

Part III - Administrative, Procedural, and Miscellaneous

Stripping Transactions for Qualified Tax Credit Bonds

Notice 2010-28

SECTION 1. INTRODUCTION

This Notice describes regulations that the Treasury Department and the Internal Revenue Service (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. Pending the promulgation and effective date of future administrative or regulatory guidance, this Notice provides interim guidance on which taxpayers may rely. In addition, this Notice describes anticipated related information reporting requirements and solicits public comments on the interim guidance and the information reporting requirements.

SECTION 2. BACKGROUND

Section 54A(a) provides that a taxpayer that holds a qualified tax credit bond on one or more credit allowance dates during any taxable year is allowed a tax credit for

such year in an amount equal to the sum of the credits determined under section 54A(b) with respect to such dates.

Section 54A(d)(1) defines a qualified tax credit bond to include the following types of bonds if they meet applicable requirements: (1) qualified forestry conservation bonds, (2) new clean renewable energy bonds, (3) qualified energy conservation bonds, (4) qualified zone academy bonds, and (5) qualified school construction bonds.

Section 54A(e)(1) provides that the credit allowance dates for a qualified tax credit bond are March 15, June 15, September 15, and December 15 of any year in which the bond is outstanding and the last day on which the bond is outstanding.

Under section 54A(b)(2), the annual credit on a qualified tax credit bond is the product of the applicable credit rate multiplied by the outstanding face amount of the bond. Subject to special rules in section 54A(b)(4) for short periods, section 54A(b)(1) provides that the amount of credit for any credit allowance date is 25 percent of the annual credit on a qualified tax credit bond.

For holders of new clean renewable energy bonds and qualified energy conservation bonds, section 54C(b) and section 54D(b) limit the amount of the annual credit otherwise determined under section 54A(b) to 70 percent of the amount so determined without regard to section 54C(b) and section 54D(b).

Section 54A(c)(1) generally provides that the credit allowed under section 54A(a) for any taxable year may not exceed the excess of (1) the sum of the regular and the alternative minimum tax liability of the taxpayer, over (2) the sum of certain allowable

credits. Under section 54A(c)(2), unused excess credits may be carried forward for use in succeeding taxable years.

Section 54A(f) provides that, for Federal income tax purposes, the credit determined under section 54A(a) is treated as interest that is includible in gross income.

Section 54A(i)(1) provides that, under regulations prescribed by the Secretary, there may be a separation (including at issuance) of the ownership of a qualified tax credit bond and the entitlement to the credit with respect to that bond. Section 54A(i)(1) further provides that, in case of any such separation, the credit under section 54A 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. Section 54A(i)(2) further provides that, in the case of any such separation, the rules of section 1286 are to apply to the qualified tax credit bond as if it were a stripped bond and to the credit under section 54A as if it were a stripped coupon.

SECTION 3. INTERIM GUIDANCE AND RELIANCE

.02 QUALIFIED TAX CREDIT BONDS--TREATMENT OF THE CREDIT BY
HOLDERS

(a) Allowance of credit— (1) General rule. 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 those credit allowance dates. Unless otherwise specifically provided, for purposes of this Notice references to the “allowance of a credit” or an “allowed credit” mean the amount of the credit determined under section 54A(b) (as limited by sections 54C(b) and 54D(b)) before application of the limitation under section 54A(c).

(2) Allowance of a credit treated as a payment of stated interest on a taxable bond. 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 includable in gross income. Thus, the allowance of a credit on a bond that has not undergone a stripping transaction is treated as a payment of qualified stated interest (within the meaning of § 1.1273-1(c) of the Income Tax Regulations) 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.

(3) Accounting method—(i) General rule. In general, a holder’s regular method of accounting determines when the holder recognizes qualified stated interest income

from a qualified tax credit bond. Thus, if the holder of a qualified tax credit bond uses the cash receipts and disbursements method of accounting, interest income in the amount of the allowed credit is generally included in income on the credit allowance date. If the holder of such a bond uses an accrual method of accounting, this interest income is included in income as it accrues over each accrual period. See § 1.1272-1(b)(1)(ii) to determine the accrual periods and § 1.446-2(b) to determine how qualified stated interest accrues over the accrual period (or periods) to which it is attributable. (For qualified tax credit bonds that have not undergone a stripping transaction, because of the regular quarterly credit allowance dates, the maximum permitted length of the accrual periods is three months.)

(ii) Other rules with respect to accounting for interest. Under certain circumstances, other rules may require the holder of a bond (including a tax credit bond) to adjust the amount of interest income that the holder recognizes. See, e.g., section 171 (amortization of bond premium by a bond purchaser); § 1.61-7(c) (purchaser's treatment of a bond purchased between interest payment dates); § 1.61-7(d) (seller's treatment of a bond sold between interest payment dates); section 1272 (accrual of original issue discount (OID) by a holder); and Section 3.03 of this Notice and section 1286 (treatment of stripping transactions).

(4) Examples. The following examples illustrate the application of this Section 3.02(a):

Example 1. Assume that, on December 15, 2011, City X issues a qualified tax credit bond with a stated principal amount of \$12,000, a credit rate

of 10% compounded quarterly, and a maturity date of December 15, 2013. B purchases the bond at original issue for \$12,000 and thus has a \$12,000 basis in the bond. B is a calendar year taxpayer that uses the cash receipts and disbursements method of accounting. Under Section 3.02(a) of this Notice and § 1.1273-1(c), the allowance of the \$300 tax credit on each credit allowance date is treated as a payment of qualified stated interest of \$300 on those dates. On March 16, 2012, B sells the bond for \$12,000. On March 15, 2012, the first credit allowance date occurring after the issuance of the bond, B becomes entitled to a \$300 tax credit and, with respect to that credit, must include in income \$300 of interest in 2012. No interest is includable in 2011.

Example 2. The facts are the same as in Example 1, except that B uses an accrual method of accounting. As in Example 1, B becomes entitled to a \$300 tax credit on March 15, 2012. B, however, must include in income \$50 of interest in 2011 and \$250 of interest in 2012 (based on a 30 day/360 day counting convention).

Example 3—(i) The facts are the same as in Example 1, except that on March 16, 2012, B sells the bond for \$12,100 to C, a taxpayer that uses the cash receipts and disbursements method and the calendar year. C has not previously elected to amortize bond premium under section 171. Under § 1.61-7(d), B treats the entire \$12,100 as sales proceeds. Because B's basis in the bond was \$12,000, B has a \$100 gain on the sale. C has a \$12,100 basis in the bond.

Because C acquired the bond with premium of \$100, C may elect to amortize the \$100 bond premium under section 171.

(ii) Assume further that C holds the bond until its retirement on December 15, 2013. C has \$900 of tax credits in 2012 and \$1,200 in 2013. If C does not elect to amortize the bond premium, C has \$900 of interest income in taxable year 2012 and \$1,200 of interest income in taxable year 2013. In addition, C has a \$100 loss in taxable year 2013. If C elects to amortize the \$100 of bond premium, the amortized portion of that bond premium reduces C's interest income in 2012 and 2013, and C does not have a \$100 loss in taxable year 2013.

Example 4. The facts are the same as in Example 3, except that B sells the bond to C on January 15, 2012, at a sales price of \$12,100. (Based on the treatment of the credits under section 3.02(a)(2) of this Notice, there was \$100 of accrued but unpaid interest with respect to the bond on the sale date.) Under § 1.61-7(d), B treats \$100 of the sales price as the receipt of interest accrued on the bond, includes this amount in income in 2012, and treats the remaining \$12,000 as sales proceeds. Because B's basis in the bond is \$12,000, B has no gain or loss on the sale of the bond. On March 15, 2012, C becomes entitled to the \$300 credit. Under § 1.61-7(c), the amount of interest income included by C with respect to the credit is \$200, and C's basis in the bond is \$12,000.

(b) Limitation based on amount of tax—(1) In general. The credit allowed under section 54A(a) and this Section 3.02 is subject to the limitation in section 54A(c)(1) based on the taxpayer's income tax liability.

(2) Carryover of unused credit—(i) In general. Under section 54A(c)(2), 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 (an excess credit) is carried to the succeeding taxable year and added to the credit allowable under section 54A(a) (as adjusted by sections 54C(b) and 54D(b)) for the succeeding taxable year (determined before the application of the limitation for the succeeding taxable year

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.

(2) RICs and REITs. If, under section 853A or section 54A(h), a regulated investment company or a real estate investment trust, respectively, 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 regulated investment company or real estate investment trust are reduced when, and to the extent that, the earnings

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.

(2) 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. Except as provided in the next sentence, the identification must be on the first information return filed under section

(d) Allowance of the tax credit to a holder of a stripped credit coupon. A taxpayer who holds a stripped credit coupon on a credit allowance date is allowed the tax credit only if all of the following requirements are satisfied:

(1) Strippable issue. The bond is part of a strippable issue within the meaning of section 310

(e) Treatment of a stripping transaction involving a qualified tax credit bond—

(1) In general. Except to the extent that a provision of this Section 3.03 explicitly provides otherwise, subsections (a), (b), and (e) of section 1286 apply to stripping transactions involving qualified tax credit bonds. In applying these provisions of section 1286, the allowance of a credit is treated in the same manner as a cash payment of stated interest on the credit allowance date. See Section 3.02(a)(2) of this Notice.

(2) Aggregation and other rules. 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 so purchased as a single debt instrument (the aggregated debt instrument) that was newly issued on the purchase date. Notwithstanding the prior sentence, none of the payments on the aggregated debt instrument is treated as qualified stated interest under § 1.1273-1(c). If, in a manner described in the first sentence of this Section 3.03(e)(2), 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, and thus the second sentence of this Section 3.03(e)(2) does not apply.

(f) Examples. The rules in this Section 3.03 are illustrated by the following examples.

Example 1—(i) Facts. On December 15, 2011, City X issues an issue of qualified school construction bonds as a single bond with a stated principal amount of \$12,000, a credit rate of 10% compounded quarterly, and a maturity date of December 15, 2013. Assume that none of the interest on the bond is payable in cash. (That is, there is no supplemental cash interest coupon.) X, on or before the date of issue, includes in the bond documents a statement that the issue is strippable and issues the issue in registered form. X obtains 10 CUSIP numbers with respect to the issue (1 CUSIP number for the \$12,000 issue of qualified school construction bonds, a separate CUSIP for the credit coupons for each of the 8 credit allowance dates through the scheduled maturity of the issue, and 1 CUSIP number for the scheduled principal payment at maturity). On the first information return that X files with the IRS with respect to this issue under section 54A(d)(3), X indicates that the issue is a strippable issue of qualified school construction bonds.

(ii) Analysis. X's issue of qualified school construction bonds is a strippable issue because it satisfies the requirements of Section 3.03(c)(1) through (4) of this Notice.

Example 2. The facts are the same as in Example 1, except that, on December 15, 2011, X sells the \$12,000 bond to Y. Y sells on December 15, 2011, a \$6,000 pro rata portion of the bond to A, a cash method, calendar year

taxpayer, and a \$6,000 pro rata portion of the bond to B, an accrual method, calendar year taxpayer. (Thus, Y's sales to A and B do not constitute a stripping transaction, because they effect a *pro rata* division of the future rights under the bond.) The purchase prices paid by A and B were \$6,000 each. On March 15, 2012 (and all subsequent credit allowance dates), subject to the limitations contained in section 54A(c)(1) and Section 3.02(b)(1) of this Notice, A and B are each entitled to claim a \$150 tax credit.

Example 3—(i) Facts. The facts are the same as in Example 2, except that, on December 15, 2011, A sells the December 15, 2013, credit coupon of \$150 to C, a cash method calendar year taxpayer for \$123.75 (its fair market value). After the sale, A holds the right to receive \$6,000 at maturity as well as the first 7 credit coupons (the “8 retained components”), and C holds only the December 15, 2013, credit coupon.

(ii) Application of definitions. The sale is a stripping transaction within the meaning of Section 3.03(b)(3) of this Notice. The credit coupon held by C and the 7 credit coupons retained by A are all stripped credit coupons. The treatment of B's bond is not affected by the sale.

(iii) A's treatment of the sale. Under Section 3.03(e)(1) of this Notice, section 1286(b) applies to this stripping transaction. Section 1286(b)(4) treats A as having purchased the 8 retained components on the date on which A sells the December 15, 2013, credit coupon to C. Under Section 3.03(e)(2) of this Notice,

the 8 retained components must be treated as an aggregated debt instrument that is newly issued on the date of the sale of that credit coupon.

Prior to the sale of the credit coupon, A's basis in the unstripped \$6,000 bond is A's purchase price of \$6,000. Because no interest is treated as having accrued on the bond prior to the sale, A is not required to include an amount in income under section

allocated to the aggregated debt instrument. Under Section 3.03(e)(2) of this Notice, A must treat the aggregated debt instrument as newly issued on that date for \$5,876.27. Thus, the aggregated debt instrument has an issue price of \$5,876.27. Under Section 3.03(e)(2) of this Notice, no payment on the aggregated debt instrument is qualified stated interest under § 1.1273-1(c). As a result, the stated redemption price at maturity of the aggregated debt instrument is \$7,050 ($\$6,000 + [7 \times \$150]$). The aggregated debt instrument, therefore, has OID of \$1,173.73 ($\$7,050 - \$5,876.27$). Although A generally uses the cash receipts and disbursements method of accounting, A must include the OID in income as it accrues on a constant yield basis over the term of the aggregated debt instrument in accordance with section 1272 and the regulations thereunder.

(v) C's treatment of the stripped tax credit coupon. Under Section 3.03(e)(1) of this Notice, section 1286(a) applies to C's purchase of the December 15, 2013, stripped credit coupon. Section 1286(a) requires C to treat the purchase of this stripped credit coupon as the purchase of a zero coupon bond that is issued on the date of purchase (December 15, 2011). The stripped credit coupon has a stated redemption price at maturity of \$150 and an issue price of \$123.75, resulting in OID of \$26.25 ($\$150 - \123.75). The term of the stripped credit coupon begins on December 15, 2011, and ends on December 15, 2013. Although C generally uses the cash receipts and disbursements method of accounting, C must include the OID in income as it

accrues on a constant yield basis over that term in accordance with section 1272 and the regulations thereunder.

C's basis in the stripped credit coupon is increased by the amount of OID that is included in C's income. As a result, C's basis in the stripped credit coupon on the December 15, 2013, credit allowance date will be \$150. On that date, C

Under section 6049(d)(6), section 6049(a) generally requires OID on any obligation to be reported 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. (This occurs when the allowance of the credit is not treated as a payment of qualified stated interest on an instrument, for example, when a stripped credit coupon is part of an aggregated debt instrument that is subject to the second sentence of Section 3.03(e)(2) of this Notice.)

Section 6049(b)(2)(B)(i) and section 6049(b)(4) generally exempt from information reporting interest that is 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 the following entities: (i) corporations; (ii) dealers in securities or commodities required to register under the laws of the United States, any State, the District of Columbia or any United States possession; (iii) real estate investment trusts (as defined in section 856); (iv) entities registered at all times during the taxable year under the Investment Company Act of 1940; (v) common trust funds (as defined in section 584(a); and (vi) trusts exempt from tax under section 664(c). Notwithstanding the preceding sentence, the exemption continues to apply to interest that is covered by an express regulatory exception.

Section

section 6049(d)(9), including regulations that require more frequent or more detailed reporting.

The Treasury Department and the IRS will attempt to ensure that both the IRS and investors receive accurate information about interest income (including OID) that is includable in income as a result of holding qualified tax credit bonds and components stripped from these bonds. The Treasury Department and the IRS will also seek to ensure that tax credits from qualified tax credit bonds (including tax credits from stripped credit coupons) are claimed only when the claimant is entitled to those credits.

To these ends, the Treasury Department and the IRS anticipate implementing the integrated system of information reporting that is described below in this Section 4. This 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 as defined in section 6045(c)(1) (see Section 3.03(d)(3) of this Notice), future guidance is expected to require the broker to compute, and report to the holder of the stripped credit coupon and to the IRS, the OID that accrues on that coupon under Section 3.03(e) of this Notice and section 1286(a)-(b).

This system of information reporting will be subject to the same penalties that

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 the stripped credit coupon) that is the basis of the credit being claimed.

.04 TAX CREDIT ALLOWANCE INFORMATION RETURN

Under section 6049, the IRS expects to publish a new form, Form 1097-BTC, 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 Section 3.02(a)(1). It is anticipated that this form will be used in two distinct situations. First, it will have to be filed by, or on behalf of, the issuer. Second, a filing will also be required of each broker or intermediary that is not acting on behalf of the issuer (an independent intermediary).

As for the issuer requirement, 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

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 (including a person acting on behalf of the bond issuer).

.05 REPORT FOR INCOME FROM INTEREST, ORIGINAL ISSUE DISCOUNT, OR DIVIDENDS

(a) For qualified tax credit bonds, information reporting for interest and OID under section 6049 will be expanded. Responsible persons under section 6049 will generally be required annually to provide the IRS and the holder of a qualified tax credit bond or stripped credit coupon with 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. As stated above, when a taxpayer holds a stripped credit coupon in an account with a broker as defined in section 6045(c)(1) (see Section 3.03(d)(3) of this Notice), future guidance is expected to require the broker to compute, and report, the OID on that coupon that accrues under Section 3.03(e) of this Notice and section 1286(a)-(b). An analogous requirement may apply to any other stripped component from a qualified tax credit bond.

(b) It is expected that if a regulated investment company or a real estate investment trust 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 when that entity reports under section 6042 dividends paid to its

shareholders, the entity must include distributed tax credits that are treated as dividends.

SECTION 5. REQUEST FOR COMMENTS

The Treasury Department and the IRS solicit comments generally on the expected regulations that are described in Section 3 of this Notice, other aspects of stripping transactions under section 1286 on which guidance is needed, and the various anticipated information reporting requirements that are described in Section 4 of this Notice.

In particular, the Treasury Department and the IRS solicit 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 this Notice to tax credit 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).

Comments should be submitted in writing and can be e-mailed to *notice.comments@irs.counsel.treas.gov* (include “Notice 2010-28” in the subject line) or

mailed to Office of Associate Chief Counsel (Financial Institutions and Products),
Re: Notice 2010-28, CC:FIP:B5, Room 3547, 1111 Constitution Avenue, NW,
Washington DC 20224. The due date for the public comments is May 24, 2010.
Comments that are submitted will be made available to the public.

SECTION 6. OMB NUMBER UNDER THE PAPERWORK REDUCTION ACT

The information collection contained in this Notice has been approved by the Office of Management and Budget (OMB) in accordance with the Paperwork Reduction Act (44 U.S.C. chapter 35) under control number 1545-2167. Under the Paperwork Reduction Act, an agency may not conduct or sponsor and a person is not required to respond to a collection of information unless it displays a valid OMB control number.

The collection of information in this Notice is in Section 3.03(c). The information is required in order to inform the IRS and holders of qualified tax credit bonds whether

free call). For questions on earnings and profits, contact Russell P. Subin on (202) 622-7790 (not a toll-free call).