



BABs and QSCBs

*Two New Municipal
Funding Options*

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Build America Bonds

Established by the American Recovery and Reinvestment Act (“stimulus bill”) signed into law in February 2009, Build America Bonds (BABs) are a new way of financing public debt that runs through 2010. They differ from traditional municipal bonds in a few key ways:

Tax Treatment: Interest received on BABs is taxable to the bond holder, however the bonds can offer two types of tax credits:

1. The first option (the tax credit option) provides a credit for 35% of the income received on the bond holder’s federal income tax liability. Any unused credit can be carried forward into subsequent tax years.
2. The second option (the direct pay option) provides no tax credit to the bond holder, however the bond issuer receives a credit from the Treasury of 35% of the interest paid on the bonds. Most, if not all, of the BABs issued up to this point, have been direct pay.

BABs can be issued by any state or local issuer of tax exempt bonds, without volume limits, for the same types of financing needs that traditional municipal bonds are used for, such as capital purchases or governmental purposes. BABs do not differ in the requirements set forth for tax exempt bonds such as arbitrage, authorized funding use and rebate requirements. Direct pay BABs must be for new money issues – they cannot be used to refund prior bond issues.

BABs call provisions can include the 10 year par call protection that many municipal issues offer, or a “make whole” call which means that the issuer makes a lump sum payment to the bond holder if and when they make a call. This lump sum payment is calculated based on the principal called and the net present value of future coupon payments that will not be paid due to the early redemption.

The Coastal municipal trading desk reports that the majority of BABs issues seen so far are partial issues, meaning that a portion of the

offerings in one bond issue are tax exempt with the remainder being BABs. There are no restrictions on the allocation of BABs per bond issue.

One of the main benefits to BABs is that non-taxable entities can invest in the credits of municipal issuers – traditionally much safer than corporate bonds. This helps investors diversify away from riskier credits and opens up a wider class of investors for municipal issuers.

QSCB (“Q-Scabs”)

The QSCB program was also established by the 2009 stimulus bill. Under the QSCB program, school districts can borrow funds interest free (assuming no supplemental coupon) in order to fund construction of public school facilities.

The QSCB program has been funded with \$22 billion that is to be allocated by the Federal Government to the states through 2010. School districts apply for the QSCB funding with the state in which they are located. Once the application is approved (based not on a first come first served basis, but rather a relative quality to other applicants basis), the school district then issues QSCB bonds, generally for a 15 year term, and then repays investors only the principal of the bonds (again, assuming no supplemental coupon). The investor receives quarterly tax credits from the Federal Government in lieu of interest on the loan. If that rate is less than what the investors demand, the district can issue a supplemental coupon bond in order to make up the difference. This coupon is taxable.

QSCB issues generally cannot be used for refunding purposes. QSCBs are also subject to arbitrage rules: the entity issuing the bonds must enter into a contract to spend at least 10% of the proceeds within six months of issuance, and must spend 100% of proceeds within 3 years or redeem the bonds at par.

For more information and for current BABs or QSCB offerings, contact your Coastal Securities representative.

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