) because grants are not separately provided for in the safe harbors. We recommend that the "look through" approach be generally adopted for BABs. The use of BABs to fund

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<sup>44</sup> Reg. § 1.150-2.

grants may be essential, for example, to allowing use of state-level issuers that may have more efficient access to credit markets and, in the case of grants, access to state-level revenues. This may be particularly important for use of BABs to benefit local communities that might have important but small dollar needs and, in the case of RZEDBs, a small allocation of volume cap.

**Form 8038-CP.** In connection with Direct Payment BABs and RZEDBs, Notice 2009-26 provides that issuers must file a Form 8038-CP, *Information Return for Credit Payments to Issuers of Qualified Bonds*, to request payment with respect to an interest payment date for the issuer. The Form 8038-CP provides for execution under penalties of perjury by the issuer's authorized representative and also contains a separate signature block for a paid preparer. The Instructions for Form 8038-CP provide that

if an authorized representative of the issuer filled in its return, the paid preparer's space should remain blank. Anyone who prepares the return but does not charge the issuer should not sign the return . . . . Anyone who is paid to prepare a return must sign it and fill in the other blanks in the *Paid Preparer's Use Only* area of the return.

Questions have arisen as to the appropriate treatment of bond trustees and paying agents who have contracted to prepare these returns for the issuer either (i) as part of their general duties as trustee or paying agent under the applicable trust indenture or bond resolution or (ii) for an additional fee pursuant to a supplemental agreement. Clarification is requested as to whether (and under what circumstances) the trustee (or paying agent) would constitute an authorized representative or a paid preparer, and if the latter, whether the Form 8038-CP must also be executed by a separate authorized representative of the issuer.

**Federal Guarantee Question.** Section 54AA(d)(2)(A) provides that a BAB shall not be treated as federally guaranteed by reason of the credit allowed under section 54AA(a) or section 6431. A question has arisen as to the treatment of tax-exempt bonds as federally guaranteed if the payments to be received by the issuer on the Direct Payment BABs are pledged to tax-exempt bonds issued concurrently with or prior to the issue of Direct Payment BABs. This question is particularly apparent in the case of Direct Payment BABs issued under a master indenture. In such a case, tax-exempt bonds have been previously issued under the indenture and, for example, the issuer may pledge the direct payments under the master indenture for purposes of meeting revenue or other covenants. If BABs are issued under the same indenture and the issuer pledges the subsidy to the BABs, those payments will be available to pay all parity bonds, including the tax-exempt bonds. The same concern arises with respect to pledges of the direct payments to completely unrelated bond issues. We recommend that Treasury clarify that such a pledge will not result in the tax-exempt bonds being treated as federally guaranteed.<sup>45</sup>

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<sup>45</sup> We believe that such treatment would be consistent with, for example, the treatment of the pledge of Medicare payments.

## Issues relating to Recovery Zone Economic Development Bonds

**General.** As mentioned above, ARRA created two categories of Recovery Zone Bonds (“RZBs”): “Recovery Zone Economic Development Bonds” or “RZEDBs”, a kind of “super BAB” that carries a 45% interest subsidy payment for governmental bonds and “Recovery Zone Facility Bonds” or “RZFBs”, a new type of exempt facility private activity bond. In addition to the general questions relating to BABs discussed above, the following special questions arise with respect to RZEDBs. To the extent they overlap, similar questions relating to RZFBs are discussed.

**Designation of Recovery Zones.** Both types of RZBs are intended to finance projects located in a so-called designated “recovery zone.” A recovery zone is defined in section 1400U-1(b) as:

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

As described more fully below, the RZBs are subject to a nationwide volume cap for the two years this category of bond is in existence under applicable provisions of current law. The cap is allocated among the states and possessions, and then required to be further allocated by the states among the counties and large municipalities. These ultimate recipients of the volume cap are the administrators of the RZB provisions, subject to certain waivers, and are the issuers of the RZBs. Notice 2009-50 provides that the issuer may designate the recovery zone “in any reasonable manner as it shall determine in good faith in its discretion.” Assuming such designation is made in “good faith,” the question has arisen as to whether a RZB cap recipient may designate its entire geographic area as a recovery zone.

It should be noted by comparison that the similar concept of “empowerment zones” under section 1391, which is referred to in section 1400U-1(b)(3), is more limited. Specifically, section 1392(a) provides that a nominated area shall be eligible for designation under section 1391 only if it meets the following criteria:

- (1) The nominated area has a maximum population of (A) in the case of an urban area, the lesser of (i) 200,000, or (ii) the greater of 50,000 or ten percent of the population of the most populous city located within the nominated area, and (B) in the case of a rural area, 30,000.
- (2) The nominated area is one of pervasive poverty, unemployment, and general distress.

(3) The nominated area (A) does not exceed 20 square miles if an urban area or 1,000 square miles if a rural area, (B) has a boundary that is continuous, or except in the case of a rural area located in more than one State, consists of not more than 3 noncontiguous parcels, (C)(i) in the case of an urban area, is located entirely within no more than two contiguous states, and (ii) in the case of a rural area, is located entirely within no more than three contiguous states, and (D) does not include any portion of a central business district (as such term is used for purposes of the most recent Census of Retail Trade) unless the poverty rate for each population census tract is not less than 35% (30% in an enterprise community).

Similarly, section 1400E(c) describes the criteria for the designation of renewal communities, including the following area requirements: (A) the area is within the jurisdiction of one or more governments; (B) the boundary of the area is continuous; and (C) the area (i) has a population of not more than 200,000 and at least (I) 4,000 if any portion of such area (other than a rural area that is within a local government jurisdiction or jurisdictions with a population of less than 50,000) is located within a metropolitan statistical area which has a population of 50,000 or greater, or (II) 1,000 in any other case, or (ii) is entirely within an Indian reservation.

There are no specific similar limitations placed on issuers regarding the designation of a recovery zone in the statute. In the absence of further guidance, it appears that an issuer may designate its entire jurisdiction as a recovery zone if the statutory criteria are satisfied for all areas within the jurisdiction. If this result is not intended, we request that guidance be provided as soon as possible.

**Waivers and Deemed Waivers of RZB Cap.** ARRA includes a nationwide dollar limit on the amount of RZBs that may be issued. The maximum amount of RZEDBs that may be issued is \$10 billion and the maximum amount of RZFB that may be issued is \$15 billion. Notice 2009-50 has allocated such amounts among the states and possessions of the United States, and within the various states to the counties and large municipalities based upon the proportional decline in employment experienced over the 2008 calendar year.

Section 1400U-1(a)(3)(A) further provides that each “State with respect to which an allocation is made . . . shall reallocate such allocation among the counties and large municipalities in such State in proportion to each such county’s or municipality’s 2008 employment decline bears to the aggregate of the 2008 employment declines for all the counties and municipalities in such State.” A large municipality is defined as a municipality with a population of more than 100,000.<sup>46</sup>

Notice 2009-50 undertakes the required suballocation on behalf of the states. Notice 2009-50 also provides for a deemed waiver of the cap allocation in situations in

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<sup>46</sup> I.R.C. § 1400U-1(a)(3)(B).

which the existence of a county or parish has no legal significance (*i.e.*, lacks significant taxing, police and eminent domain powers) in a particular state.

Section 5.04 of Notice 2009-50 states

In the event that a county or large municipality that receives an allocation of volume cap under Section 1400U-1(a)(3)(A) . . . does not possess substantial taxing, eminent domain, and police powers, any entity the jurisdiction of which includes such county or large municipality may issue bonds and designate such bonds as [recovery zone bonds] . . . on behalf of, and for the benefit of, such country or municipality, subject to the applicable volume cap limitations for those Recovery Zone Bonds allocated to such county or large municipality. In such case, the proceeds of an issue of [Recovery Zone Bonds] . . . must be allocated to eligible costs for qualified economic development purposes or recovery zone property, as applicable, that is located within, or attributable to, both the jurisdiction of the issuer of the bonds and the jurisdiction of the county or large municipality that received the volume cap allocation. . . . In all events, the proceeds of the issue must be used to finance eligible costs for qualified economic development purposes or recovery zone property, as applicable, that is located within, or attributable to, both the jurisdiction of the issuer of the bonds and the jurisdiction of the county or large municipality authorized to allocate volume cap to an ultimate beneficiary of the issue of Recovery Zone Bonds for the financing of those purposes or property.

The foregoing provisions of Notice 2009-50 appear to limit the ability of a state in which the counties, parishes, large municipalities, or some combination thereof do not possess significant taxing, police and eminent domain powers to apply the Recovery Zone Bond cap in an economically rational and expedient (given the time limitations for the issuance of the bonds) manner when the volume cap could be better used in other regions of the state. This limitation appears unnecessary to accomplish the goal of the statute. Moreover, to best accomplish the economic stimulus objective of this provision, we suggest that states be given the authority to reallocate volume cap that would not otherwise be used.

When the counties, parishes, large municipalities, or some combination thereof within a state *are* possessed of substantial taxing, police and eminent domain powers, the state appears to have no power to compel those counties, parishes or large municipalities to transfer their volume cap. The applicable Code provision provides that a “county or municipality *may* waive any portion of an allocation made.”<sup>47</sup> Section 5.05 of Notice 2009-50 addresses waivers of the RZB cap, referring to the statutory provision cited in the immediately preceding sentence, adding “[u]pon any such waiver, the State in which such county or large municipality is located shall be authorized to reallocate the waived volume cap in any reasonable manner as it shall determine in good faith in its discretion.” Thus, it would appear that the counties and large municipalities that are the intended recipients of the RZB cap may not be compelled by the states to waive their cap in favor

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<sup>47</sup> I.R.C. § 1400U-1(a)(3)(A) (emphasis added).

of the state. Presumably, a state may mandate an accounting of the intended use of the cap, but a mandatory accounting may give rise to a question as to whether a state may require a county or large municipality to exercise its right to waive its cap in favor of the state to facilitate an eventual reallocation of the cap. It would be helpful to have more specific guidance regarding the scope of the ability of a state to “deem” or require a waiver of the cap, to minimize the risk that the sunset for these provisions will result in large amounts of unused cap expiring. This risk is particularly high in situations in which the suballocations of cap have resulted in relatively small amounts being available for use. If the available amounts are small, the bond issue may be uneconomic, unless effectuated on a pooled basis.

**Maturity Limitations for RZEDBs used for Job Training.** RZEDBs may be used for “purposes of promoting development or other economic activity in a recovery zone, including (1) capital expenditures paid or incurred with respect to property located in such zone, (2) expenditures for public infrastructure and construction of public facilities, and (3) expenditures for job training and educational programs.”<sup>48</sup> RZEDBs, as noted above, are a form of BAB and consequently subject to all of the requirements applicable to tax-exempt governmental bonds, including the requirement that the bonds not be outstanding longer than necessary to accomplish the governmental purpose thereof. This standard may be met by reference to the 120% test in respect of capital projects, but there are no applicable standards for purposes of issuing RZEDBs to finance the costs of job training and educational programs. Guidance should be issued regarding the maturity limits that apply to such financings. One possibility would be to treat such costs as not included (either in the numerator or the denominator) when calculating the average life of the assets financed.

**Prevailing Wage Considerations.** Section 1601 of ARRA makes the prevailing wage requirements of the Davis-Bacon Act<sup>49</sup> applicable to certain of the tax credit bonds created by ARRA, including RZEDBs. The interplay between the requirements of these provisions and the qualification of the bonds to be designated RZEDBs and consequently eligible for the refund of the tax credit is unclear. We believe that the effect of any violation of section 1601 is appropriately handled by the Labor Department and should not affect the tax status of any bonds. Confirmation of this view would be appreciated.

**Definition of Qualified Business for RZFB Purposes.** RZFBs may be issued to finance recovery zone property “substantially all of the use of which is in the recovery zone and is in the active conduct of a qualified business by the taxpayer in such zone.”<sup>50</sup>

A qualified business is defined to mean “any trade or business, except that:  
(A) the rental to others of real property in a recovery zone shall be treated as a qualified

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<sup>48</sup> I.R.C. § 1400U-2(c).

<sup>49</sup> 40 U.S.C. ch. 31 subch. IV.

<sup>50</sup> I.R.C. § 1400U-3(c)(1)(C).

business only if the property is not residential rental property . . . and (B) such term shall not include any trade or business consisting of the operation of any [private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises].”<sup>51</sup>

It is unclear whether there is a general public use requirement, similar to the general public use requirement that pertains to other categories of exempt facility bonds under Regulation section 1.103-8(a)(2). This provision of the Regulations establishes that to qualify as an exempt facility for purposes of being eligible to be financed with an exempt facility bond (under section 103(b)(4)), “a facility must serve or be available on a regular basis for general public use, or be a part of a facility so used . . . . Sewage or solid waste disposal facilities . . . will be treated in all events as serving a general public use although they may be part of a nonpublic facility such as a manufacturing facility used in the trade or business of a nonexempt user.” We believe that in effect ARRA has treated facilities to be financed with RZFBs as serving a general public purpose. Clarification on this point would be appreciated.

**Recovery Zone Property.** Section 1400U-3 provides, in part, that “recovery zone property” must be “property to which section 168 applies (or would apply but for section 179).” Pursuant to this requirement, recovery zone property must be property that is subject to depreciation under section 167, which would appear to disallow the financing of any land with the proceeds of RZFBs. This same language is found in section 1397D relating to “qualified zone property” in the context of Enterprise Zone financings. Nevertheless, Regulation section 1.1394-1(i) provides that “the determination of whether land is functionally related and subordinate to qualified zone property is made in a manner consistent with the rules for exempt facilities under section 142.” Regulation section 1.103-8(a)(3) provides that “an exempt facility includes any land . . . functionally related and subordinate to such facility.” Guidance should be issued regarding whether a similar rule applies for RZFBs, which would permit financing of land to the extent that it is functionally related and subordinate to recovery zone property consistent with the rules for exempt facilities under section 142.

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<sup>51</sup> I.R.C. § 1400U-3(c)(2).