HAWKINS ADVISORY

Build America Bonds

The America Recovery and Reinvestment Act of 2009 ("**ARRA**") enacted February 17, 2009, among other things, authorized the issuance of Build America Bonds ("**BABs**"). Two categories of BABS were authorized: Tax Credit BABs ("**TC-BABs**") and Direct Payment BABs ("**DP-BABs**"). The holder of a TC-BAB is entitled to a credit against the holder's federal income tax liability. The issuer of a DP-BAB is entitled to a tax credit refund from the federal government. In the year since the enactment of ARRA, most if not all of the BABs which have been issued have been DP-BABs.

ARRA also authorized the issuance of Recovery Zone Bonds ("**RZBs**"). Two categories of RZBs were authorized: Recovery Zone Economic Development Bonds ("**RZEDBs**") and Recovery Zone Facility Bonds ("**RZFBs**"). RZEDBs are treated as a form of BABs. This edition of the Hawkins Advisory summarizes the requirements of DP-BABs and TC-BABs. Future editions will summarize the requirements of RZEDBs and RZFBs.

Requirements for All BABs

- Interest on BABs is subject to federal income taxation.
- BABs must be issued before January 1, 2011.
- The issuer must irrevocably elect under §54AA(d) of the Code to have the bonds be BABs.
- Notwithstanding that interest on BABs is federally taxable, BABs must meet the requirements applicable to tax-exempt "governmental bonds". This means that the amount of "private activity" financed by the BABs must not exceed permissible levels. Thus, BABs may not be issued to finance, among other things, conduit borrowings by section 501(c)(3) organizations.
- Notwithstanding that interest on BABs is federally taxable, BABs must also meet both the arbitrage yield restrictions and rebate requirements applicable to tax-exempt bonds.
- BABs must not be sold with more than de minimis original issue premium ("**OIP**"). The general rule for determining de minimis OIP for a maturity is 1/4% for each full year until the maturity date, measured from the issue date. However, special rules may apply to BABs sold with OIP and that are subject to mandatory or expected redemptions, such as term bonds subject to mandatory sinking fund installment redemptions or bonds subject to certain make-whole redemptions.
- Issuers of BABs must timely file after the closing date of the BABs Form 8038-G with the IRS following special instructions provided in Notice 2009-26.
- The IRS announced in October, 2009 that it will examine all BAB issues through a special compliance unit which will focus on fraud and will have certain referral powers within the IRS Tax-Exempt Bond office.

Requirements for DP-BABs

- In addition to the irrevocable election under §54AA(d) of the Code to have the bonds be BABs, the issuer also must irrevocably elect under §54AA(g)) to have the BABs be DP-BABs.
- An issuer of DP-BABs is entitled to receive a tax credit refund from the federal government in the amount of 35% of the stated interest payable on the DP-BABs. Payments of such tax credit refund are to be made contemporaneously with each interest payment date on the DP-BABs.
- All of the "available project proceeds" of DP-BABs (*i.e.,* sale proceeds, less cost of issuance not to exceed 2%, plus investment earnings thereon), less the amount funding a reasonably required reserve fund, must be used to pay new money, capital expenditures.
  - Refundings and working capital financings are not permitted.
  - Funding capitalized interest is permitted.
  - Reimbursement of capital expenditures, including such expenditures incurred or paid on or prior to February 17, 2009, is permitted if there is a valid declaration of intent to reimburse (See Notice 2009-26).
  - Current refunding of short-term obligations (*e.g.,* bond anticipation notes or commercial paper) issued after February 17, 2009 to finance capital expenditures incurred or paid after February 17, 2009 is also permitted (See Notice 2009-26).
  - A reasonably required reserve fund is an amount not exceeding the least of 10% of the sale proceeds, maximum annual debt service or 125% of average annual debt service. It may be unclear whether the 35% tax credit refund should be netted in determining the amount of the reasonably required reserve fund for tax purposes.
- Arbitrage yield on DP-BABS is determined net of the 35% tax credit refund.

- Issuers of DP-BABs must file a Form 8038-CP with the IRS to obtain the 35% tax credit refund. For fixed rate DP-BABs, such filings must be made not more than 90 days and less than 45 days prior to each interest payment date. The first such filing for refund must not be made less than 30 days after the filing of Form 8038-G. Different procedures apply to variable rate DP-BABs. Revised procedures that would reduce the need to make filings with respect to each interest payment date and provide for a direct electronic deposit, instead of a paper check, are expected to be issued by the IRS or U.S. Treasury Department by mid 2010.
- The 35% tax credit refund is subject to a right of offsets against any liability the issuer (generally the holder of the EIN) owes to the federal government, including liabilities unrelated to the issuer's DP-BABs.
- Offering documents should reflect the risk of offsets if the tax credit refunds are material to the security for payment of the DP-BABs.
- Consideration should be given to whether the tax credit refunds are subject to the pledge made in the bond documents securing bonds and the application of such refunds thereunder. Consideration also should be given to the treatment of the 35% tax credit refunds for purposes of additional bond tests, debt service coverage and other financial tests or covenants and funding of the debt service reserve fund under the bond documents. Such considerations may affect disclosure on the issuer's offering documents.

Requirements for TC-BABs

- A holder of TC-BABs on each interest payment date is entitled to a tax credit against the holder's federal income tax liability in the amount of 35% of the stated interest payable on the TC-BABs on that interest payment date.
- The credit is subject to certain limits and carryover provisions.
- The credit, as well as the interest paid on the TC-BABs, is included in gross income of the holder.
- The credit may be stripped. However, stripping regulations have not been issued.
- TC-BABs, unlike DP-BABs, may be issued for both new money and refunding purposes and are not limited to the financing of capital expenditures.
- Arbitrage yield on TC-BABS is determined without any netting of the 35% tax credit.

Budget Proposals for BABs

- The Obama administration's budget proposals for BABs include extending the authorization for issuance of BABs beyond the current December 31, 2010 sunset date, permitting BABs to be issued for certain refunding and short-term working capital purposes and to provide conduit financings to 501(c)(3) organizations, and reducing the 35% tax credit refund for DP-BABs to 28%.

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