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IRS Reviews Build America Bonds

Build America Bonds (BABs) that were issued last year along with the stimulus program is being reviewed by the IRS to ensure they comply with tax laws. According to a notice on the IRS website, the agency is also seeking to understand this new type of bonds.

The government's purpose for BABs was to increase investment in infrastructure. These bonds pay a federal rebate equal to 35% of interest costs. This type of bond payments is called 'direct pay'. This makes them very popular despite the fact that they are taxable. Since its introduction, cities and local governments have been issuing BABs, which has accounted for nearly 25% of new bonds issued this year. The popularity of BABs has prompted Congress to reevaluate the other bonds issued under the stimulus package and change them to the same model as BABs i.e. taxable bonds paying federal rebates or direct pay bonds.

The IRS stated in its notice that it is studying whether issuers of BABs have complied with bond issuance limitations like premiums, capital spending requirements and issuance cost limitations and whether BABs can be retired.

On the other hand, local governments issuing the bonds have expressed their concern whether they will lose the federal rebate or if the payments will be delayed if they are found to have violated any laws on securities.

But the IRS has assured that they are committed to having the same type of compliance program for direct pay bonds as tax-free bonds. The present practice if the IRS finds a bond issuer suspected of violating tax laws is the agency will work with the bond issuer to comply with tax laws. But this applies to traditional municipal bonds that are tax-free.

On the other hand, for taxable direct pay bonds like BABs, the IRS is considering new regulations unique to these bonds and resolutions for violating securities laws that are proportional to the violation.

In a related development, the Securities and Exchange Commission (SEC) has also expressed their concern over the tax treatment of bonds. An issue of concern to the SEC includes disclosures relating to the tax treatment of municipal securities for both tax-exempt bonds and taxable BABs.

The SEC, Treasury Department and IRS are all working together to identify potential problems with the new type of bond, specifically how the bonds were priced for offering.