

New Ways for School Districts to Issue Bonds under the Recovery Act

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Such lower interest is great for the school district because it saves the district the 1.5% difference in interest expense. On the other hand, it costs the federal government the tax revenue it would have received on 6% taxable income.

There are other ways to structure a federal debt subsidy. The American Recovery and Reinvestment Act of 2009 provides two other methods: (1) a direct federal subsidy to school districts through Build America Bonds and (2) another indirect subsidy using tax credits through Qualified School Construction Bonds.

Build America Bonds

With Build America Bonds (BABs), the school district issues taxable-interest bonds. Staying with the sample percentages used above, the district issues bonds at 6%. The bondholders pay tax on their 6% interest income.

The kicker is the federal government pays the district a direct subsidy payment equal to 35% of each interest payment. This subsidy payment generates a net interest cost to the district of 65% of 6%, or 3.9%. This product is called a Direct Payment BAB. (There is also a Tax Credit BAB product in which the bondholder receives taxable income and a tax credit, but that option has not proved popular and is not described in this article.)

Some economists believe that the BAB approach is a more efficient subsidy because school districts can sell BABs in the much larger international taxable debt market. These



The federal government has traditionally given local school districts an indirect subsidy by allowing them to issue tax-exempt bonds. Because the bondholders pay no tax on the interest income, they are willing to take a bond bearing interest at, say, 4.5% rather than 6%.



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economists view the domestic tax-exempt market as being too small and inefficient.

Under the Recovery Act, BABs must be government bonds issued to finance capital expenditures. There is no volume cap on BABs, but there is a sunset on the issuance of BABs at the end of 2010. The costs of issuance may not exceed 2% of the sale proceeds, and BABs may be sold with only a small amount of original issue premium.

Qualified School Construction Bonds

With Qualified School Construction Bonds (QSCBs), the school district issues bonds and the bondholders receive a “tax credit” that they can use to offset their tax liability. The amount of the tax credit and the maximum maturity of QSCBs are set by the Bureau of Public Debt. With some QSCBs, the district pays no interest; however, in other cases, the district may need to include some taxable interest on top of the tax credit in order to sell the QSCBs.

Proceeds from QSCBs must be used to finance the construction, rehabilitation, or repair of a public

school facility or the acquisition of land on which such a facility will be constructed.

The national limitation for QSCBs is \$11 billion per year in 2009 and 2010. Forty percent of this limit has been allocated directly to large school districts with a high proportion of students living below the poverty level. The remaining 60% has been allocated directly among the states, and within each state, the state will make allocations for specific issuers.

Overall Perspective

How has the market accepted these BABs and QSCBs? Through mid-November 2009, approximately 620 BAB issues totaling \$52 billion and 93 QSCB issues totaling \$1.2 billion had come to market.

BAB issues are generally longer in maturity, and often a financing will use tax-exempt rates in the earlier maturities (1 to 15 years) and BABs in the later maturities. The decision of how to structure the financing and the use of both tax-exempt debt and BAB taxable debt will depend on the shape of the yield curve at the time of the financing. BABs have largely been

issued with 10-year par calls, and there appears to be a significant pricing difference between a 10-year callable BAB and a noncallable BAB or “make whole” callable BAB.

BABs have been well received by the investor community, and an unanticipated by-product of the BAB market has been lower interest rates on longer-term tax-exempt bonds. The issuance of BABs reduces the supply of longer-term tax-exempt bonds, and thus the traditional tax-exempt market has benefited.

QSCB issuance is still relatively in its infancy but is gaining momentum. Several states have yet to issue guidelines for their school districts and entities on borrowing restrictions and qualifications. Once all states address their allocation of QSCBs, issuance could increase. Most recent issues of QSCBs have included “supplemental coupons” or increased interest payments to the purchasers. The demand for federal tax credits will ultimately determine the demand for the QSCB product.

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