Client Alert

Chapman and Cutler LLP
Attorneys at Law · Focused on Finance®

CURRENT ISSUES RELEVANT TO OUR CLIENTS MARCH 28, 2012

Spending the Last of Your Build America Bond Proceeds

The American Recovery and Reinvestment Act of 2009 allowed the issuance of taxable municipal bonds, called build America bonds, which provide the issuer of such bonds with a direct payment from the federal government equal to 35 percent of the interest payable on such bonds. One of the tax law requirements for these bonds is that 100 percent of bond proceeds (other than amounts spent on costs of issuing the bonds) must be allocated to capital expenditures.

The following is a brief explanation of capital expenditures. With an idea of what qualifies as a capital expenditure, you can spend remaining build America bond proceeds on qualifying capital expenditures and prevent certain negative consequences outlined below resulting from the failure to spend build America bond proceeds on capital expenditures.

Tax Requirements of Build America Bonds

One of the tax law requirements of qualified build America bonds (which are build America bonds for which the issuer is entitled to receive a subsidy payment) is that 100 percent of the sale proceeds of the bonds and investment earnings thereon (other than a certain amount of proceeds that may be used for costs of issuance or to fund a reasonably required reserve fund) must be used to finance capital expenditures. Unlike the tax-exempt bond rules, which allow five percent of the proceeds of an issue of tax-exempt bonds to finance working capital expenditures directly related to capital expenditures financed by the issue, the build America bond rules do not allow any proceeds to be spent on working capital. If proceeds of qualified build America bonds are spent on costs that are not capital expenditures, the bonds will fail to be build America bonds for which the issuer is entitled to receive the subsidy payment. In a recent IRS audit, the IRS challenged an expenditure of bond proceeds on a cost the IRS argued was not a capital expenditure. The IRS and the issuer agreed on a settlement whereby the issuer was required to pay approximately $175,000 to reduce the amount of subsidy payments already received by it and was also required to reduce future subsidy payments to 29 percent.

While many municipal issuers likely have spent all of their build America bond proceeds, some issuers may have unspent bond proceeds. It is imperative that all build America bond proceeds, including those not yet spent, be allocated to capital expenditures.

To assure compliance it is useful for an issuer of qualified build America bonds to review expenditures that have been allocated to proceeds. If non-capital items are discovered, there may be time to reallocate proceeds so that the restrictions are not violated. It is important to remember that mistakes can often be fixed if recognized soon enough. Such reallocations are generally limited to 18 months or in some cases three years after the date of the expenditure.

Definition of Capital Expenditure

A capital expenditure is any cost that is properly chargeable to a capital account under Federal income tax principles. While a municipal issuer is not a taxpayer, it is generally treated as if it were a corporation subject to taxation under the Internal Revenue Code for purposes of applying the Federal income tax principles.

Generally, a cost is a capital expenditure if it materially enhances the value, use, life expectancy, strength, or capacity of property. In addition, increased future operating efficiencies is a factor that is taken into account in determining whether a cost is a capital expenditure. More specifically, a capital expenditure includes the cost of acquisition or construction of buildings, machinery, equipment, furniture, fixtures, and similar property having a useful life of substantially beyond one year. Amounts paid for items having a useful life of less than one year generally are not capitalized. In addition, some items that may have a useful life of beyond one year may not be capital expenditures, as described below, if the costs are to keep property in normal working order.

Examples of the Classification of Certain Expenditures

Whether a cost qualifies as a capital expenditure depends on the facts and circumstances surrounding that cost. Included below is a brief overview of common costs and each cost's treatment as a capital expenditure.

Generally, costs incurred to acquire, construct, or improve land, buildings, and equipment qualify as capital expenditures. Ancillary costs of constructing, acquiring, or materially improving property, such as architect, engineering, and design costs, may also be capital expenditures. Costs may be classified as capital expenditures if they are equivalent to the installation of a completely new item or the making of an improvement. For example, land improvements (e.g., paving new streets, landscaping that lasts beyond a year), building renovations (e.g., carpet replacement, window replacement), or replacement of building systems can qualify as capital expenditures.

However, routine, incidental, or annual maintenance that does not materially add to the value of the property nor appreciably prolong its life is not considered a capital expenditure. For example, annual testing of fire alarms, patching walls, or the cleaning of the exterior of a building and other costs that keep property in "working order" generally would not be capital expenditures for purposes of spending build America bond proceeds. Notwithstanding the foregoing, if repair and maintenance costs are incurred in the course of a renovation that is capital in nature, such repair and maintenances costs that generally would not be treated as capital expenditures may be treated as such. For example, the cost of cleaning up a construction site may be capital. Certain studies, such as a feasibility study performed in conjunction with the expansion of a building that results in the expansion project taking place, is likely to be a capital expenditure.

Similarly, the cost of a feasibility study conducted to replace or renovate building systems such as heating and cooling can be a capital expense if the study results in the improvement or replacement being made. If, however, the feasibility study is conducted in conjunction with a project that does not go forward, the costs of such study would likely be classified as working capital and not as a capital expenditure. Therefore, studies should only be financed with build America bond proceeds if such studies are certain to result in the acquisition or incurrence of capital expenditures.

Finally, a group of costs that does not typically qualify as capital expenditures is that of employee training. The costs of trainers and routine updates of training materials, including routine software or system upgrade training costs, are not treated as capital expenditures even though they may result in a future benefit. Training costs may be capitalized only in circumstances where that training is intended primarily to obtain future benefits significantly beyond the benefits traditionally associated with the issuer's ordinary course of operations. For example, training employees to use a newly acquired piece of machinery may be a capital item. Proceeds of certain qualified build America bonds called Recovery Zone Economic Development Bonds may be used for training costs in some cases.

Our attorneys have composed a more exhaustive memorandum on capital expenditures that can be provided upon request. It is important to keep in mind that whether a cost constitutes a capital expenditure is based on all the facts and circumstances surrounding a particular transaction. Thus, in the event questions arise with regard to specific expenditures, consult with counsel, internal accounting staff, or your external accounting department.

If you would like to discuss any of the issues addressed in this Client Alert or would simply like to find out more about Chapman, please contact any attorney in Chapman's Public Finance Department or visit us online at chapman.com.