

## Build America Bonds

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March 2, 2009

The purpose of this alert is to bring to your attention a new option for governmental financing called "Build America Bonds," or BABs. BABs were included in the American Recovery and Reinvestment Act (the "Act") signed into law by President Obama on February 17, 2009. The following questions and answers highlight the major characteristics of these bonds.

### **What are BABs?**

BABs are state or local governmental bonds that could be issued as tax-exempt bonds, but which the issuer elects to treat as BABs. Interest on BABs is taxable to the bondholder, but tax credits are provided in lieu of the tax-exemption.

There are two general types of BABs. The first, or basic, form provides the bondholder with a non-refundable federal income tax credit of 35% of the interest paid on the bond in each tax year. If the bondholder lacks sufficient tax liability in any year to fully utilize that year's credit, the excess credit can be carried forward for use in future years.

The second form, "Issuer BABs," provides no credit to the bondholder, but instead the issuer of the BABs receives payments from the Federal Treasury equal to 35% of the interest paid by the issuer. No more than 2% of Issuer BABs proceeds may be used to pay costs of issuance and, with this type of BABs, it appears that only new money projects for capital purposes can qualify. Because the credit is paid to the issuer, and BABs are taxable obligations, the purchasers of these bonds need not be taxpayers. This opens a new market for the debt of State or local governmental units, including tax-exempt entities like pension plans and foreign entities.

Unless extended, BABs can be issued only from February 17, 2009 through 2010.

### **Who can issue BABs and what can be financed?**

BABs can be issued by any State or local governmental issuer of tax-exempt bonds. The proceeds can be used for any purpose for which tax-exempt financing is generally available. BABs must satisfy all the rules applicable to tax-exempt financing generally, including limits on private use, arbitrage limitations and rebate requirements. In effect, the issuer structures a transaction in the manner of a tax-exempt bond, but elects to exchange the tax-exemption for the tax credits, paid either to the bondholder or the issuer. BABs treatment is not available for any financing which benefits private parties, including 501(c)(3) organizations.

### **Can bonds be issued as part BABs and part tax-exempt bonds?**

Yes. The statutory language allows BABs treatment to be elected for selected bonds constituting a portion of an issue (for example, the later maturing bonds in the issue). Because of the differing tax treatment it would be necessary in such case to split the overall issue into identifiable separate series, one consisting of tax-exempt bonds and the other made up of BABs.

### **Is the interest payable on BABs exempt from State taxation?**

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The Act is drafted to maximize the likelihood that States that exempt interest from State income taxation based on a federal exemption would treat BABs as tax-exempt for State law purposes. The Act does allow the States to specifically overrule this position. Therefore, there may be some uncertainty as to State law treatment of the interest on the BABs.

### **Are BABs authorized under State law?**

BABs provide a new structure for bonds which, as always, the borrower must have the independent power to issue for particular purposes under State law. BABs are bonds similar to other interest bearing bonds and should be able to comply with State law. However, some legislative amendments may be necessary in order to properly receive and apply the tax credits payable to the issuer of Issuer BABs.

### **What remains to be clarified regarding BABs?**

There remain several open issues affecting the issuance and effect of BABs, some of which will require Federal or State guidance or possibly legislative changes. This is a totally new financing vehicle and implementing regulations and guidance should be forthcoming from regulators in the very near future. The open issues or unknowns include:

- Whether there are limitations or restrictions regarding the use of credit payments to issuers of Issuer BABs.
- Taxable governmental bonds have constituted a relatively small market, so the size and composition of the market for BABs and the structural requirements that such market may impose are currently unclear.
- Are BABs a good deal for issuers? Issuers should check with their financial advisors and underwriters for help evaluating the overall cost of a financing using either of the BABs types as compared to traditional tax-exempt financing.
- Disclosure for BABs may be more substantial, if the experience in the taxable bond market generally is applicable.
- The nature and extent of required legal opinions regarding BABs, and their credits, is not yet fully known.
- Procedures that might be imposed by the Internal Revenue Service regarding the election of BABs treatment and enforcement in the area are also unknown.
- What legal and market constraints may limit the refinancing of BABs.