

Background On The Current Build America Bonds Controversy

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As a follow-up to our prior post, [More Thoughts On The BAB Reissuance Memo](#), we turn to a related question and its history:

Why is the treatment of BAB reissuances only being addressed now? The short answer is that refundings of BABs are new. But please join us as we explore the important backstory.

Prior to the *Cottage Savings* Tax Court decision (90 T.C. 372), decided in 1988, a common type of state or local bond issue was a variable rate demand note, a kind of floating rate instrument. These are security instruments with a long maturity (20 or 30 years) where the holder can “put” the instrument with short notice (typically, one day’s or seven days’ notice). The interest rate on these instruments normally resets once a week, and is set by a remarketing agent based on whatever 7 day interest rate will result in the bonds being remarketed at par.

After the Tax Court found that there had been an “exchange” in a transaction involving ever changing mortgage portfolios held by banks, concerns arose that the precedent set by the case could have further ramifications to the financial markets, including the floating rate tax-exempt bond market. To allay these concerns, the IRS issued Notice 88-130, which set out rules for when typical variable rate state and local bonds, defined as “qualified tender bonds”, would be considered retired and reissued and, more importantly, when those qualified tender bonds would not be deemed reissued (For a contemporaneous and extensive discussion of the notice, see M. Henry, *Reissuance Revisited*, 42 Tax Notes 91 (January 2, 1989), which was written by the notice’s author). Meanwhile the *Cottage Savings* case was working its way up from the Tax Court to the United States Supreme Court. The Supreme Court rendered its *Cottage Savings* decision in 1991 (499 U.S. 554), and that in turn prompted the § 1.1001-3 regulations (sometimes called the reissuance regulations or the *Cottage Savings* regulations), which were first issued in final form in 1996, and which govern treatment of modification of bonds that are not qualified tender bonds.

For those readers frustrated by the 5 year delay in issuing the reissuance regulations after the Supreme Court ruled, this was not the first nor the last time 5 years or more passed between the occurrence of the relevant event and the time regulations were finally issued. For instance the Arbitrage Regulations under the 1986 Tax Act were not issued in final form until seven years later, in 1993. There are also numerous instances of proposed regulations that were never finalized and

many instances of notices of proposed regulations that never actually resulted in the issuance of proposed regulations, let alone final regulations. The old adage your mother may have told you, “don’t start something if you cannot finish it”, apparently does not apply to tax law.

At the time Treas. Reg. § 1.1001-3 was finalized, the only kind of tax advantaged bonds were tax-exempt bonds, and there was no expectation of future Congressionally created tax-credit bonds that would pay taxable interest (and were meant to be a substitute for tax-exempt bonds). These regulations excluded “qualified tender bonds”, thereby preserving the rules in Notice 88-130 for qualified tender bonds. When Notice 2008-27 was issued (an update to the 1988 Notice), there was still no significant amount of state and local government bonds upon which interest was taxable. Notice 2008-27 was prompted by the economic collapse and its effect on auction rate bonds, which did not exist in 1988. Notice 2008-27 was very quickly superceded by Notice 2008-41, which made it clear that certain approaches to fixing the problems with auction rate bonds would not trigger a reissuance.

A bit of this history can be found in the IRS Tax Exempt and Government Entities’s training materials.

Build America Bonds were first authorized in 2009, and represented the first time that a large, organized program existed that permitted a type of state or local bond that would require payments of taxes on the interest. Still later, the sequester was unleashed by Congress, and the amount of the federal subsidy paid to issuers was reduced, which created an incentive for those issuers to issue tax –exempt bonds to refund, defease and call the BABs. For practitioners and issuers accustomed to applying the special tax-exempt bond defeasance rules, the IRS advice memorandum is an unexpected result, and the underpinning of this different result for BABs versus tax-exempt bonds has never been apparent.

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