



## **The Opportunity in Build America Bonds**

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July 20, 2010

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Some recent headlines about Build America Bonds (BABs) have generated concerns among investors and advisors. Those headlines focus on the subsidy payment to issuers by the Internal Revenue Service (IRS) and legal requirements regarding the price at which bonds are issued as written in the American Recovery and Reinvestment Act of 2009.

While these unique aspects of BABs and recent Treasury Department actions are meaningful, the risks to investors and issuers have been over-emphasized. BABs remain an attractive vehicle for investors and issuers, and the market for them is likely to grow.

While the details of how the various mechanisms that the IRS employs can risk becoming rather arcane, an overview of how these rules are structured will help clarify the current news. At the same time, a general overview of how municipal bonds are regulated and the role of the IRS in the municipal bond market will provide context for understanding the situation.

### **Build America Bonds and the IRS**

The BAB market was created by passage of the American Recovery and Reinvestment Act of 2009. The Act contained a number of provisions related to the municipal bond market, and it is important to understand why.

As the financial crisis and the recession unfolded, state and local governments were negatively affected in dramatic fashion. Access to the capital markets was restricted by two specific developments:

- The failure of the auction rate securities (ARS) market; and
- The downfall of bond insurers such as MBIA, FGIC and AMBAC caused by their ill-fated expansion into insuring asset-backed securities and derivatives.

From an economic standpoint, the recession negatively curtailed municipal revenues because of:

- Lower personal income taxes due to higher unemployment;
- Lower property tax revenues; and
- Lower corporate income taxes.



Against this backdrop, Congress took explicit steps to aid municipalities through measures included in the Act that are designed to accomplish twin goals: job creation and easing of access to the credit markets. Once the Act became law, it fell to the IRS to translate the provisions related to municipal issuance into working guidelines for municipalities and the dealers who issue bonds on their behalf.

## **Why the IRS?**

Unlike corporations that issue securities, municipal issuers are not directly regulated by the SEC, thanks to a 1975 amendment to the Securities Exchange Act (commonly referred to as The Tower Amendment) that prohibited the SEC from directly requiring municipal issuers to submit registration documents. The SEC does, however, regulate the financial services companies that bring municipal bonds to market and serve investors. It does so through a self-regulatory organization, the Municipal Securities Rulemaking Board (MSRB). In summary, the SEC has the power to regulate dealers of municipal bonds, but not the municipalities themselves.

Upon issuing bonds, municipal issuers must meet ongoing IRS requirements, because those bonds are subject to specific parts of the tax code, whether they are traditional tax-exempt bonds or the bond types created in the Act. In fact, the new types of bonds result in increased involvement between issuers and the IRS than do traditional tax-exempt issues.

Upon passage of the Act, the IRS developed guidelines for the issuance of BABs that were first communicated to the market in early April 2009. The first BAB issue, by the University of Virginia, came to market shortly thereafter, on April 15, 2009. The new financing option certainly met the goals for which it was designed – issuing debt designated as “BAB” was popular in the ensuing months.

## **BAB specifics**

Why have BABs proven to be so popular with issuers and investors alike?

From the issuer’s perspective, they make financial sense. The way that BABs work for an issuer, as defined by the IRS guidelines, is pretty straightforward. A BAB is sold, with federally taxable interest payments, to the bondholder. The issuer fills out and submits a form to the IRS detailing the interest costs, payment date and other information. The IRS then makes a payment to the issuer for 35% of the interest payment (45% for Recovery Zone issues, designed to benefit areas with high poverty or unemployment). The net interest cost to the issuer after the subsidy has proven to be financially compelling, leading to well over \$100 billion of BAB issuance through May of 2010.



For investors, BABs represent a new taxable fixed income option to complement corporate, asset-backed, Federal agency and Treasury bonds. By some measures BABs have offered higher interest rates to investors than comparable traditional types of taxable bonds.

### **The current situation**

As the BABs market has evolved, the IRS has continued to refine and develop its position regarding oversight. Specifically, two issues have become important and received scrutiny in the press as of late:

- Withholding of interest payment subsidies; and
- Adherence to rules regarding *de minimis* pricing of new issues

Examining these in more detail will allow us to objectively analyze the current news stories.

### **IRS withholding**

As the rules from the IRS have evolved, the payment of the interest subsidy to the issuer has been tied to an issuer's "account" with the Federal government. Simply put, the IRS will withhold payment if there is an outstanding "debt" owed by the municipality to the Federal Government. As for an individual who is expecting a refund on his or her income taxes, any outstanding taxes owed by the municipality must be settled before the net refund will be paid. A BAB issuer needs to settle any outstanding unpaid liabilities.

This rule is a very logical position for the IRS to take, but many news stories have seemed to portray this rule as an ominous threat to municipal issuers. We simply do not see the prerequisite of paying outstanding debts to receive the interest subsidy as a significant factor in the overall fiscal health of municipal issuers.

### ***De minimis* pricing**

In this instance, the term *de minimis* means that the bonds have to be priced without too much of a discount or premium from par. "Too much" is defined as meeting existing rules that were originally developed for market discount calculations.

As the IRS has promulgated the guidelines related to this provision, questions have arisen about whether issuers have adhered to the *de minimis* rule. Beginning in January of 2010, the IRS began mailing a questionnaire to BABs issuers related to new issue pricing. Some news stories quoted an IRS official as stating that up to 50% of issuers may be audited for compliance with the provision.

This problem is potentially troubling. The IRS has recently made a number of comments related to the prices at which BABs bonds have been issued. The reason this is an issue at all is because the Act specifically states that, in order to qualify as a BAB, bonds must



meet a *de minimis* pricing test. The risk embodied in not meeting this test is that the IRS will disallow the maturity of any issue that fails to qualify as a BAB – thereby disqualifying it for the interest subsidy payment. The pitfalls here should be obvious — any time that financial market participants have to interpret Latin is not an optimal situation.

Understandably, this rule has created uncertainty about what the potential impact might be for issuers and for investors. In response, the IRS recently took the unusual step of issuing public statements to clarify these uncertainties. The situation is fluid and additional guidelines are probable.

The consequences of the IRS disqualifying a maturity or an entire BAB issue would be more severe than withholding an interest subsidy payment in isolation. That said, it is likely that most issuers would then exercise any extraordinary call provisions that would become available related to the removal of the subsidy. Most BAB issues to date have this type of provision. In such a scenario, the impact for investors would be an early return of principal.

## **Conclusions**

As a new segment of the municipal bond market, BABs are fundamentally different from traditional tax-exempt bond issues. The requirements specific to BABs mean that issuers have to follow more stringent guidelines and that the role of the IRS in this market is greater than in others. The IRS guidelines and requirements for issuers have evolved as the BAB market has developed, and this evolution will continue. No doubt there will be additional confusion surrounding other, as yet unknown, guidelines.

That said, we do not see any of this as cause for significant concern as to the fundamental credit quality of BABs or of the validity of BABs as a financing option for issuers. On the contrary, the overwhelming amount of issuance since these bonds' inception points directly at the success of this program in achieving the goals intended by its creation: promoting economic and employment growth while improving municipal issuers' access to the credit markets. Rather than curtailing BAB issuance, the Federal government will likely expand the program. And as long as it makes financial sense, municipal issuers should continue to avail themselves of this financing option.

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