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BUILD AMERICA BONDS:
AN INTRODUCTION

On February 17, 2009, President Obama signed the widely anticipated economic stimulus legislation formally known as the American Recovery and Reinvestment Act of 2009 (the Act). The Act encourages more activity in the public finance sector by, among other things, introducing new types of bonds. The following information is intended to serve as a general overview of one such type – Build America Bonds (BABs) – and does not constitute an exhaustive discussion or legal advice.

Build America Bonds are taxable tax credit bonds.

Like their tax-exempt counterparts, taxable tax credit bonds are a vehicle for federal subsidization of state and local government obligations. Taxable tax credit bonds are different from tax-exempt bonds, however, in that the interest paid to bondholders is taxable, and a portion of the interest consists of a federal tax credit (the amount of which is also taxable). Despite the taxable status of the interest and credit, the Act provides that until a state legislates to the contrary, interest and credits attributable to BABs are treated as exempt from federal income tax for the purposes of state income taxes.

Issuers may receive a direct payment from the U.S. Treasury to apply toward debt service on Build America Bonds.

BABs have an innovative feature that allows issuers to receive a direct payment from the U.S. Treasury (the Direct Payment Option) as of each interest payment date in lieu of providing bondholder tax credits (the Bondholder Tax Credit Option).

The Direct Payment Option reflects a significant change in the federal government's approach to subsidizing municipal obligations. The following example illustrates the effect of this approach on issuers and bondholders. If the issuer elects the Direct Payment Option, the issuer will receive, as of each interest payment date, a payment equal to 35% of the interest payable on that date (excluding any original issue discount). Therefore, on bonds with an 8% yield for the bondholder, the issuer will pay an effective interest rate of 5.2%. In contrast, if the issuer elects the Bondholder Tax Credit Option for bonds payable at 6%, the bondholder will accrue a tax credit equal to 2.1% (35% of 6%), for a total yield of 8.1% for the bondholder. Congress anticipates that bondholders will accept an interest rate approximately 74.1% of an otherwise equivalent taxable rate.

Build America Bonds can be used to finance a wide range of projects.

Subject to the following limitations, state and local governments can issue BABs for any purpose for which they can issue tax-exempt governmental (i.e., not private activity) bonds. BABs issued in connection with the Direct Payment Option can only be used to finance new capital expenditures, reasonably required reserve funds, and costs of issuance (of up to 2% of the proceeds). BABs issued in connection with the Bondholder Tax Credit Option, however, may be used for working capital and current and advance refundings, in addition to the foregoing purposes.

Rules Applicable to Tax-Exempt Bonds also apply to Build America Bonds.

Despite their taxable status, BABs are subject to the rules applicable to tax-exempt bonds (with some modifications), and they may not be private activity bonds. For example, BABs are not treated as federally guaranteed on the basis of the tax credit or direct payment. Further, BABs are subject to the arbitrage rules in Section 148 of the Internal Revenue Code. For the purposes of the these rules, the yield on BABs issued in connection with the Bondholder Tax Credit Option is calculated without regard to the tax credit allowed, while the yield on BABs issued in connection with the Direct Payment Option is reduced by the payment amount. Also, while the IRS is still working out the details, it is likely that the reimbursement rules under Treasury Regulations §1.150-2 will apply to BABs. The IRS has indicated that further guidance will be forthcoming.

Build America Bonds may only be issued in 2009 and 2010.

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