Client Alert

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CURRENT ISSUES RELEVANT TO OUR CLIENTS DECEMBER, 2012

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Expenditure of Build America Bond Proceeds on Bond Insurance Is a Capital Expenditure

In a recently released Chief Counsel Advice Memorandum, the IRS concluded that the expenditure of build America bond proceeds on bond insurance is a capital expenditure. Because one hundred percent of the sale proceeds of build America bonds and investment earnings thereon (minus certain amounts used for costs of issuance and amounts deposited in a reasonably required reserve fund) must be spent on capital expenditures, had the IRS determined that the expenditure of build America bond proceeds on bond insurance was not a capital expenditure, the issuer would not have met the one hundred percent requirement and the bonds would not be qualified build America bonds for which the issuer would be eligible to receive an interest subsidy from the Federal government.

A county issued its build America bonds on January 1, 2010 to finance a capital project. The county allocated a portion of the available project proceeds to a reasonably required reserve and, of the remaining available project proceeds, a portion to the bond insurance premium, which was prepaid in full at the time the county entered into the bond insurance contract.

In determining that the expenditure of build America bond proceeds for bond insurance was a capital expenditure, Chief Counsel looked at whether the bond insurance premium would be chargeable to a capital account under general Federal income tax principles. Chief Counsel analyzed the regulations under Section 263 of the Internal Revenue Code, which governs the treatment of expenditures as capital expenditures. These regulations provide that, in general, a taxpayer must capitalize prepaid expenses. In addition, the regulations provide that, in general, a taxpayer must capitalize amounts paid to another party to create, originate, enter into, renew or renegotiate with that party an agreement providing the taxpayer (as the covered party) with an annuity, an endowment or insurance coverage. Generally, a taxpayer

is not required to capitalize any right or benefit for the taxpayer that does not extend beyond the earlier of (i)12 months after the first date on which the taxpayer realizes the right or benefit or (ii) the end of the taxable year following the taxable year in which the payment is made.

The IRS concluded that because the county prepaid for the insurance contract by paying the entire premium at the time it entered into the contract, based on the regulations, the prepaid expenses must be capitalized. In addition, the IRS determined that the amounts paid by the county (the covered party) for insurance against its debt service default must be capitalized, and noted that the exception to capitalization for certain benefits not extending beyond the earlier of 12 months or the end of the taxable year following the taxable year in which the payment is made does not apply because the insurance contract covers any debt service default from the effective date of the contract through the 30-year term of the bonds.

IRS Revises Instructions to Form 8038-G

In September, the IRS revised its instructions to Form 8038-G, Information Return for Tax-Exempt Governmental Obligations. The form itself was not revised at that time. The instructions were revised to provide clarification as to how Lines 37 and 38 addressing pooled financings are to be completed. The revised instructions include a definition of a pooled financing issue, which the instructions define as an issue of tax-exempt bonds, the proceeds of which

are to be used to finance purpose investments representing conduit loans to two or more conduit borrowers, unless those conduit loans are to be used to finance a single capital project. The prior instructions to the form required that the issuer enter the amount of the proceeds of this issue used to make a loan to another governmental unit, the interest of which is tax-exempt, on Line 37. The revised instructions clarify that an amount is only to be entered on Line 37 if the issue is a pooled financing issue, as defined in the instructions. Line 38 on the form provides that if the issue is a loan of proceeds from another tax-exempt issue, the issuer should check the box and enter the date of issue, EIN and name of issuer of the master pool obligation. The revised instructions clarify that the information on Line 38 is only to be completed if the issue is a loan of proceeds from a pooled financing issue.

Treasury's 2012-2013 Priority Guidance Plan

In November 2012, the Treasury published its 2012-2013 Priority Guidance Plan for the twelve-month period from July 2012 through June 2013. The 2012-2013 Priority Guidance Plan represents projects the Treasury and the Internal Revenue Service intend to work on actively during the twelve-month period covered by the plan, but does not place any deadline on completion of such projects.

The Treasury intends to periodically update and republish the 2012-2013 Priority Guidance Plan during the plan year to reflect additional items that the Treasury publishes during the plan year. Section references below are to the Internal Revenue Code.

The following items were listed in the Priority Guidance Plan under the heading "Tax-Exempt Bonds":

(i) final regulations on public approval requirements for private activity bonds under Section 147(f) (these regulations are commonly referred to as the TEFRA regulations. The Treasury published proposed TEFRA regulations on September 9, 2008);

(ii) regulations on arbitrage investment restrictions under Section 148 (tax practitioners expect these regulations to address issue price concerns);

(iii) regulations on rebate overpayment under Section 148;

(iv) regulations on bond reissuance under Section 150; and

(v) notice on tribal economic development bond allocations under Section 7871 (published as Notice 2012-48 (released July 16, 2012)).

The Treasury invites public comment on the Priority Guidance Plan throughout the plan year and will consider comments it receives from taxpayers and tax practitioners relating to additional projects.

If you would like to discuss any of the issues addressed in this Client Alert, please contact Jeffrey D. Berry at (312) 845-3713 or berry@chapman.com; David J. Cholst at (312) 845-3862 or cholst@chapman.com; Anthony R. Rosso at (312) 845-3913 or rosso@chapman.com; or Brent L. Feller at (312) 845-3822 or feller@chapman.com. To learn more about Chapman, please visit us online at chapman.com.

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