Client Advisory | *May 2010*

Public Finance Advisory

Summary of IRS Notice 2010-35 Providing Interim Guidance Regarding Direct Payment Subsidy Option for Certain Qualified Tax Credit Bonds and Build America Bonds

On March 18, 2010, President Barack Obama signed into law the Hiring Incentives to Restore Employment Act (the "HIRE Act"), which, among other things, contains provisions authorizing certain qualified tax credit bonds to be issued as direct payment bonds, pursuant to which an issuer may elect to receive cash subsidy payments from the United States Department of the Treasury (the "Treasury") equal to a portion of the interest payable on such bonds, similar to the cash subsidy mechanism in place for direct pay Build America Bonds ("BABs").

The Treasury and the Internal Revenue Service (the "IRS") recently released IRS Notice 2010-35, which provides guidance on the HIRE Act bond provisions, as well as additional guidance with respect to BABs, in particular with respect to the issue price of BABs and certain other matters. This advisory summarizes the guidance set forth in IRS Notice 2010-35. A full copy of IRS Notice 2010-35 is available on the IRS website at http://www.irs.gov/pub/irs-drop/n-10-35.pdf.

Direct Pay Tax Credit Bonds

The direct payment subsidy option authorized by the HIRE Act applies to the following specified tax credit bonds (referred to herein as "Direct Pay Tax Credit Bonds"):

- New Clean Renewable Energy Bonds ("New CREBs");
- Qualified Energy Conservation Bonds ("QECBs");
- Qualified Zone Academy Bonds ("QZABs"); and
- Qualified School Construction Bonds ("QSCBs").

Generally, Direct Pay Tax Credit Bonds provide issuers a Federal borrowing subsidy with respect to each interest payment due under the bonds through a cash subsidy paid directly to issuers on each interest payment date, generally equal to (i) with respect to QZABs and QSCBs, the amount of interest that would have been payable if the bonds were sold as tax credit bonds, and (ii) with respect to New CREBs and QECBs, 70% of the amount of interest that would have been payable if the bonds were sold as tax credit bonds.

The direct payment subsidy option applies only if the bonds are issued after March 18, 2010, the date of enactment of the HIRE Act, and the issuer makes an irrevocable election to apply this option.

In applying arbitrage investment restrictions, the yield on a Direct Pay Tax Credit Bond is reduced by the amount of the cash subsidy. Interest paid on a Direct Pay Tax Credit Bond is includable in gross income of the owner of the bond; however, the Federal subsidy payment received by the issuer is not includable in income for purposes of the Internal Revenue Code (the "Code"). No tax credit to the holder of a Direct Pay Tax Credit Bond is permitted.[1]

IRS Notice 2010-35 provides guidance as to Direct Pay Tax Credit Bonds. The notice includes information on maximum maturity and credit rate, sinking fund yield calculation, information reporting and eligible expenditures.

Direct Pay Tax Credit Bond Requirements

Direct Pay Tax Credit Bonds have different program requirements and different levels of Federal borrowing subsidies depending on the type of qualified tax credit bond. Edwards Angell Palmer & Dodge LLP provided an overview of the program requirements, eligible expenditures and levels of Federal borrowing subsidies available for each type of qualified tax credit bond in our June 2009 Public Finance Advisory located at http://www.eapdlaw.com/newsstand/detail.aspx?news=1645 (the "June 2009 Advisory"). In general, the requirements for and characteristics of qualified tax credit bonds as set forth in the June 2009 Advisory apply to Direct Pay Tax Credit Bonds, except that, as noted above, the holders of such bonds do not receive any tax credit with respect to them. Further, the provisions relating to maximum maturity, determination of the credit rate (which is used to determine the amount of the cash subsidy payment), sinking fund yield calculation, eligible expenditures and arbitrage investment restrictions for each type of qualified tax credit bond described in the June 2009 Advisory apply equally to its Direct Pay Tax Credit Bond counterpart.

Information Reporting for Direct Pay Tax Credit Bonds

Notice 2010-35 provides that in order to obtain cash subsidy payments for an issue of Direct Pay Tax Credit Bonds, the issuer must submit IRS Form 8038-CP, Return for Credit Payments to Issuers of Qualified Bonds ("Form 8038-CP") within a prescribed time before or after each applicable interest payment date, depending on whether the bonds are issued as fixed rate or variable rate obligations. For fixed rate Direct Pay Tax Credit Bonds, the issuer must submit Form 8038-CP at least 45 days, but not more than 90 days, before each interest payment date. For variable rate Direct Pay Tax Credit Bonds, the issuer must submit Form 8038-CP within 45 days after the last interest payment date within the quarterly period for which reimbursement is requested, provided that, if the issuer knows the interest payment amount at least 45 days prior to the interest payment date, Form 8038-CP may be filed within the same timeframe as that for fixed rate bonds, as described in the immediately preceding sentence. The actual issuer of the Direct Pay Tax Credit Bonds must file Form 8038-CP, though the issuer can direct Treasury to pay the subsidy to a third party such as a bond trustee. Issuers should expect to receive requested payments within 45 days of the date that Form 8038-CP is filed with the IRS.

Issuers of Direct Pay Tax Credit Bonds must also comply with existing informational reporting requirements, including submission of IRS Form 8038-TC, Information Return for Tax Credit Bonds and Specified Tax Credit Bonds (which will be available on the IRS web site at http://www.irs.gov/app/picklist/list/formsInstructions.html on or before June 25, 2010) on or before the 15th day of the 2nd calendar month after the close of the calendar quarter in which the issue was issued.

The notice also provides that the election to designate bonds as Direct Pay Tax Credit Bonds must be made on the issuer's books and records on or before the issue date of the bonds.

Other Interim Guidance for Direct Pay Tax Credit Bonds and BABs

Limitation on Bond Premium

Direct Pay Tax Credit Bonds, like BABs, may not be issued with more than a *de minimis* amount of premium in the issue price of the bond over the stated principal amount of the bond. A "de minimis" amount generally means 0.25 percent of the stated redemption price at maturity of the bond multiplied by the number of complete years from the bond's issue date to its maturity, which means, generally, its legal maturity date or, in some cases, the first optional call date. The notice provides additional clarification as to the determination of issue price for both Direct Pay Tax Credit Bonds and BABs, and confirms that such determination shall be made pursuant to the same rules as now apply to determine the issue price of tax-exempt bonds. Treasury and the IRS are reviewing the definition of issue price in this area and considering whether further limitations or special rules may be necessary or appropriate with respect to the allowability and treatment of bond issuance premium on Direct Pay Tax Credit Bonds and BABs in certain circumstances. Further guidance will likely be released on this subject.

Direct Pay Tax Credit Bonds, like BABs, may not be issued with more than a de minimis *amount of premium in the issue price of the bond over the stated principal amount of the bond.*

Original Issue Discount

For purposes of determining the cash subsidy payment on Direct Pay Tax Credit Bonds and BABs, original issue discount (whether paid upon accrual, bond redemption, at maturity or otherwise) is not treated as a payment of interest.

Reimbursements

Generally, as with BABs, proceeds of Direct Pay Tax Credit Bonds may not be issued to refund prior bonds, the proceeds of which were used to refinance eligible expenditures for qualified purposes. Direct Pay Tax Credit Bonds, however, may be issued to reimburse otherwise eligible expenditures for qualified purposes regardless of whether such expenditures were paid or incurred before or after the date of enactment of the HIRE Act, provided the applicable reimbursement rules of the Code are satisfied. If such expenditures were financed originally with temporary short-term financing, such expenditures shall be reimbursable provided the temporary short-term financing was issued after the date of enactment of the HIRE Act, the expenditures were paid or incurred after the date of the Hire Act, and the applicable reimbursement rules of the Code are otherwise satisfied. Comparable reimbursement rules for BABs, which turn on the effective date of the American Recovery and Reinvestment Tax Act of 2009, were announced by the IRS in 2009.

Preissuance Accrued Interest

With respect to bonds issued with preissuance accrued interest, for purposes of determining the cash subsidy payment on Direct Pay Tax Credit Bonds and BABs, the portion of the stated interest on the bond paid by the issuer that is allocable to interest accrued prior to the issue date of the bond is not taken into account.

Please feel free to contact the usual Edwards Angell Palmer & Dodge LLP lawyer who handles your matters or one of the lawyers listed below should you have any questions about the Direct Pay Tax Credit Bond provisions of the HIRE Act or IRS Notice 2010-35.

[1] Further, the deduction otherwise allowed under the Code to obligors of certain Direct Pay Tax Credit Bonds, such as New CREBs, with respect to interest paid under the bond shall be reduced by the amount of the Federal subsidy payment made with respect to that interest.

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