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Bruce Glassman, JD,
CPA/PFS

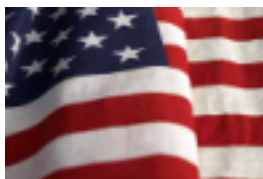
Attorney at Law
Jacksonville, FL
(904) 254-0504

webresponse@anywherelegal.com
<http://www.anywherelegal.com>

Investing in America: Build America Bonds

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What is a Build America Bond?

Investors have a new mechanism for investing in municipal bonds, courtesy of the American Recovery and Reinvestment Act of 2009. As part of the Obama administration's economic stimulus program, the bill authorized a subsidy for local and state governments that issue what are known as Build America Bonds (BABs) to finance capital expenditures.

Unlike most municipal bonds issued by a state or local government, the interest payments on a Build America Bond are taxable on your federal income tax return. However, the federal government subsidizes 35% of the interest payments on a BAB, which typically have relatively long maturities and must be issued before January 1, 2011. Those subsidies enable state and local governments to offer a higher interest rate to attract investors while at the same time reducing the cost of borrowing money to fund construction and infrastructure projects. Because of the subsidies, many muni bonds issued over the next two years are expected to be BABs.

There are several types of BABs; the governmental body that issues one determines which it will be. A Tax Credit BAB offers the bondholder a 35% federal income tax credit on the net coupon interest. A Direct Payment BAB pays the 35% subsidy directly to the issuer. Still a third type, known as a Recovery Zone Economic Development Bond, is a Direct Payment BAB that provides a 45% refundable tax credit to the governmental issuer.

Why buy a Build America Bond?

A BAB may offer some advantages that ordinary taxable municipal bonds don't. The most obvious benefit comes from a Tax Credit BAB. Even though a BAB is a taxable bond, the 35% tax credit means that your after-tax return will be higher than the bond's stated coupon rate. Also, the 35% tax credit may be especially valuable to investors whose marginal tax bracket is less than 35%, for whom the tax benefits of muni bonds may not previously have been as valuable. In some cases, a BAB's net return may be as good or better than an equivalent corporate bond or an ordinary tax-free municipal bond. Your tax bracket will determine the extent to which you benefit from a Tax Credit BAB.

Even a BAB whose federal subsidy is paid to the issuer may provide benefits. The federal subsidy may enable an issuer to offer a higher coupon rate than it might otherwise have been able to afford. And though default is not impossible, munis have traditionally had a lower default rate than corporate bonds; the federal subsidies should enhance governments' ability to meet their financial obligations.

Factors to consider

Before investing, make sure you understand whether a given BAB offers you the 35% tax credit and what that will mean given your tax bracket. Remember that the balance of those interest payments will be included as part of your taxable income, unlike most muni bonds. You may want to get assistance in determining whether a BAB makes sense for you.

New-issue BABs may be challenging for individuals to invest in. Some BAB auctions have focused on large institutional investors to the exclusion of individuals; it may be easier to find BABs being resold on the secondary market. As with any bond, BABs are affected by changes in interest rates. If interest rates rise, the value of an existing BAB with a lower coupon rate is likely to drop.

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