

**MEMO# 24202**

March 31, 2010

# **IRS Issues Interim Guidance on Stripping Transactions for Qualified Tax Credit Bonds**

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TO: TAX MEMBERS No. 9-10  
FIXED-INCOME ADVISORY COMMITTEE No. 4-10  
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 9-10  
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 7-10 RE: IRS ISSUES INTERIM  
GUIDANCE ON STRIPPING TRANSACTIONS FOR QUALIFIED TAX CREDIT BONDS

The Internal Revenue Service (“IRS”) has issued Notice 2010-28 [\[1\]](#) describing regulations that the Treasury Department and the IRS expect to issue concerning both stripping transactions for qualified tax credit bonds under section 54A of the Internal Revenue Code and certain income tax accounting matters associated with holding and stripping these bonds. Until the promulgation and effective date of future guidance, taxpayers may rely upon the interim guidance provided in this notice. The Notice also describes anticipated related information reporting requirements and solicits public comments on the interim guidance and the information reporting requirements.

## **Qualified Tax Credit Bonds - Treatment of Credit by Holders**

In general, a taxpayer that holds a qualified tax credit bond on one or more credit allowance dates (as defined in section 54A(e)(1)) of the bond occurring during a taxable year is allowed as a credit against income tax for the taxable year an amount equal to the sum of the credits determined under section 54A(b) with respect to such credit allowance dates. For purposes of this interim guidance, references to the “allowance of a credit” or an “allowed credit” mean the amount of the credit determined under section 54A(b) before

application of the limitation under section 54A(c).

For federal income tax purposes, the allowance of a credit on a qualified tax credit bond on a credit allowance date is treated as a payment, in the amount of the allowed credit, of stated interest on a debt obligation, the interest on which is includible in gross income. Therefore, the allowance of a credit on a bond that has not been subject to a stripping transaction is treated as a payment of qualified stated interest (within the meaning of Treas. Reg. § 1.1273-1(c)) to the same extent that a payment of stated interest in cash in the same amount and on the same date would have been so treated. [\[2\]](#)

A holder's regular method of accounting generally determines when the holder recognizes qualified stated interest income from a qualified tax credit bond. If the holder uses the cash receipts and disbursements method of accounting, interest income in the amount of the allowed credit generally is included in income on the credit allowance date. If the holder uses an accrual method of accounting, the interest income is included in income as it accrues over each accrual period. For qualified tax credit bonds that have not been subject to a stripping transaction, the maximum permitted length of the accrual periods is three months due to the regular quarterly credit allowance dates. Other rules may require the holder of a tax credit bond to adjust the amount of interest income that the holder recognizes (e.g., amortization of bond premium by a bond purchaser under section 171; accrual of original issue discount ("OID") by a holder under section 1272).

The credit allowed under section 54A(a) and the Notice is subject to the limitation in section 54A(c)(1) based on the taxpayer's income tax liability. If the credit allowable for the taxable year under section 54A(a) exceeds the limitation imposed for the taxable year by section 54A(c)(1), the excess credit is carried to the succeeding taxable year and added to the credit allowable under section 54A(a) for the succeeding taxable year (determined before the application of the limitation for the succeeding taxable year under section 54A(c)(1)). [\[3\]](#) An excess credit can be carried forward to succeeding taxable years and used in a succeeding year to the extent that the excess credit does not exceed the limitation for that taxable year. Any allowed credit, including any excess credit from a prior year, however, must be taken for the first taxable year in which, and to the extent that, the allowed credit (including the excess credit) does not exceed the limitation under section 54A(c)(1) and Notice 2010-28.

Tax credits from qualified tax credit bonds are treated as interest income that increases a corporation's earnings and profits. A corporation reduces its earnings and profits when, and to the extent that, it would have reduced its earnings and profits had it satisfied its tax liability with cash rather than reducing that liability with tax credits from qualified tax credit bonds. If, under section 853A, a regulated investment company ("RIC") distributes with respect to its stock a tax credit from a qualified tax credit bond or from a stripped credit coupon from a qualified tax credit bond (including a credit passed through from a partnership or trust), then the earnings and profits of the RIC are reduced when, and to the extent that, the earnings and profits would have been reduced if the distribution had

consisted of cash in the amount of the credit.

## **Qualified Tax Credit Bonds - Treatment of Stripping Transactions [4]**

Section 54A(i)(1) provides that, under regulations, there may be a separation, including at issuance, of the ownership of a qualified tax credit bond and the entitlement to a credit under section 54A with respect to the bond. In the case of any such separation, the credit is allowed to the person who on the credit allowance date holds the instrument evidencing the entitlement to the credit and not to the holder of the bond. Further, the rules of section 1286 for stripped bonds apply to the qualified tax credit bond as if it were a stripped bond and to the credit as if it were a stripped coupon.

For purposes of the Notice, the following definitions apply:

- **Credit coupon:** The right to receive a tax credit under section 54A with respect to a qualified tax credit bond on a credit allowance date.
- **Issue:** As defined in Treas. Reg. § 1.150-1(c) except that, in applying that definition for purposes of the Notice, the only bonds taken into account are qualified tax credit bonds as defined in section 54A(d)(1).
- **Stripping transaction:** A transaction that results in the separation in ownership between any credit coupon with respect to a qualified tax credit bond for any credit allowance date that has not yet occurred and any right to receive cash (whether stated principal or stated interest) that has not yet become payable. Notwithstanding the preceding sentence, the term “stripping transaction” does not include a transaction with respect to a particular bond in which the post-transaction future rights (i.e., rights to cash that is not yet payable and credits whose credit allowance dates have not yet occurred) reflect a pro rata division of all the pre-transaction future rights.
- **Stripped credit coupon:** A credit coupon with respect to a qualified tax credit bond if the bond has undergone a stripping transaction.

For purposes of the Notice, the term “strippable issue” means an issue of qualified tax credit bonds that complies with all of the following requirements:

- **Designation requirement.** The issuer on or before the date of issue includes a statement in the bond documents that the issue of qualified tax credit bonds is strippable. For an issue of qualified tax credit bonds that is issued before March 31, 2010, this designation may be effected on or before May 17, 2010.
- **Identification requirement.** On an information return filed with the IRS under section 54A(d)(3), the issuer identifies the issue of qualified tax credit bonds as a strippable issue. The identification must be on the first information return filed under section 54A(d)(3) with respect to the issue of qualified tax credit bonds. An exception applies for an issue of qualified tax credit bonds issued before March 31, 2010, the identification of which may instead be on an amended information return filed before May 17, 2010.
- **Registration requirement.** The issue of qualified tax credit bonds is issued in registered form.

- CUSIP number requirement. A CUSIP number is assigned to the issue of qualified tax credit bonds, a separate CUSIP number is assigned to all rights to receive tax credits on each credit allowance date with respect to the issue, and at least one separate CUSIP number is assigned to all rights to receive cash (whether stated principal or stated interest) with respect to the issue.

A taxpayer who holds a stripped coupon on a credit allowance date is allowed the tax credit only if all of the following requirements are satisfied:

- The bond is part of a strippable issue within the meaning of paragraph (c) of Section 3.03 of the Notice.
- The stripped coupon is either a whole credit coupon or a proportional share of a whole credit coupon. Thus, if a person holds any other division of a whole credit coupon, including any direct or indirect division or modification of a whole credit coupon effected through a partnership, trust, or other investment arrangement that, in substance, causes the person to hold a variable share of the whole credit coupon, then no tax credit is allowed with respect to that interest in the credit coupon.
- The taxpayer holds the stripped credit coupon in an account with (i) a broker as defined in section 6045(c)(1); or (ii) any other person to the extent provided by the IRS in published guidance.

Except to the extent that a provision of the Notice explicitly provides otherwise, subsections (a), (b), and (e) of section 1286 apply to stripping transactions involving qualified tax credit bonds. In applying these provisions, the allowance of a credit is treated in the same manner as a cash payment of stated interest on the credit allowance date.

If, on a single date, a taxpayer purchases (including a purchase under section 1286(b)(4)), as part of a single transaction or series of related transactions, more than one component (stated principal, stated cash interest, or credit coupons) of a qualified tax credit bond that has been subject to a stripping transaction, then, for purposes of sections 1271 through 1286 and the regulations thereunder, the taxpayer must treat the components as a single debt instrument (the aggregated debt instrument) that was newly issued on the purchase date. None of the payments on the aggregated debt instrument is treated as qualified stated interest under Treas. Reg. § 1.1273-1(c). If the taxpayer purchases all of the then-outstanding components of a qualified tax credit bond, then the resulting aggregated debt instrument is treated as of the purchase date as if it had not been subject to a previous stripping transaction.

## **Information Reporting Requirements Related to Tax Credit Bonds**

The Treasury Department and IRS believe that qualified tax credit bonds raise significant tax compliance and tax administration issues and therefore intend to implement and maintain a detailed system of information reporting in this area.

Section 54A(d)(3) requires issuers of qualified tax credit bonds to submit information reports regarding the bonds similar to those required under section 149(e). Section 6049(d)(9)(A) provides that, for purposes of the information reporting requirements under section 6049(a) regarding payments of interest, the term “interest” includes amounts includible in gross income under section 54A, and those amounts are treated as paid on the credit allowance date. Under section 6049(d)(6), payors generally must report OID on any obligation as if it were paid at the time that the OID is includible in income under section 1272. This provision governs section 6049 information reporting when a tax credit under a qualified tax credit bond is included in an instrument’s stated redemption price at maturity and thus contributes to OID.

Sections 6049(b)(2)(B)(i) and 6049(b)(4) generally exempt from information reporting interest paid to certain persons. Section 6049(d)(9)(B), however, generally makes this exemption inapplicable for interest on qualified tax credit bonds that is treated as paid to certain entities, including RICs. Section 6049(b)(9)(c) provides broad authority to the Treasury Department and the IRS to issue regulations as necessary or appropriate to carry out the purposes of section 6049(d)(9), including regulations that require more frequent or more detailed reporting.

The government anticipates implementing an integrated system of information reporting, as described in the Notice, which may involve implementing new requirements. Revised forms and, if necessary, regulations will be issued to implement these information reporting requirements. For example, when a taxpayer holds a stripped credit coupon in an account with a broker, future guidance is expected to require the broker to compute, and report to the holder of the striped credit coupon and to the IRS, the OID that accrues on that coupon under the Notice and section 1286(a) and (b). This system of information reporting will be subject to the same penalties that apply generally with respect to the failure to accurately file required forms, including (but not limited to) the penalties under sections 6049, 6721, 6722, and 6694.

As the forms and instructions to be used to implement the integrated information reporting system become available for use or for review in draft form, the IRS plans to publish them on its website. Taxpayers also may provide comments to the IRS on draft tax forms on the IRS’s website.

### **Information Returns under Section 54A(d)(3)**

Section 54A(d)(3) requires issuers of qualified tax credit bonds to file information returns. Form 8038 currently is used for this purpose, but the IRS intends to publish a new form (Form 8038-TC) for use with qualified tax credit bonds. As is provided by section 3.03(c)(2) of the Notice, the issuer of a strippable issuer is now required, as part of this reporting obligation, to identify the issue as a strippable issue and to provide all of the CUSIP numbers required under section 3.03(c)(4) of the Notice. Issuers must provide this information on Form 8038 or an attachment thereto until the new Form 8038-TC becomes

available.

## **Report of a Taxpayer Claiming a Tax Credit on an Income Tax Return**

If a taxpayer claims on its income tax return a tax credit authorized by section 54A, the taxpayer must include Form 8912 as part of the return. The Treasury Department and IRS anticipate that the information required on this form will be modified to include not only the type of tax credit bond and the amount of credit claimed, but also the tax identification number of the issuer of the bond and the CUSIP number for the qualified tax credit bond or stripped credit coupon that is the basis the credit being claimed.

## **Tax Credit Allowance Information Return**

The IRS expects to publish a new form, Form 1097-BTC, under section 6049 to inform both the IRS and any recipient of a credit under section 54A of the amount of the tax credit that the credit recipient has received for each credit allowance date. The amount to be reported is the amount of the allowed credit to which the recipient is entitled within the meaning of the Notice. It is anticipated that this form will be used in two distinct situations: (1) It will be filed by, or on behalf of, the issuer; and (2) it will be filed by each broker or intermediary that is not acting on behalf of the issuer (an “independent intermediary”).

The principles under section 6049(d)(4) are expected to apply to limit this requirement to the last responsible person or intermediary acting on behalf of the issuer. The requirement for independent intermediaries is expected to apply whenever such an intermediary serves as an agent or nominee with respect to a credit, or the intermediary receives a credit and passes it on either to another independent intermediary or to the taxpayer that ultimately will claim the credit. Examples of independent intermediaries include, among other things, a RIC that distributes tax credits with respect to its stock under section 853A.

It is anticipated that the information required by the form will include not only the amount of the credit transferred to the recipient but also the bond issuer’s tax identification number and the CUSIP number for the qualified tax credit bond or stripped credit coupon that is the basis for the credit being transmitted. Effective for credits received in 2010 and thereafter, responsible persons under section 6049 will be required to submit a form to the IRS annually after the close of the calendar year. The form will include the total amount of tax credits for which the responsible persons served as a responsible person during the taxable year with respect to each independent intermediary and each holder of a tax credit bond or stripped credit coupon. The form will require the CUSIP number of the bond or stripped credit coupon generating the tax credit and the tax identification number of the issuer of the bond that underlies the tax credit. Effective starting with credits received in 2011, responsible persons under section 6049 will be required to send this form to the credit recipient quarterly within 20 to 60 days following the credit allowance date to which the tax credit relates. The form will require that the entity generating the form indicate whether the entity is the bond issuer (including a person acting on behalf of the bond issuer) or whether it is an independent intermediary, and thus is not only the generator of a form but

also the recipient of such a form from another independent intermediary or from the bond issuer.

## **Report for Income from Interest, OID or Dividends**

For qualified tax credit bonds, information reporting for interest and OID under section 6049 will be expanded. Responsible persons under section 6049 generally will be required to provide annually to the IRS and the holder of a qualified tax credit bond or stripped credit coupon an information return indicating the amount of interest income paid (or treated as paid for purposes of section 6049) to the holder during that annual period with respect to any qualified tax credit bond. When a taxpayer holds a stripped credit coupon in an account with a broker, future guidance is expected to require the broker to compute and report the amount of OID on that coupon that accrues under the Notice and section 1286(a) and (b). A similar requirement may apply to any other stripped component from a qualified tax credit bond.

The IRS expects that if a RIC receives tax credits allowed by section 54A (either because it holds a qualified tax credit bond or stripped coupon or because it received the credits from an independent intermediary) and distributes with respect to its stock some or all of those credits, then the RIC will include distributed tax credits that are treated as dividends when it reports dividends paid to its shareholders under section 6042.

## **Request for Comments**

The IRS and Treasury Department request comments generally on the expected regulations that are described in the Notice, other aspects of stripping transactions under section 1286 on which guidance is needed, and the anticipated information reporting requirements described in the Notice. In particular, the government seeks comments regarding:

- Systems challenges, time needed to implement systems changes to enable affected parties to comply with the anticipated information reporting requirements, and alternative approaches to alleviate systems challenges consistent with the overall objectives for information reporting in this area;
- The application of the principles in the Notice to Build America Bonds under section 54AA and any additional rules that may be necessary to accommodate that application; and
- Whether any particular guidance is needed to limit potential duplicative claims of entitlement to tax credits (e.g., specifying that credits are allowable only to record holders as of a particular time in a particular time zone on a credit allowance date).

In addition, the IRS has asked for comments regarding persons other than brokers who may hold tax credit bonds and thus should be eligible for the tax credit. [\[5\]](#) The due date for public comments on Notice 2010-28 is May 24, 2010.

## Effective Date

The effective date of the Notice is March 23, 2010. The interim guidance applies to stripping transactions that occur on or after the effective date of the Notice and taxable years ending on or after the effective date of the Notice for holders of qualified tax credit bonds and of cash or credit coupons stripped from qualified tax credit bonds. Taxpayers may choose to apply the interim guidance regarding the treatment of the credit by holders consistently to taxable years ending before the effective date of the Notice. The IRS and Treasury Department anticipate that the date of applicability of the expected regulations described in the Notice will be March 23, 2010. If, and to the extent, the expected regulations differ from the interim guidance in the Notice, the different provisions of the final regulations will be applied without adverse retroactive effect.

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### endnotes

[1] Notice 2010-28 can be found on the IRS website at:  
<http://www.irs.gov/pub/irs-drop/n-10-28.pdf>.

[2] See page 4 of the Notice for examples.

[3] Section 54A(c)(2).

[4] See page 14 of the Notice for examples of the application of these rules.

[5] The Notice provides that a taxpayer who holds a stripped credit coupon is allowed the tax credit only if certain requirements are satisfied, including the requirement that the stripped credit coupon be held in an account with (i) a broker; or (ii) any other person to the extent provided in published guidance. See section 3.03(d)(3) of the Notice.