

## Build America Bonds in the American Recovery and Reinvestment Tax Act of 2009

The American Recovery and Reinvestment Tax Act of 2009 (the "Act") provides new tools for state and local governments to finance basic infrastructure, government facilities, and public schools. The Act's new Build America Bonds may provide a more cost-effective method of borrowing.

The Act created the new category of Build America Bonds. State and local government issuers can elect to have any bond (other than a private activity bond) that would qualify for tax exemption under Section 103 of the Code instead be issued as a taxable bond with the bondholder receiving a tax credit equal to 35% of the interest on the bond. The bonds pay taxable interest but the bondholder claims a credit.

Build America Bonds may be issued only for those purposes for which tax-exempt governmental bonds may be issued under existing law. Thus the rules that apply to tax-exempt governmental bonds (e.g., private-use restrictions, arbitrage) also apply to Build America Bonds. Build America Bonds are not subject to any volume cap allocations or state limitations and are not otherwise limited to certain types of facilities or purposes as are most tax credit bonds (although, as noted below, one type must be used for capital purposes).

The Act in effect creates two types of Build America Bonds:

1. The first type is for all non-private activity bonds (not limited to those issued for capital purposes – such that it include refundings, cash flow borrowings, etc.) where the bondholder receives taxable interest and gets a federal tax credit equal to 35% of the interest paid.
2. In the second type, the issuer elects to receive direct payments from the federal government in the amount of 35% of the interest payable on the bond, in lieu of the tax credit provided to bondholders. This direct payment provision is only available for new money bond issues where 100% of the proceeds (i.e., sale proceeds less up to 2% costs of issuance and an allowance for a debt service reserve fund) are used for capital expenditures. Note that a 2% cost of issuance limitation is being applied to governmental issuers. This second type can only be issued during 2009 and 2010.

Issuers should consider whether the Build America Bonds result in a lower cost of borrowing than the traditional tax exempt borrowing. That determination likely needs to be made at the time that an issuer is about to enter the market as the difference between taxable and tax exempt rates changes over time.

For example, if a city can issue tax exempt bonds with a 20-year maturity and a single coupon of 5.00% or instead issue taxable bonds with the same 20-year maturity but at a taxable rate of 6.50%, the city is better off issuing the taxable bonds and receiving the 35% of the interest from the Federal Government:

Principal	Interest	
	5%	6.50%
\$10,000,000.00	\$10,000,000.00	\$13,000,000.00
Total P & I	\$20,000,000.00	\$23,000,000.00
Federal Contribution	\$_____	\$(4,550,000.00)
Economic Cost	\$20,000,000.00	\$18,450,000.00

No regulations have yet been issued. Several questions remain, such as whether the Federal contribution is subject to annual appropriation and whether Build America Bonds can be safely issued prior to the issuance of the regulations.

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