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**AN INTRODUCTION TO  
BUILD AMERICA BONDS  
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## BUILD AMERICA BONDS

- Build America Bonds ("BABs") are a new financing tool created through the American Recovery and Reinvestment Act of 2009 ("ARRA"). It is a new financing tool for state and local governments and is an alternative to traditional tax-exempt debt.
- The purpose of BABs is to attract a different buyer who may not be chasing tax-exemption (i.e., the global taxable market) to a struggling market. The intent was that this temporary financing alternative would bring more borrowing capacity and lower borrowing costs to state and local governments with borrowing needs.

## TYPES OF BABs

- The ARRA authorized state and local governments to issue two general types of BABs as taxable bonds with Federal subsidies. The Federal subsidies are either (1) tax credits given to holders of the BABs or (2) refundable tax credit subsidies paid directly to the state or local government which issued the BABs.
- The latter are Direct Subsidy BABs, the focus of this presentation. Tax Credit BABs are not operative pending Treasury guidance on stripping and market acceptance.
- Generally, some of the same tax restrictions apply to BABs which apply to traditional tax-exempt bonds. BABs cannot be issued to finance private activity (e.g., to benefit non-profits).

## DIRECT SUBSIDY BABs

- Direct Subsidy BABs can be issued in combination with traditional tax-exempt bonds.
- A Federal subsidy through a refundable tax credit is paid to the issuer by the IRS. The subsidy is paid in an amount equal to 35% of total coupon interest on the Direct Subsidy BAB.

## DIRECT SUBSIDY BABs (cont.)

- Direct Subsidy BABs must meet the definition of a “qualified bond” which means the following requirements must be met for issuance of Direct Subsidy BABs:
  - Direct Subsidy BABs can be issued for purposes for which tax-exempt bonds could have been issued;
  - The bond cannot be classified as a private activity bond;
  - Cannot be issued with more than a de minimis amount of original issue premium;
  - Direct Subsidy BABs must be issued before January 1, 2011 (there is no volume cap limitation);

## DIRECT SUBSIDY BABs (cont.)

- The issuer must make an irrevocable election in order to issue Direct Subsidy BABs; and
- 100% of the excess of (i) the available project proceeds (i.e., sale proceeds less up to 2% for costs of issuance) over (ii) the amount deposited in a reasonably required reserve fund are to be used for capital expenditures.
- Federal tax law does not require that the subsidy payments actually be used to pay debt service on the Direct Subsidy BABs, although state law may require that (e.g., voted millage).

## DIRECT SUBSIDY BABs (cont.)

- Direct Subsidy BABs may be used to finance governmental purposes for which tax-exempt bonds may be issued, but the excess of available project proceeds may be used to finance only capital expenditures.
- Generally, Direct Subsidy BABs are more limited than Tax Credit BABs in terms of permitted uses, and may not be issued to finance working capital expenditures or to refinance capital expenditures through a refunding issue.
- Direct Subsidy BABs may be issued to reimburse otherwise eligible capital expenditures. Up to 2% of proceeds may finance transaction costs.

## DIRECT SUBSIDY BABs (cont.)

- The issuer receives a refundable tax credit for each interest payment made on the Direct Subsidy BAB. The IRS will pay 35% of the interest payable under the Direct Subsidy BAB directly to the issuer. Such payment is not federally guaranteed. Electronic direct-deposit system, while not here yet, is on its way.
- For arbitrage yield purposes, yield on a Direct Subsidy BAB is calculated by reducing the amount of interest paid on the Direct Subsidy BAB by the amount of subsidy payments received.
- One unresolved issue is how the calculation will be made if the direct subsidy payment receipt date is different than interest payment date.

## DIRECT SUBSIDY BABs (cont.)

- The state or local government issuer will have a lower net interest cost due to receipt of the direct subsidy payment as a partial offset. OID is not treated as an interest payment for purposes of calculating the direct subsidy payment.
- All of the Direct Subsidy BABs I have seen have seen so far have been sold at par and as term bonds.
- Example: A state or local government issues Direct Subsidy BABs at a 10% taxable interest rate. The Treasury will then make a payment directly to the issuer of 3.5% of that interest, which results in the issuer's net interest cost equaling only 6.5% on the Direct Subsidy BAB which pays 10% interest.

## DIRECT SUBSIDY BABs (cont.)

- ADDITIONAL CONSIDERATIONS--

1. Do tax covenants run to the Holders of the Direct Subsidy BABs? Do Holders of Direct Subsidy BABs receive a federal tax law opinion that should be included as an appendix in the Official Statement? Does it depend on whether the subsidy payment is pledged or not, or is otherwise economically significant? Should issuer receive an opinion as a side letter or as a supplemental opinion in any event?

## DIRECT SUBSIDY BABs (cont.)

2. For purposes of the anti-dilution test, parity test and/or rate covenant, can/should the direct subsidy payment be taken into account as a revenue increase or a deduction in debt service? If there are no such provisions, is an amendment advisable or achievable? If insurer cannot effectively consent in lieu of bondholders given ratings situation, is a springing amendment an option?
3. For bond contract purposes, how do you calculate the "Reserve Requirement?" Does "lesser of" test allow you to net direct subsidy payment? Does the calculation of a reasonably required reserve fund for tax purposes require/allow netting?

## DIRECT SUBSIDY BABs (cont.)

4. Is there a material risk that Congress can reduce or eliminate the direct subsidy payment after the Direct Subsidy BABs are issued? If so, how might an issuer mitigate this risk? The Treasury and the Chief Tax Counsel to the House Ways and Means Committee have stated that the direct subsidy payment is a permanent (rather than an annual) appropriation, along the lines of a tax refund, and therefore, is not subject to appropriation risk.

## FILING/PAYMENT PROCEDURES

- The issuer is required to make an irrevocable election in its books and records prior to or at closing in order to issue Direct Subsidy BABs.
- The issuer will then be required to report the issuance of the Direct Subsidy BABs on its Form 8038-G post closing and at least 30 days before the first filing of its Form 8038-CP.
- For Direct Subsidy BABs, the issuer must submit a new Form 8038-CP each time it requests payment of the amount of the direct subsidy payment. Issuer should receive payment within 45 days after the form is processed.

## FILING/PAYMENT PROCEDURES (cont.)

- For fixed rate Direct Subsidy BABs, the due date for the issuer to file the Form 8038-CP is the 45th day before the applicable interest payment date, however not earlier than the 90th day before the applicable interest payment date.
- For variable rate Direct Subsidy BABs, the due date for the issuer to file the Form 8038-CP is the 45th day after the last interest payment date within the quarterly period for which reimbursement is requested.

## POST-ISSUANCE COMPLIANCE

- The IRS Bond Branch has put together a team of agents to check validity of requests for payment.
- The team will compare information on Form 8038-CP, which requests payment, with that on Form 8038-G, which is filed post closing, so there are no irregularities, and will also conduct additional research, including checking EMMA for documentation that shows that the BABs are being used for and whether they qualify as BABs.
- IRS has stated that they will send out questionnaires relating to all Direct Subsidy BABs which have been issued, which in some cases will be a pre-cursor to an IRS audit.

# BABs UNCERTAINTY

## QUESTIONS REMAIN/ADDITIONAL GUIDANCE NEEDED—

1. Can Direct Subsidy BABs be advance refunded in the future through the issuance of tax-exempt bonds (we suspect that current refunding will be permitted, but Treasury has not issued guidance on this point)?
2. What actions may be taken post-issuance, such as whether issuers may change the use of the financed facility to a non-governmental use?
3. How will the IRS handle enforcement actions? Will issuers face penalty assessments for negligence?
4. How will tax controversies be resolved?

## BABs UNCERTAINTY (cont.)

4. Will issuers have the same rights as taxpayers during audits or when seeking refunds?
5. Can the IRS reclaim past direct subsidy payments if it is determined a prior violation of federal tax law has occurred?
6. Will the IRS be more aggressive policing subsidy payments than they have been making determinations of taxability in regards to traditional tax-exempt bonds?
7. Will there be more litigation between the IRS and issuers?
8. Can the IRS offset subsidy payments based on unrelated disputed (e.g., payroll tax or other dispute with the feds)?

## DIRECT SUBSIDY "SUPER" BABs

- Up to \$10 billion national volume cap in Recovery Zone Economic Development Bonds ("RZEDBs").
- The Treasury has provided guidance regarding allocations received by each state, including distributions to counties and large municipalities.
- RZEDBs, which are taxable bonds, are really Direct Subsidy BABs with more limitations but a higher subsidy payment.

## DIRECT SUBSIDY “SUPER” BABs (cont.)

- A RZEDB means any BAB issued before January 1, 2011 if, in addition to meeting the requirements stated previously for the issuance of a Direct Subsidy BAB:
  1. 100% of (i) the excess the available project proceeds of such issue (i.e., sale proceeds less up to 2% for costs of issuance), over (ii) the amounts in a reasonably required reserve, are to be used for one or more Qualified Economic Development Purposes; and
  2. The issuer designates the bonds for such purposes as RZEDBs.

## DIRECT SUBSIDY “SUPER” BABs (cont.)

- RZEDBs give an enhanced subsidy rate of 45% (rather than 35% for BABs) which is received as a direct subsidy paid by the Internal Revenue Service to the issuer.
- The prevailing wage requirement of the Davis-Bacon Act will apply to any project financed with the proceeds of any RZEDB. Contractors and their subcontractors are required to pay their workers who are employed on the actual work site no less than the prevailing wages locally, plus the fringe benefits normally paid on similar projects.
- If bond financed project is not Davis-Bacon compliant, could IRS offset subsidy payments with some sort of penalty?

## DIRECT SUBSIDY "SUPER" BABs (cont.)

- "Qualified Economic Development Purposes" means expenditures for purposes of promoting development or other economic activity in a recovery zone including:
  1. Capital expenditures paid/incurred with respect to property located in such zone;
  2. Expenditures for public infrastructure and construction of public facilities; and
  3. Expenditures for job training and educational programs.

## DIRECT SUBSIDY "SUPER" BABs

- The bond financed project must be in a Recovery Zone.
- A "Recovery Zone" is any area designated by an issuer as having significant poverty, unemployment, rate of home foreclosures, or "general distress" or any area designated by the issuer as economically distressed by reason of the closure or realignment of a military installation.
  - The adoption of a resolution identifying one or more of the factors stated above should suffice to designate an area as a Recovery Zone.
  - A Recovery Zone also includes any area currently designated as an Empowerment Zone or a Renewal Community Area.

## DIRECT SUBSIDY "SUPER" BABs (cont.)

- A State must reallocate its share of the national limitation among the counties and large municipalities within the State in the proportion that each county's or municipality's 2008 employment decline bears to the aggregate of the 2008 employment declines for all of the counties and large municipalities.
- A county or large municipality may waive some or all of its allocation.

## CONCLUSION

- The final day for issuing Direct Subsidy BABs and Direct Subsidy “Super” BABs is December 31, 2010.
- While the reduction in net interest costs can be compelling, it is important to be aware that:
  - Direct subsidy payments do not constitute a full faith and credit guarantee of the United States.
  - The issuer may not receive direct subsidy payments when expected or at all, either whether due to failure of the issuer to timely file payment request forms or satisfy other eligibility requirements or for any other reason.

## CONCLUSION

- No assurance can be given that any future legislation, clarification, amendments to the Code, if enacted into law, or judicial decisions will not potentially reduce or eliminate the direct subsidy payments.

