

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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to: Bob Henn
Acting Director
Tax-Exempt Bonds
Government Entities
Tax-Exempt and Government Entities
(SE:T:GE:TEB)

from: Associate Chief Counsel
(Financial Institutions & Products)

subject: Use of proceeds of build America bonds issued under section 54AA(g)

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

Whether an expenditure of proceeds of an issue of build America bonds (with respect to which the issuer irrevocably elected to have § 54AA(g) apply), incurred for bond insurance premium for the issue, is a capital expenditure within the meaning of § 54AA(g)(2)(A)?

CONCLUSION

An expenditure of proceeds of an issue of build America bonds (with respect to which the issuer irrevocably elected to have § 54AA(g) apply), incurred for bond insurance premium for the issue, is a capital expenditure within the meaning of § 54AA(g)(2)(A).

FACTS

On January 1, 2010, County A (Issuer), issued general obligation bonds with a single maturity of 30 years (the Bonds) to finance a capital project (the capital project). Issuer

irrevocably elected under §§ 54AA(d)(1)(C) and 54AA(g)(2)(B) to have §§ 54AA and 54AA(g), respectively, apply. Issuer entered into an insurance contract with Insurance Company, Inc. (Bond Insurer), which provides that in the event of a debt service default by Issuer during the term of the Bonds, the principal and interest on the Bonds is to be paid by the Bond Insurer. Issuer prepaid the entire premium for the insurance contract at the time it entered into the contract. Issuer 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.

LAW

Section 54AA(a) provides that if a taxpayer holds a build America bond on one or more interest payment dates of the bond during any taxable year, there shall be allowed as a credit against income tax for the taxable year an amount equal to the sum of the credits determined under § 54AA(b) with respect to such dates. Subject to limitations under § 54AA(c), § 54AA(b) provides that the amount of the credit with respect to any interest payment date for a build America bond is 35 percent of the amount of interest payable by the issuer with respect to such date.

Section 54AA(d)(1) provides that, for purposes of § 54AA, the term “build America bond” means any obligation (other than a private activity bond) if (A) the interest on such obligation would (but for § 54AA) be excludable from gross income under § 103; (B) such obligation is issued before January 1, 2011, and (C) the issuer makes an irrevocable election to have § 54AA apply.

Section 54AA(g) provides a special rule for qualified bonds issued before January 1, 2011. In the case of a qualified bond issued before January 1, 2011, in lieu of any credit allowed under § 54AA with respect to such bond, the issuer of such bond shall be allowed a credit as provided in § 6431.

Section 54AA(g)(2) provides that for purposes of § 54AA(g), the term “qualified bond” means any build America bond issued as part of an issue if (A) 100 percent of the excess of (i) the available project proceeds (as defined in § 54A) of such issue, over (ii) the amounts in a reasonably required reserve (within the meaning of § 150(a)(3)) with respect to such issue, are to be used for capital expenditures; and (B) the issuer makes an irrevocable election to have § 54AA(g) apply.

Section 1.150-1(b) of the Income Tax Regulations provides that “capital expenditure” means any cost of a type that is properly chargeable to capital account (or would be so chargeable with a proper election or with the application of the definition of placed in service under § 1.150-2(c)) under general Federal income tax principles. Whether an expenditure is a capital expenditure is determined at the time the expenditure is paid with respect to the property.

Section 263(a) generally requires capitalization of amounts paid for permanent improvements or betterments made to increase the value of any property or estate.

Section 1.263(a)-4 applies § 263(a) to require capitalization of amounts paid to acquire or create intangibles. See §§ 1.263(a)-4(b)(1)(i) and (ii).

Section 1.263(a)-4(d)(3)(i) provides, in general, that a taxpayer must capitalize prepaid expenses. Section 1.263(a)-4(d)(3)(ii) provides examples illustrating the rules of § 1.263(a)-4(d)(3). Example (1), regarding prepaid insurance, provides as follows:

N corporation, an accrual method taxpayer, pays \$10,000 to an insurer to obtain three years of coverage under a property and casualty insurance policy. The \$10,000 is a prepaid expense and must be capitalized under [§ 1.263(a)-4(d)(3)].

Further, § 1.263(a)-4(d)(6)(i)(E) provides, in general, that except as otherwise provided in § 1.263(a)-4(d)(6), 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.

Section 1.263(a)-4(f)(1) provides, in general, that, except as otherwise provided in § 1.263(a)-4(f), a taxpayer is not required to capitalize under § 1.263(a)-4 amounts paid to create (or to facilitate the creation of) 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.

ANALYSIS

Issuer issued the Bonds and irrevocably elected under § 54AA(d)(1)(C) to have § 54AA apply and under § 54AA(g)(2)(B) to have § 54AA(g) apply. Accordingly, in order for the Bonds to be treated as qualified bonds under §§ 54AA(g) and 6431, Issuer must use 100 percent of the amount of proceeds equal to the excess of the available project proceeds over the amounts in a reasonably required reserve for capital expenditures. If the premium paid for the insurance contract is not a capital expenditure, the issuer will not have met the 100 percent requirement.

Issuer prepaid for the insurance contract by paying the entire premium at the time it entered into the contract. Under § 1.263(a)-4(d)(3), expenses prepaid by Issuer must be capitalized. In addition, under § 1.263(a)-4(d)(6)(i)(E), amounts paid by Issuer (the covered party) for insurance against its debt service default must be capitalized. The exception under § 1.263(a)-4(f)(1) does not apply because the insurance contract covers any debt service default from the effective date of the insurance contract through the entire 30-year term of the Bonds. Therefore, the amounts paid by Issuer are properly chargeable to a capital account (or would be so chargeable with a proper election) within the meaning of “capital expenditure” under § 1.150-1(b). Accordingly, the amount paid by Issuer for insurance to cover a debt service default is allocable to

capital expenditures for purposes of determining whether the 100 percent requirement under § 54AA(g)(2)(A) has been met.

Please call (202) 622-3980 if you have any further questions.

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