

Treasury Guidance on Build America Bonds—Notice 2009-26 and Form 8038-CP

On Friday, April 3, 2009, the Internal Revenue Service ("IRS") released guidance relating to Build America Bonds ("BABs"), a new financing option created by the American Recovery and Reinvestment Act of 2009 ("ARRA"). Notice 2009-26 describes the procedures for electing BABs treatment and for claiming a direct payment from the federal government in the case of Direct Payment BABs (as defined below). Notice 2009-26 also provides guidance on the types of eligible projects and financings. This Update provides a brief review of the general requirements of BABs¹ and summarizes this new guidance for state and local governments who may be interested in issuing BABs. Notice 2009-26 is available on the IRS's website at <http://www.irs.gov/pub/irs-drop/n-09-26.pdf>.

Build America Bonds Overview

The ARRA allows issuers to elect to treat certain bonds issued in 2009 and 2010 as BABs. Unlike traditional tax-exempt bonds, BABs bear taxable interest for the holder. Although the interest is taxable, the issuer can elect to issue the BABs either as "Direct Payment BABs," where the federal government will provide a subsidy payment directly to the issuer equal to 35% of the interest coupon on the bonds, or as "Credit BABs," where the bondholders receive a tax credit equal to 35% of the interest coupon on the bonds. Notice 2009-26 summarizes and clarifies the requirements for all BABs and also the additional requirements and procedures for Direct Payment BABs.

In general, all BABs must meet the requirements for traditional tax-exempt bonds under existing law, but may not be private activity bonds and may not be issued with more than a de minimis amount of

premium. Notice 2009-26 provides that the irrevocable election to issue bonds as BABs (including the election to issue as Direct Payment BABs or Credit BABs) must be made on the issuer's books and records on or before the date of issuance of the bonds. A timely Form 8038-G must be filed with the IRS for the BABs, with a notation on Line 18 that the bonds are issued as either "Build America Bond (payment option)" for Direct Payment BABs or "Build America Bond (tax credit)" for Credit BABs.

Direct Payment BABs

For Direct Payment BABs, the federal government will pay to the issuer or its designee an amount equal to 35% of the coupon interest payable to the bondholders. This provides a direct subsidy of approximately 35% of the issuer's taxable borrowing cost. The amount of the direct payment is taken into account in the calculation of arbitrage yield on Direct Payment BABs. Notice 2009-26 clarifies some of the requirements for bonds to be issued as Direct Payment BABs and provides procedures for requesting payments.

Sale proceeds of Direct Payment BABs may only be used for (1) capital expenditures, (2) costs of issuance not exceeding 2% of the proceeds and (3) a reasonably required debt service reserve fund. Notice 2009-26 provides that reimbursement of capital expenditures under the traditional reimbursement rules of Treasury Regulations Section 1.150-2 will be treated as capital expenditures for this purpose. In addition, costs paid or incurred after February 17, 2009, that have been financed with temporary short-term financing issued after that date may be repaid with proceeds of Direct Payment BABs. Otherwise, proceeds of Direct Payment BABs may not be used for refundings. Proceeds of Direct Payment BABs may not be used for working capital expenses.

Notice 2009-26 provides the filing requirements and initial payment procedures for Direct Payment BABs. In general, a detailed debt service schedule must be attached to the Form 8038-G for the BABs, and a Form 8038-CP (a new form also released on April 3, 2009) must be filed to request each direct payment. The Form 8038-CP is a one-page form requiring (i) the name and address of the entity to receive the payment, (ii) general information about the issuer and the bonds, and (iii) the calculation of the amount of the direct payment to be made.

Payments on Fixed Rate BABs. For fixed rate BABs, a separate Form 8038-CP is due at least 45 days (but not

¹ For a more detailed description of these and other financing options created by the ARRA, please see Orrick's February 24, 2009 client alert, "The American Recovery and Reinvestment Act of 2009: What It Means to You and Your Financing Options," available at <http://www.orrick.com/fileupload/1657.pdf>. Also on April 3, 2009, the IRS issued Notice 2009-30, relating to Qualified Zone Academy Bonds, and Notice 2009-35, relating to Qualified School Construction Bonds. For summaries of these Notices and other general guidance on tax-exempt financings, please see the publications page of Orrick's website, available at <http://www.orrick.com/publications>.

more than 90 days) before each interest payment date. If timely received, the IRS will make the direct payment contemporaneously with the interest payment date.

Payments on Variable Rate BABs. For variable rate BABs, a separate Form 8038-CP is to be filed for interest payments made in each quarter, due 45 days after the last payment for each quarter. The IRS will then make the direct payment on a reimbursement basis with respect to the interest payments made over that prior quarter.

In addition to these timing requirements for the Form 8038-CP, the Form 8038-G for the Direct Payment BABs must be filed at least 30 days prior to the first Form 8038-CP. An exception to the 30-day rule is made for Direct Payment BABs issued prior to July 1, 2009, but Forms 8038-G for such BABs must still be filed prior to (and separately from) the first Form 8038-CP. The IRS will be prepared to accept Forms 8038-CP by May 1, 2009, and the IRS and Treasury Department will be prepared to make timely payments with respect to interest payment dates beginning on or after July 1, 2009.

Notice 2009-26 states that these procedures for direct payments are initial procedures and will be refined over time. The IRS and the Treasury Department have solicited comments as to ways to improve these procedures. Notice 2009-26 also discusses Recovery Zone Economic Development Bonds ("RZEDBs"), a separate type of bond created by the ARRA in which the direct payment subsidy paid to the issuer is 45% of the total interest coupon paid to bondholders. In general, Notice 2009-26 indicates that the same direct payment procedures for Direct Payment BABs will also apply to RZEDBs. However, separate guidance on RZEDBs will be issued, including guidance on the allocation of special volume cap for RZEDBs. Unlike Direct Payment BABs and Credit BABs, federal Davis-Bacon prevailing wage rules apply to projects financed with RZEDBs.

Credit BABs

If a BAB is issued as a Credit BAB, on each interest payment date bondholders will be entitled to a tax credit equal to 35% of each interest payment payable on such date. The credit is non-refundable, but the unused portion may be carried forward to successive years. The tax-credit mechanism for Credit BABs is fundamentally different from that applicable to other existing types of tax-credit bonds, such as Qualified Zone Academy Bonds or Clean Renewable Energy Bonds. Whereas those other types of tax-credit bonds were intended to enable the issuer to borrow without interest, Credit BABs instead are designed to provide a subsidy to issuers of approximately 25% of their

taxable borrowing rates². The 25% subsidy for Credit BABs is less than the 35% subsidy provided for Direct Payment BABs.

Unlike Direct Payment BABs, the uses of Credit BABs are not limited to capital expenditures and are not subject to the 2% cost of issuance limitation. Credit BABs may be issued for capital expenditures or working capital costs and may be issued for both new money and refunding purposes. The credit received by the bondholders is not taken into account in the calculation of arbitrage yield on the Credit BABs. The credit portion of Credit BABs may also be stripped from the bonds, which could increase the marketability of these bonds by allowing the taxable bonds and the credit to be sold to different investors.

This summary is designed to inform the reader, in a general manner, of the substance of Notice 2009-26, and is not intended to be comprehensive. Anyone with questions should contact publicfinance@orrick.com, or one of the members of our Public Finance Tax Group listed below:

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² Although the amount of the credit to bondholders is 35% of the interest coupon, the subsidy to issuers is approximately 25% because the amount of the tax credit must be included in the bondholder's income.