Saul Ewing LLP

PUBLIC FINANCE DEPARTMENT

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"What keeps you up at night?"

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IRS begins Compliance Check of Direct Payment Build America Bonds

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In February 2009, President Obama signed into law the American Recovery and Reinvestment Act of 2009 (the "Act"). The Act amended the Internal Revenue Code of 1986, as amended ("Code") to allow state and local governments to issue two types of taxable bonds ("Build America Bonds"), that would otherwise qualify as tax-exempt bonds. An issuer can choose one of two options when issuing Build America Bonds: (i) the issuer can elect to issue tax-credit Build America Bonds, which allow an investor to receive taxable interest along with a federal tax-credit equal to 35 percent of the interest received; or (ii) the issuer can choose to receive a direct payment from the federal government equal to 35 percent of the interest paid on the bonds ("Direct Payment BABs").

Even though Direct Payment BABs are taxable bonds, the Direct Payment BABs must satisfy all applicable requirements of the Code so that the Direct Payment BABs would have qualified to be issued, and would continue to be treated, as tax-exempt bonds for as long as the Direct Payment BABs are outstanding. An issuer of Direct Payment BABs must ensure that its use of proceeds of Direct Payment BABs complies with applicable rules under the Code. In December of 2009, the Internal Revenue Service (the "IRS") announced that issuers of Direct Payment BABs would receieve a compliance check questionnaire from the IRS (the "Questionnaire") to ensure that issuers of Direct Payment BABs are in compliance with the Code. A compliance check is not an audit. Pursuant to the IRS website, the Questionnaire will be sent out to issuers of Direct Payment BABs, on a continuous basis, beginning the week of February 8, 2010.

The Questionnaire focuses on six post issuance compliance and record retention practices. The first portion of the Questionarre focuses on the requirement that Direct Payment BABs are not issued with more than a *de minimis* amount of premium. The Questionnaire asks if issuers of Direct Payment BABs have written procedures to ensure that none of the maturities of the Direct Payment BABs are issued with more than a *de minimis* amount of premium. If written procedures are not in place, the Questionnaire asks the issuer to explain what guidelines are in place to ensure that Direct Payment BABs issued with premium fall within the *de minimis* rule.

The second portion of the Questionnaire inquires as to whether records of secondary market trading activity for the particlaur issuer's Direct Payment BABs are available through the Municipal Securities Rulemaking Board's Electronic Municipal Market Access System (EMMA). This portion of the Questionnaire also inquires as to whether any Direct Payment BABs traded at a price greater than the issue price prior to the delivery of the Direct Payment BABs on the date of issue.

The next portion of the Questionnaire asks if issuers have written procedures in place to ensure that Direct Payment BABs remain in compliance with a number of federal tax requirements including: timely expenditure of bond proceeds; requirements regarding the use of bond proceeds (specifically, the calculation of Available Project Proceeds (as such term is defined in Section 54A(e)(4) of the Code) and the use of Available Project Proceeds); arbitrage yield and rebate requirements; costs of issuance; interest payment amounts; Form 8038-CP reporting and filing; and payment of the refundable credit.

The Questionnaire continues with an inquiry as to whether the issuer has written procedures in place to ensure timely identification of violations of federal tax requirements after the Direct Payment BABs are issued and whether remedial action procedures described in the Treasury Regulations or through the Tax Exempt Bonds Voluntary Closing Agreement Program (VCAP) are in place with respect to the Direct Payment BABs.

Finally, the Questionnaire investigates whether the issuer maintains records necessary to support the status of the Direct Payment BABs as qualified to receive the interest subsidy described in the Code, the length of time records are kept and the medium by which records are kept.

The Questionnaire itself does not provide a timeframe by which issuers have to complete and return the Questionnaire; however, a letter of instruction accompanying the Questionnaire will contain a date by which the Questionnaire must be returned to the IRS. It is important that issuers of Direct Payment BABs adopt post-issuance compliance and record keeping guidelines and also respond to the Questionnaire in a timely manner.

If you have questions about the Questionnaire, post compliance issues or other related topics regarding Direct Payment BABs please contact George Magnatta (gmagnatta@saul.com), Chair of the Public Finance Department, or Joshua Pasker (jpasker@saul.com).

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