ADVISORY

A GFOA ***advisory*** identifies specific policies and procedures necessary to minimize a government's exposure to potential loss in connection with its financial management activities. It is *not* to be interpreted as GFOA sanctioning the underlying activity that gives rise to the exposure.

Issuing Build America and other Direct Subsidy Bonds (2010)

Background. Congress authorized or expanded several tax-advantaged alternatives for financing governmental infrastructure under the *American Recovery and Reinvestment Act of 2009*. The subject of this advisory is the new Build America Bond program (direct pay to issuers), which expires on December 31, 2010. Build America Bonds ("BABs") can be used as an alternative to traditional tax-exempt bonds for new money financings of governmental capital outlay projects. Under current law, BABs can only be issued for capital projects, not for working capital or refinancings. BABs are issued as taxable bonds but entitle the issuer to receive a payment from the federal government equal to thirty-five percent (35%) of the interest paid on the bonds (the "subsidy payment") for the lifetime of the bond. In many cases, BABs provide the issuer with a lower net interest cost on the financing (65% of the taxable rate on the bonds) compared with conventional tax-exempt interest rates. Therefore, issuers should evaluate using BABs as an alternative to traditional tax-exempt bonds to achieve the lowest possible borrowing cost on its bonds.

Advisory. The Government Finance Officers Association (GFOA) advises governments that are considering issuing Build America Bonds to exercise caution and have a full understanding of the differences between tax-exempt bonds and these taxable bond instruments, where the federal subsidy goes to the issuer rather than to the investor. If you determine that issuing this type of bond is appropriate, the following items should be taking into consideration.

Risks

Governments should take into account the following risks associated with issuing Build America and other direct subsidy bonds:

1. Consider the risk that the federal government (through an act of Congress) could reduce or eliminate the subsidy payments at any time during the years that the BABs are outstanding and evaluate strategies or techniques to mitigate this risk (i.e., ten year (10) par call option or extraordinary call option).

2. Consider the risk that the subsidy payments could be "offset" or reduced by any amounts the issuer may owe the federal government. The reduction in subsidy payments or "offset" can occur for tax liabilities or any other amount that may be owed the federal government, e.g., non-compliance with terms or grants or any federally funded program. The federal law authorizing "offsets" is the "Debt Collection Improvement Act of 1996" and the Treasury Offset Program ("TOP") describes the procedures for reducing subsidy payments which is currently keyed to the issuer's employer identification (EI) number.

3. The IRS has stated that they will send all BABs issuers a tax compliance questionnaire. If an issuer fails to complete the questionnaire, they are more susceptible to being audited. Governments are encouraged to discuss this questionnaire with their bond counsel, and respond accordingly. It should be noted that there are no IRS regulations that require an issuer to have written policies and procedures regarding tax compliance

(although governments are encouraged to develop such policies for their internal use), nor are there regulations requiring issuers to monitor and report market trading on their bonds as suggested by the questionnaire.

4. The number of IRS audits on Build America Bonds is likely to be greater than those for tax-exempt bonds.

Planning Considerations

1. Consult with an independent financial advisor and analyze whether tax-exempt interest rates or taxable interest rates (net of the subsidy payment) results in a lower borrowing cost.
2. Consider dual-track analysis of BABs and tax-exempt bonds. Consider dual-track analysis of BABs and tax-exempt bonds. When employing a competitive sales process, consider allowing bidders to select BAB or traditional tax exempt bids on different maturities.
3. Evaluate permitted use of subsidy payments under the bond documents and determine what to do with those payments:

    a. deposit into sinking fund and use to pay debt service - effectively reduces borrowing cost to net interest rate;
    b. pledge subsidy payment as security for bonds – normally requires amendment of bond resolution or indenture; consult bond counsel;
    c. use subsidy payment for some other purpose - however, diverting subsidy payment is effectively borrowing for the other purpose
        i. Create a process for filing IRS Form 8038-CP to request the subsidy payment and for verifying that the subsidy payments are received.
        ii. Evaluate/quantify potential reductions in bonding capacity from issuing debt at higher interest rate (i.e., taxable rates).
        iii. Evaluate the impact that the BABs' gross debt service may have on funding requirements of reserves.
        iv. Analyze/amend bond indentures/resolutions to incorporate BABs subsidy payments.
        v. Quantify the total subsidy payments to be received over the term of the bonds to measure the monetary amount at risk of potential changes in the subsidy rate if retroactive changes are enacted.
        vi. If subsidy payment is to be used to pay debt service, consider modifying debt structure to achieve desired level debt payments after applying subsidy payment.

Transaction Execution

1. Taxable market conventions are different than municipal market conventions in several respects including the terms of the bonds and the sale process.
2. For BABs sales done on a negotiated basis, issuers should give attention to the coordination of the taxable and tax-exempt underwriting desks of the book-running senior manager.
3. Issuers should familiarize themselves with terminology used in the taxable market (e.g., price indications, launch print and set the coupon), and the process for marketing taxable bonds in order to effectively manage a negotiated bond sale.
4. Most BABs were initially sold through negotiated sale but competitive sales are currently a viable option for selling BABs. Likewise, BABs structured with the standard municipal 10-year par calls have also become more viable as the BABs program has matured.
5. Call provisions for taxable bonds can be very different than call provisions for tax-exempt bonds. Make-whole calls, typical of taxable bonds, can effectively make bonds non-callable because the redemption premium can be punitive. Issuers should seriously consider the propriety of selling non-callable bonds or using a make-whole call.
6. General obligation and bonds for essential services or with high-grade ratings (AA or better) are well received by the taxable market; lower rated credits or unconventional structures are more challenging in the taxable market and may require extra education of analysts/investors.

7. Taxable investors are less familiar with municipal market credits and, therefore, special consideration should be given to educating analysts/investors on the structure or credit (e.g., using Web site to educate investors about your entity, investor 'road show').
8. Issuers will typically use a combination of tax-exempt bonds and BABs to achieve the lowest possible borrowing cost. Tax-exempt bonds may be more cost effective for some maturities, (e.g., shorter maturities), and BABs may be more cost effective for other maturities (e.g., ten (10) years and longer).
9. BABs are saleable as both serial bonds and term bonds and issuers should evaluate the cost effectiveness of using serial versus term bonds.
10. Analysis for determining the most cost effective alternative, tax-exempt versus BABs, should be updated immediately prior to sale to enable a modification, if market conditions warrant.
11. The underwriting spread on BABs should not be materially higher than the underwriting spread on tax-exempt bonds absent extenuating circumstances.
12. In the taxable market, underwriting compensation for negotiated sales is typically determined on a 'group net' basis in which compensation is set and determined ahead of the bond sale and is unrelated to actual underwriting/sales performance. As the BABs program has matured, more issuers are providing underwriting compensation on a 'net designated' basis for negotiated sales.
13. Modifications to the preliminary official statement and official statement will need to be made to accurately describe BABs, the gross debt service schedule, and the tax treatment of interest.
14. Fees for professionals (e.g., bond counsel, financial advisors and disclosure counsel) should not be materially higher than for tax-exempt bonds absent unusual circumstances.

Post-Sale Considerations

1. Issuers should prepare a post-sale analysis to evaluate the estimated savings from using the BABs alternative and compare results to pre-sale estimates for future reference in evaluating the potential use of BABs for other financings.

2. Issuers should obtain written assurance from bond counsel that the issuer/bonds meet the tax requirements for BABs which entitles the issuer to qualify for the 35% interest subsidy payments.

3. Governments should ensure that they have ongoing systems in place for filing IRS Form 8038-CP, and confirming receipt of the payments from the federal government.

This advisory is intended to highlight considerations that issuers will confront in evaluating and implementing BABs and other types of direct subsidy to the issuer bonds. It is not exhaustive or all-inclusive of the issues that may be encountered.

Approved by the GFOA's Executive Board, October 15, 2010.