Build America Bonds: Post-Issuance Compliance

By Jose Matamoros

The popular Build America Bond program was created in 2009 with the passage of the American Recovery and Reinvestment Act. The original legislation created a new category of municipal bond dubbed "Direct-Pay" — taxable municipal securities that were eligible for a federal interest-rate subsidy to offset issuer costs. Although the program is typically known as the Build America Bond (BAB) program, in fact two types of Direct-Pay bonds came into existence, Build America Bonds and Recovery Zone Economic Development Bonds (RZEDB).

In early 2010, the Direct-Pay subsidy option was extended to four more types of "Specified Tax Credit Bonds" with the passage of the H.I.R.E. Act: Qualified School Construction Bonds; Qualified Zone Academy Bonds, Clean Renewable Energy Bonds, and Qualified Energy Conservation Bonds. These four types of bonds previously offered a tax credit subsidy to the holders of the bonds, and not a direct pay subsidy to the issuers. Whereas BABs and RZEDB's had fixed subsidy rates of 35 percent and 45 percent, respectively, the subsidy for Specified Tax Credit Bonds was calculated as 70 percent or 100 percent of the variable credit rate published daily by the Bureau of Public Debt.

In addition to the normal IRS compliance requirements relating to a taxable bond, a host of new disclosure and reporting requirements were also created for issuers and market participants. Since their inception, these new requirements have generated plenty of buzz in the public finance community as market participants struggled with how to address the new requests from the IRS. This article looks at best practices to address the questions on two forms distributed by the IRS to Direct Pay bond issuers: IRS Form 14127, Direct Pay Bonds Compliance Check Questionnaire and IRS Form 4564, Information Document Request.

The Questionnaire is devoted to gathering information about issuer's post-issuance bond compliance and record retention practices. In contrast, the Information Document Request is distributed to issuers whose bonds have been chosen for review by the IRS and requests information related to specific bond issues.

February 2011

Internal vs. External Resources

While it is of course possible for an issuer to administer the written policies alluded to in the Questionnaire internally, issuers may want to consider contracting with outside parties to assist with compliance items and document requests. In the course of structuring, issuing and administering a bond issue, service providers create and/or house most of the information needed to respond to the requests. To give just a few examples:

- The bond trustee may house the majority of the documents requested in the Information Document Request.
- The arbitrage rebate analyst provides many of the post-issuance calculations requested by the IRS.
- The underwriter tracks the initial trading of securities.

If Direct-Pay Bonds are going away, why care about these forms?

Although the Direct Pay Bond program will not survive in its earlier form into 2011, the administrative burden will remain for bonds previously issued and we may yet see a requirement for issuers to create and use various written procedures similar to those named in the Questionnaire. The Dodd-Frank Wall Street Reform and Consumer Protection Act (2010) calls for a host of studies and rulemaking affecting the municipal bond market in the next 12-24 months. A good portion of this effort will be devoted to a potential overhaul of the level and type of municipal disclosure. IRS Form 14127, in particular, focuses on the existence of various written procedures. It is therefore prudent for market participants and issuers to begin agreeing on best practices.

IRS Form 14127 Direct Pay Bond Compliance Check Questionnaire

1. **Type of Bond Sale/Certification of Public Offering/Affiliate Purchasers**
   The first question addresses three issues that the IRS is concerned with regarding the issuance of Direct Pay bonds: type of bond sale, certification of public offering at the initial offering price for each maturity and record of offering to underwriter affiliates. Evidence to support compliance can be gathered from the underwriter.

2. **De minimis premium calculation**
   The de minimis premium requirement is a limitation on the maximum amount of premium at which a bond can be sold in excess of its issue price. The de minimis premium amount is generally calculated as 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 first call date or maturity date. The de minimis premium can be calculated by multiple parties, including bond counsel, underwriter, financial advisor/consultant and/or the arbitrage rebate agent.

3. **Trading Activity Records in EMMA**
   EMMA maintains an online portal for information on municipal securities. In addition to being a publicly available source for official statements and continuing disclosure documents, EMMA also displays trading activity for primary and secondary market trades. Trading records are available for most municipal securities that have been issued a CUSIP-9 identifier. Securities that are traded in municipal funds such as 529 college savings plans and certain private placements are not included in the EMMA records. Consult the underwriter and/or bond counsel for information about a specific bond issue.

4. **Review of Trading Activity/ "Customer" purchase price**
   This question is meant as a follow up to questions 1 and 3. There has been a concern that securities trading between the sale and settlement date could drive up the eventual prices that are offered to the public. With this question the IRS intends to determine if there is oversight, independent of the underwriter, over trading activity. There has been concern from the issuer standpoint, that tracking of trade activity presents an onerous administrative demand. However, most issues, except the exceptions listed above, will have trading activity listed on EMMA.

5. **Post Issuance Federal Tax Requirement Compliance**
   BABs and RZEDBs are subject to all of the same IRS requirements as many other taxable governmental bonds including yield restriction, arbitrage rebate and certain requirements on use of proceeds. In the course of performing their duties, the trustee, arbitrage rebate analyst, and

the agent completing and filing the 8038-CP form can typically gather most of the information required to confirm compliance with the items below in accordance with IRS regulation.

a. **Timely expenditure of bond proceeds**
   Bond proceeds from Direct Pay bonds should be spent within the 24-month guideline set by the IRS. Specified Tax Credit Bonds with the direct pay option are exempt from this requirement instead having a 36-month spending window. Evidence of the timing of expenditures usually comes in the form of an account statement.

b. **Calculation of Available Project Proceeds**
   For this purpose, the IRS defines "Available Project Proceeds" as issue proceeds less cost of issuance and a reasonable reserve fund. The reserve fund is generally limited to 10 percent of the total issue amount. This calculation is generally performed at issuance by bond counsel or other third party, and can also be confirmed by an arbitrage rebate analyst.

c. **Use of Available Project Proceeds for Capital Expenditures**
   The proceeds of Direct Pay bonds are restricted to use on capital expenditures. The exact restrictions vary between each type of Direct Pay Bond. To that end the IRS requires that 100 percent of bond proceeds less funds for costs of issuance and a reserve fund ("available project proceeds") be used for capital projects. This data can often be retrieved from the trustee or arbitrage rebate analyst who is in receipt of detailed requisitions, eventually paid from project funds

d. **Arbitrage Yield Restriction and Rebate**
   Direct Pay bonds (BABs and RZEDBs) are subject to yield restriction and arbitrage rebate regulations. Specified Tax Credit Bonds with the direct pay option are not subject to arbitrage rebate and or yield restriction (except sinking funds). The arbitrage rebate analyst calculates the applicable arbitrage yield, confirms the combined investment yield of bond funds and calculates any rebate amount.

e. **Cost of Issuance percentage of Issue Proceeds**
   The costs of issuance for Direct Pay bonds are restricted in amount to 2 percent of issue proceeds. Since the cost of issuance is typically an estimate at the time of issuance, the underwriter, bond counsel, or arbitrage rebate analyst can provide the data to support the calculation of this percentage based on actual costs.

f. **Determination of interest payable**
   Since the federal rebate amount is directly connected to the interest payment on the bonds, the IRS is concerned with the determination of that payment. For fixed rate bonds, this is an easy task since the interest payments are set at issuance and only change at redemption. For variable rate bonds, ongoing oversight is required. Typically, the trustee, arbitrage rebate analyst, or 8038-CP calculation agent can provide data related to the interest payable on the bonds.

g. **Calculation of Refund Credit on Form 8038-CP**
   The refundable credit is calculated differently for each type of Direct Pay bond. The agent filling out the 8038-CP form can calculate the refund credit and partially or fully complete the form 8038-CP once the payable interest has been determined.

h. **Form 8038-CP Filing**
   Just as with individual tax filings, the issuer is ultimately responsible for filing timely and accurate information. Although issuers can choose to file their own forms, generally the trustee or other party can file and maintain data supporting the 8038-CP as a paid preparer.

i. **Refundable Credit Payee**
   The issuer is ultimately responsible for designating the proper person to receive the refundable credit. Often, since the trustee holds the project accounts and disburses principal and interest payments, they may be best positioned to receive the refundable credit. However, an issuer may find that direct payments to them are a more effective strategy.

6. **Identification of Violations**
   Issuers should think carefully about their procedures for ensuring compliance with all IRS regulations. While providers such as the trustee will have strong risk management controls in place, it is ultimately the responsibility of the issuer to ensure compliance. To this end, all issuers should have a regular review process in place to ensure that all bonds remain in compliance. This process may include regular statement review from service providers and/or other document review.

7. **Record Retention (Questions 7 and 8)**
   To issue Direct Pay bonds, issuers must make an election on their books and record that they intended to apply section 54AA(g) of the IRS Code. In addition to this they must maintain records that confirm that the bonds remain in compliance with IRS regulations through maturity. Questions 7 and 8 of the Questionnaire address this by asking about methods of maintaining bond records. All issuers should have record retention policies that maintain bond documents and related records for at least the life of the bonds plus three years. As more issuers upgrade their technological capability, more information can be stored electronically although there may always be a place for certain key documents to be stored in paper format. Service providers such as the trustee that maintain records can also be a part of an issuers record retention practice.

IRS Form 4564 Information Document Request

This second form is required when the IRS chooses to review a particular bond issue and requests documents for their investigation. The requested documents listed in the eight questions can generally be broken down into three categories. The examples below in each category are not an exhaustive list.

1. **Documents establishing the structure of the bonds**
   a. Official Statement
   b. Tax Certificate
   c. Agreements relating to the bonds

Much of the information regarding the bond structure can be found in the bond transcript. The transcript is typically held with the issuer and service providers, such as bond counsel or the trustee.

2. **Records of primary and secondary market trading**
   a. Schedule of bond sales
   b. Trading record

This information can be requested from the underwriter or, in most cases, gathered from EMMA.

3. **Records of planned and historical proceeds and cost of issuance spending**
   a. Invoices
   b. Expenditure descriptions

Documents supporting the disposition of funds should be maintained by both the issuer and the trustee or paying agent.

BNY MELLON

bnymellon.com

Jose Matamoros is a vice president-business development at The Bank of New York Mellon Trust Company, N.A., a subsidiary of The Bank of New York Mellon Corporation.

This article was first published in the February 2011 edition of *Debt Line*, a publication of the California Debt and Investment Advisory Commission (CDIAC).

