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Two new munis and swaps recap

Build America Bonds offer investors taxable alternatives; watch out for swaps withholding

By Robert N. Gordon

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Through the passage of the American Recovery and Reinvestment Act, the government has created Build America Bonds. These are vehicles through which the federal government subsidizes municipal issues so that issuers can offer investors higher interest rates without raising the municipality's cost of borrowing.

The bonds come in two taxable varieties and may offer opportunities for some individual investors.

The more popular variety of the two is attracting buying interest from pension plans, foreign investors and tax-exempt entities that normally would be interested in corporate and federal government debt only.

In this variant of Build America Bonds, the Department of the Treasury pays a cash subsidy to the muni issuer equal to 35% of the interest payments made on a conventional taxable muni bond.

A 30-year California Build America Bond issue, rated A, recently was marketed at a coupon of 7.4%. By comparison, a corporate issue by A-rated Verizon Communications Inc. of New York was done around the same time at 7.35%.

After the federal rebate, the cost to California on this issue is only 4.8%, as compared with a recent California tax-free issue that carried a 5.65% yield.

In the second variety of Build America Bonds — which has attracted no issuers to date — the issuing jurisdiction receives no subsidy from the government. Instead, the individual who buys the bond receives a tax credit from the federal government to defray the tax cost.

Under the recovery act that created the bonds, municipalities are eligible to issue either type of Build America Bond this year or in 2010 for any public purpose other than refinancing another bond issue. Money raised in this manner cannot be used for private-activity purposes.

Build America Bond issues have totaled $7.4 billion as of this writing. There is no dollar limit on the program, and Wall Street estimates that issuance could exceed $40 billion this year.

There is no question that Build America Bonds are doing their job: saving municipalities billions of dollars while offering investors another asset class within taxable bonds.

Separately, let me return to an issue I first covered in a column last fall. At that time, I noted that the government had some concern with transactions executed in a "circular" manner that had the effect of reducing withholding tax on U.S. dividends held by offshore funds.

Recently, in its new Green Book, the Treasury Department proposed characteristics for a swap that would make a transaction eligible for an exemption from withholding.

Since some of the requirements seem severe, they may be softened before the recommendations become law. But no matter what final rules are adopted, offshore investors and their brokers will welcome any certainty in this area.

According to the Treasury Department's proposal, to be exempt from tax withholding, a swap would have to possess the following six characteristics:

• The foreign person does not sell the stock to the counterparty at the inception of the contract or buy the stock from the counterparty at the termination of the contract.

• The swap cannot require the foreign person to post more than 20% of the value of the underlying stock as collateral.

• The swap cannot include any provision addressing the hedge position of the counterparty to the transaction.

• The underlying stock is publicly traded, and the notional amount of the swap represents less than 5% of the total public float of that class of stock and less than 20% of the 30-day average daily trading volume.

• The prices of the equity used to measure the parties' entitlements or obligations are based on an objectively observable price.

• The swap must have a term of at least 90 days.

The proposal would be effective for payments made after Dec. 31, 2010, and thereby would cover all dividends paid after that date, no matter when the swap were entered into.

From the Treasury Department proposal, it is interesting to infer the government's thinking on transactions it deems executed "in a circular manner."

Lessons learned here may be used when approaching any over-the-counter trade where contract terms and execution techniques may raise government eyebrows.

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