T-9 TAX LAW SUPER SESSION: HOT TOPICS

Chair:

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Panelists:

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I. Refunding of Build America Bonds

City X in 2009 sold and issued two concurrent issues of bonds. Its Series 2009 C Bonds (the "Series C Bonds") were sold and issued as tax-exempt bonds. Its Series 2009 D Bonds (the "Series D Bonds") were sold and issued as direct subsidy "build America bonds" ("BABs").

The proceeds of the Series C Bonds, net of issuance costs and amounts deposited in a debt service reserve fund, were used to advance refund a prior issue of fixed rate bonds, which were originally used by City X in 2002 for new money purposes. The proceeds of the Series D Bonds, net of issuance costs and amounts deposited in a debt service reserve fund, were deposited in the Series D Construction Fund, to be used to finance capital expenditures, including the reimbursement of several pre-issuance capital expenditures.

The Series C Bonds have maturities in years 1 through 12, and the Series D Bonds have maturities in years 13 through 25.

The Series C Bonds are optionally redeemable by City X beginning approximately 10 years after issuance. The indenture for the Series D Bonds, as has been customary for taxable debt, contains a "make-whole call" provision (the "MWC"), whereby although City X may optionally redeem all or a portion of the Series D Bonds at any time, City X may be required to make a payment to the holders of the Series D Bonds, in addition to the outstanding par amount of the Series D Bonds, to compensate them for not realizing their expected investment return over the term of the Series D Bonds. The MWC is calculated under the documents based on the future stream of interest payments that would otherwise be made, present valued based on the rate on U.S. Treasury securities with a term approximating the remaining term of the Series D Bonds, but in any case no less than the original issue price of the Series D Bonds.

It is March 2011, and City X has received advice from its financial advisor that it could issue tax-exempt bonds currently that would produce a lower interest cost than its current net interest cost on the Series D Bonds (the interest cost on the Series D Bonds, less the 35% subsidy).

A. May City X issue tax-exempt bonds in 2011 to advance refund the BABs?

B. Assuming there are no document-related or cash-flow-related reasons to support a refunding, is there justification to issue advance refunding bonds at all? What level of governmental purpose does one need?

C. Irrespective of B., because the Series D Bonds are callable at any time, though possibly with a make-whole premium, must the Series D Bonds be called on their first optional call date, subject to required notice under the bond documents?

D. If the MWC is sufficient to eliminate present value savings entirely, may City X establish an escrow? If so, for how long? Through maturity? Must one keep testing to determine the first date on which there will be PV savings?

E. Does any of the analysis above change if, in addition to the MWC, City X has the ability to redeem the Series D Bonds at the end of year 10 at par (prior to year 10, the MWC would kick in)?

F. Assuming City X may advance refund the Series D Bonds, during the escrow period, will City X continue to receive the 35% subsidy payment from the federal government?

G. If the answer in F. is yes, must City X size its escrow to take into account the subsidy and hence net fund the escrow? If so, will City X accomplish a legal defeasance of the Series D Bonds? Is the right to receive the stream of subsidy payments sufficient to defease? Consider the conditions necessary to receive the subsidy (e.g., filing Form 8038-CP, making arbitrage rebate payments as required, compliance with private use restrictions), as well as the ability of the federal government to offset other liabilities due and owing to it against any subsidy payment.

H. If the pledge of City X's right to receive future subsidy payments will not enable City X to effect a legal defeasance of the Series D Bonds, could City X fund an escrow based on the gross debt service due on the Series D Bonds? Does this raise overburdening concerns?

I. If a defeasance escrow is established, will that result in a "reissuance" of the Series D Bonds under Treas. Reg. § 1.1001-3(e)(5)(ii)? While the caption of Treas. Reg. § 1.1001-3(e)(5)(ii)(B)*(1)* is "Defeasance of tax-exempt bonds," could the language arguably extend to BABs? Note the definition of "Tax-exempt bond" in Treas. Reg. § 1.1001-3(f)(5)(iii), which defines tax-exempt bond to mean a "state or local bond that satisfies the requirements of section 103(a)." Don't BABs satisfy the requirements of section 103(a), and then some (e.g., no refunding, no working capital)? Does the issuer's election to treat bonds as BABs negate that?

J. If there is a reissuance of the Series D Bonds, would the subsidy at that point be lost in any case because (i) the reissued bonds would be issued in 2011 (unless the ability to issue BABs is extended), and/or (ii) the reissued bonds would be viewed as refinancing the original Series D Bonds and not as directly financing capital expenditures? Is it good practice to have bond counsel act as "gatekeeper" by ensuring that the bond documents not only provide what is necessary to effect a legal defeasance (U.S. government securities, cash flow sufficiency) but also to require an opinion of bond counsel to the effect that the defeasance of the bond issue in question will not adversely affect its status, whether an issue of tax-exempt bonds BABs or tax credit bonds.

K. Are there allocation considerations for City X to avoid the 1x/2x limitations of Code Section 149(d)? In other words, because the Series C Bonds and Series D Bonds were sold and issued at the same time, must City X meet the rules under Treas. Reg. § 1.148-9(h)(4)(v)? The "better" answer is that that should not be

necessary since the proper treatment of the Series C Bonds and Series D Bonds initially was that they were not part of a single issue for purposes of Code Sections 103 and 141 – 150.

II. Delay in Issuance of Hedged Bonds

City Y signed a confirmation with Counterparty for a forward-starting variable-to-fixed interest rate swap (the "Swap") in May 2010, reasonably expecting to issue bonds to be hedged by the Swap (the "Bonds") sometime in September 2010. The certificate identifying the Swap, signed within three days of the signing of the confirm, sets forth all of the information required by the regulations for a proper identification, including City Y's expectation that the Swap is not expected to be terminated upon the issuance of the Bonds.

For reasons unrelated to tax, City Y was unable to issue the Bonds, but did not want the Swap to become effective absent the issuance of the Bonds. City Y would like to negotiate with Counterparty to extend the start date of the Swap.

A. May the issuer negotiate an extension of the start date for the Swap, without jeopardizing City Y's ability to treat the Swap as a qualified hedge?

B. Suppose that Counterparty requires a payment or a change in the fixed rate on the Swap in exchange for agreeing to the extension? If there is a payment, how may/must such payment be taken into account? Does either a payment or a change in the fixed rate on the Swap affect the ability of the Swap to qualify as a qualified hedge? Does the treatment of the Swap depend on whether there is a significant modification of the Swap as a result of the extension (and payment) under Code Section 1001 principles? See Treas. Reg § 1.148-4(h)(3)(iv)(A), second sentence. How are these principles actually to be applied?

C. If the Counterparty does not agree to extend the Swap, what is the "reasonable interval" during which City Y must integrate the Swap with other bonds issued for the same governmental purpose? Does there come a point at which the Swap no longer may/must be integrated with any bond issue?

D. What if there is more than one potential candidate, e.g., where the identified bonds are variable rate, City Y issues variable rate bonds 60 days after the start date of the Swap, but also issued fixed rate bonds 15 days after the start date of the Swap, both for the identified governmental purpose? Must the Swap be integrated with the fixed rate bonds simply because they were closest in time, or with the variable rate bonds because they have the type of interest rate described in the identification certificate? Does it make sense to integrate a variable-to-fixed swap with fixed rate bonds?

E. Are there circumstances where the Swap would be "bifurcated" and allocated to more than one bond issue?

III. Limitation on Original Issue Premium on BABs

On March 1, 2010, City Z intends to issue $100 million of direct subsidy BABs. $25 million will mature on March 1, 2025, and an additional $25 million will mature at successive 5-year intervals, the last corresponding to March 1, 2040. City Z will be seeking the maximum permitted amount of OIP for each maturity of its BABs, as follows:

A	**B**	**C**	**D**	**E**
Due Date	Maturity Amount	Number of Complete Years to Maturity	Maximum Premium Col. C x 0.0025	Expected Offering Price Col. B + Col. D
Mar. 1, 2025	$ 25,000,000	15	$ 937,500	$ 25,937,500
Mar. 1, 2030	$ 25,000,000	20	$ 1,250,000	$ 26,250,000
Mar. 1, 2035	$ 25,000,000	25	$ 1,562,500	$ 26,562,500
Mar. 1, 2040	$ 25,000,000	30	$ 1,875,000	$ 26,875,000
	$ 100,000,000		$ 5,625,000	$ 105,625,000

A. On the issue date, March 1, 2010, in reliance on Treas. Reg. § 1.1273-2(a)(1) and treating 10% as "substantial," City Z accepts a certificate from the underwriter of the BABs stating that the first price at which at least 10% of the bonds of each maturity was sold is the respective dollar price shown in Column E above. Assume that investor interest in City Z's BABs is overwhelming, and that a portion of the bonds of each maturity is sold for a premium significantly in excess of 0.25% multiplied by the number of complete years to maturity, resulting in an aggregate premium for the entire issue of $15 million. For purposes of the limitation on OIP specified in Code Section 54AA(d)(2)(C), what is the issue price of the BABs?

B. The facts are the same as in A. above, except that the bonds of all maturities other than the 2025 maturity are sold for a premium not exceeding 0.25% multiplied by the number of complete years to maturity. The 2025 maturity is undersubscribed and, notwithstanding the reasonable expectations (based on prevailing market conditions) of both the underwriter of the BABs and City Z's financial advisor (to which each certifies), far fewer than 10% of the bonds of the 2025 maturity were sold at the same price. On the issue date, $5 million of the 2025 maturity remain unsold and are taken into inventory by the underwriter with a verbal promise to City Z to the effect that the inventoried BABs will eventually be sold at prices that individually or in the aggregate do not exceed the limitation on OIP in Code Section 54AA(d)(2)(C). At some point (is it relevant when?) the capital markets

make an unexpected favorable move, and that one of the underwriter's traders, unaware of the promise made to City Z, sells the entire $5 million block of BABs to a favored customer for $6 million. For purposes of the limitation on OIP in Code Section 54AA(d)(2)(C), what is the issue price of the 2025 maturity? Specifically, in reliance on the definition of "issue price" contained in Treas. Reg. § 1.148-1(b), is it reasonable for City Z to rely on the reasonable expectations regarding the initial public offering price of that maturity to which the underwriter and City Z's financial advisor have each certified?

C. The facts are the same as in B. above, except that reliance on the Treas. Reg. § 1.148-1(b) definition of "issue price" is determined not to be reasonable. What may/must City Z do to remediate non-compliance with Code Section 54AA(d)(2)(C)? Is a possible theoretical answer to determine the amount of the 35% subsidy payment by reference not to the interest payable on the BABs but on the (lower) yield on the BABs? Might one approach the Service for a closing agreement recommending such approach?

IV. <u>BABs and Grants</u>

City C wishes to issue tax increment bonds (the "Bonds") to fund a redevelopment project. The Bonds will be secured by incremental property tax revenues generated by an ad valorem real property tax levied upon the property located in City C's redevelopment area. As with many redevelopment projects, there is a good deal of public-private collaboration. Several of the projects within the redevelopment area to be funded by the Bonds involve City C's granting of a portion of the proceeds of the Bonds to Developer D, to be used by Developer D to construct and or renovate such projects. The arrangement will not be structured as a loan, nor will Developer D otherwise be obligated to make any payment to City C.

City C's financial advisor has recently advised it that it may save a few dollars of debt service by considering the use of direct subsidy BABs to fund some or all of the projects in City C's redevelopment area.

A. May City C finance the grant to Developer D using the proceeds of the BABs? How should/must one characterize the use of proceeds to make the grant?

B. Is a grant a working capital expenditure per se (as it does not create an asset on City C's books)? Or does/should one look through to the grantee's use of the proceeds?

C. Does the "use" analysis end at the point City C makes the grant to Developer D, akin to the expenditure rule for grants in Treas. Reg. § 1.148-6, or does one look through the grant to the grantee and its use of the proceeds? In any case, because there is no loan and Developer D is not otherwise obligated to make payments, the private security or payment test will not be satisfied here.

V. Qualified Tax Credit Bond Rates

Code Section 54A provides rules for the issuance and of qualified tax credit bonds including new clean renewable energy bonds, qualified energy conservation bonds, qualified zone academy bonds and qualified school construction bonds and the use and investment of proceeds of such bonds. The following table is taken from the Bureau of the Public Debt's "Treasury Direct" site, where tax credit bond rates can be found:

Date	Rate	Maturity	PSFY*
Feb 8, 2010	5.86%	17 years	4.38%

*Permitted Sinking Fund Yield

Question: Is the maximum maturity, to which reference is made in Notice 2009-29 and the information furnished under "Maturity" in the above table, together intended to be a safe harbor that, in effect, overcomes the potential consequences of the "back-end" replacement rules of Treas. Reg. § 1.148-1(c)(4)(i)(B), including "overburdening" under Treas. Reg. § 1.148-10(a)(4)? The replacement rules incorporate a 120% average maturity-to-economic life test in order to avoid "back-end" replacement proceeds. Here, there is no tax-exempt market to be overburdened.

VI. Waiver of RZEDB Cap

County A of State Q has been allocated a portion of State Q's allocation of recovery zone economic development bond ("RZEDB") cap. County A, like many other counties within State Q, is a small county and is unlikely to issue RZEDBs in 2010 (or any time thereafter, for that matter). State Q's dilemma concerns the fact that a 45% interest subsidy would make the financing of certain projects in the various recovery zones in the state fairly attractive, and State Q would like to exploit that fact. State Q's financial advisor has indeed suggested to State Q that a statewide pooled financing may be a very worthwhile undertaking by State Q, should it be able to issue RZEDBs in an amount close to or equal to the amount of RZEDB cap initially allocated to State Q.

County A, like other counties within State Q, possesses substantial eminent domain, taxing and police powers.

A. If, for whatever reason, neither County A nor other counties within State Q are willing to sign a written waiver of their RZEDB cap, ceding such cap back to State Q, may State Q deem there to be waiver of such cap, either through the establishment and implementation of a statewide process or otherwise?

B. Does Section 5.04 of Notice 2009-50 provide a negative implication? It states that "[i]n the event that a county or large municipality that receives an allocation of volume cap under Section 1400U-1(a)(3)(A) . . . does not possess substantial taxing, eminent domain, and police powers, any entity the jurisdiction of which

includes such county or large municipality may issue bonds and designate such bonds as [RZEDBs]." Does this suggest that a state is powerless to issue RZEDBs and/or to regain the RZEDB cap from its counties and large municipalities where such counties and large municipalities have Shamberg-type powers? Does the state have no power to compel its counties and large municipalities to cede their volume cap back to the state? Section 1400U-1(a)(3)(A) of the Code provides that "[a] county or municipality may waive any portion of an allocation." Section 5.05 of Notice 2009-50 provides that "[u]pon such waiver, "the State in which such county or large municipality is located shall be authorized to reallocate the waived volume cap in any reasonable manner as it shall determine in good faith in its discretion."

VII. RZEDBs – Capital vs. Working Capital Costs

Municipality M, which is a large municipality, has been allocated a portion of State S's RZEDB volume cap in accordance with Code Section 1400U(a)(1) and (2) and Notice 2009-50. Municipality M has identified and properly designated certain areas within its corporate boundaries as "recovery zones." Municipality M proposes to issue RZEDBs at individual issue prices of par or less, and to use 100% of the available project proceeds for job training and educational programs pursuant to Code Section 1400U-2(c)(3).

A. Section 3.03 of Notice 2009-50 states in part in respect of RZEDBs: "This broad definition of qualified economic development purpose includes capital expenditures . . . and working capital expenditures to promote development or other economic activity in a recovery zone." Is this reference to "working capital expenditures" a veiled reference to expenditures for job training and educational programs (whatever they are)?

B. RZEDBs are a subclass of build America bonds (Code Section 1400U-2(b)(1)) and, as such, subject to most of the rules and limitations applicable to for tax-exempt governmental bonds (Code Sections 6431(e) and 54AA(d)). Assuming that expenditures for job training and educational programs would normally be classified as restricted working capital expenditures, does this imply that Code Section 1400U-2(b)(1) trumps the requirement of Section 54AA(g)(2) that all available project proceeds, after reduction for costs of issuance and reasonably required reserves, be allocated to capital expenditures?

C. Assuming such working capital costs could be financed and are considered restricted working capital expenditures, is there any basis for excepting such expenditures from the proceeds-spent-last accounting regime under Treas. Reg. § 1.148-6(d)(3)? The exception for extraordinary items? Suffice it to say that if issuers are stuck with the proceeds-spent-last accounting regime, the possibility of financing expenditures for job training and educational programs will be lost on many of them.

D. Assuming that expenditures for job training and educational programs, programs would normally be classified as restricted working capital expenditures, over what

period of time may the RZEDBs be amortized? Obvious traps are Treas. Reg. § 1.148-1(c)(4)(i) (relating to "back-end" replacement proceeds) and the rules under Treas. Reg. § 1.148-10(a)(4) and (b) (relating to actions that overburden the tax-exempt market and the consequences of overburdening). The fall-back would be to require testing for available amounts two years after issuance à la Treas. Reg. § 1.148-1(c)(4)(i)(B)*(1)* with the possibility of early redemptions – not a very attractive option, especially if the RZEDBs are required to be issued with a make-whole call provision.