SALISBURY TRUST
WEALTH ADVISORY SERVICES

Build America Bonds

May 2009 – There are new players on the municipal bond stage, Build America Bonds (BABs). The new instruments, introduced by the American Recovery and Reinvestment Act (also known as the "stimulus bill"), are a new type of taxable municipal bond.

BABs will have one of two types of subsidies from the federal government. Either the federal government will pay the issuer 35% of the interest costs of the bond, or the issuer may pass along a 35% tax credit to the bond buyers. BABs can be issued only in 2009 (after February 17, 2009) and throughout 2010, under current law. They generally are intended to finance new capital projects of state and local governments.

BABs could be free of state income tax in the state of issuance, depending upon how the state wants to handle it.

Why is a new kind of municipal bond helpful to the economic recovery? Because it has the potential to pull many more buyers into the market. Pension funds, endowments and other tax-free investment funds will give consideration to BABs, although they would not ordinarily consider tax-free municipal bonds. Foreign investors not subject to U.S. tax laws also may find BABs attractive. The bonds are expected to have risk and yield characteristics that fall between U.S. Treasury issues and corporate bonds.

The market for tax-free municipals has been hard hit by the current economic turmoil, making it difficult for state and local governments to raise new money. The availability of this alternative instrument may help the tax-free muni market to stabilize.

Early market reaction has been positive. BABs were first offered in April. California, for example, with the worst credit rating of any state, successfully sold $6.9 billion in bonds, of which $1.62 billion was in traditional tax-free format. The balance was subsidized by the federal government picking up 35% of the interest cost.

Market observers expect that $150 billion worth of BABs may be issued, though there is no cap on issuance in the law.

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