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Quick Takes

June 2009

Quick Takes: Stimulus Bonds- All About Recovery Bonds, Cash Refunds, Tax Credits, and More

This issue of *Quick Takes* will shine a spotlight on some ways that the new federal stimulus programs can make private or public projects work by making their financing and funding cheaper and more available.

For discussion purposes, I am grouping both the new types of bonds, and the new features for existing bond types, created by the American Recovery and Reinvestment Act (the "**Recovery Act**"), together under the label of "**Stimulus Bonds**." In the discussion below, I will flag some of the more interesting features of these bonds. There are some restrictions and qualifications, of course. Some of these benefits are only available after the effective date of the Recovery Act (February 17, 2009) through the end of 2010 (the "**Recovery Period**").

Now, take a look at the captions below. If you recognize yourself or your project, you may be able to get more financing and funding using Stimulus Bonds.

High Tech Companies. Used to be, if you weren't actually manufacturing a tangible "widget" of some kind, your high tech project was ineligible for tax-exempt financing using "small issue" industrial development revenue bonds ("**IDB**s"). Now, during the Recovery Period, a "manufacturing" facility includes a facility used in the manufacturing, creation or production of intangible property. "Intangible property" means any patent, copyright, formula, process, design, pattern, know-how, format, or other similar item. The definition of intangible property is intended to include, among other items, the creation of computer software, and intellectual property associated with bio-tech and pharmaceuticals. If your business needs new equipment or other facilities to produce that type of property, then you should consider "small issue" Stimulus Bonds for tax-exempt financing.

Nonprofits and For-Profits. If you are a "nonprofit" recognized by the IRS as a tax-exempt 501(c)(3) organization and have a number of projects, or a larger project, the Recovery Act makes your tax-exempt "qualified 501(c)(3) bonds" more attractive for purchase by a bank (or other financial institution). In addition to the benefit of not paying federal income tax on the interest it receives, the bank (or other financial institution) also gets an 80% interest expense deduction on deposits used for purchasing or carrying "bank qualified" ("**BQ**") bonds. If your bonds are BQ bonds, the bank (or other financial institution) should quote you a lower interest rate. The old BQ limit was $10 million, and applied not just to your bonds, but to all qualified 501(c)(3) bonds and governmental purpose bonds issued by a particular bond issuer during each year. The Recovery Act raises this limit to $30 million for bonds issued during the Recovery Period. Moreover, the 501(c)(3) organization that uses the proceeds of the bonds is treated as the "issuer" of those bonds, and the bonds issued for such 501(c)(3) organization do not count against the issuer's own $30 million BQ allowance. Thus, a bond issuer can, in each year, issue up to $30 million BQ governmental purpose bonds on its own behalf (if it is a governmental issuer), <u>and</u> issue up to $30 million of BQ bonds for <u>each</u> 501(c)(3) organization for which it issues such bonds.

The Recovery Act also creates a temporary 2% safe harbor permitting banks (and other financial institutions) to purchase most tax-exempt investments without the corresponding interest expense disallowance. Even if your bonds are not BQ bonds (for example, if you are a for-profit business), the Recovery Act probably makes them more attractive for purchase by a bank (or other financial institution). Up to a point, a bank (or other financial institution) is permitted the same 80% interest deduction for most tax-exempt bonds it purchases. This new rule under the Recovery Act applies to the extent the average adjusted basis of this type of bond purchaser's holdings of tax-exempt obligations is 2% or less of the average adjusted basis of its total assets. The 2% safe harbor applies only to bonds issued during the Recovery Period (and to bonds issued during the Recovery Period to refund such bonds).

<u>Manufacturers and Developers.</u> What do those types of borrowers have in common? The Recovery Act removes a penalty, the Alternative Minimum Tax ("**AMT**"), that had artificially increased the interest investors charge on their tax-exempt bonds. By doing so, it also deepens the pool of potential investors in these bonds. Recently, an airport refunded its AMT tax-exempt floating rate bonds with non-AMT tax-exempt floating rate bonds, and saved 50 basis points (a 1.5% rate dropped to 1%)! Spreads are even wider for longer term or fixed rate financings. For manufacturers, this benefits the "small issue" manufacturing IDBs mentioned above. For developers and owners, it benefits "exempt facility" bonds used to finance infrastructure or facilities for private projects, such as water furnishing facilities; sewage disposal components for a manufacturing project; solid waste disposal facilities; local electric and gas facilities; qualified hazardous waste facilities; and high-speed intercity rail facilities. This benefit actually applies to all "private activity" bonds, not just bonds for manufacturers and developers.

Non-Manufacturing Components of Manufacturing Projects. For tax-exempt bond purposes, even if a project manufactures tangible products, the project is usually not all "core manufacturing." For example, a storage component or a warehouse is something that the IRS calls "directly related and ancillary", and if it comprises too large a part of the project, it can't be financed tax-exempt. The Recovery Act liberalizes the rules applicable to this and other non-manufacturing components of manufacturing projects. During the Recovery Period more than 25% of bond proceeds may be used to provide functionally related and subordinate facilities, so long as 95% of the net proceeds are used for core manufacturing and functionally related and subordinate facilities. Other examples of components for a manufacturing project that might now be eligible for tax-exempt financing include parking areas, facilities for heating and cooling, trash disposal equipment, property for maintenance personnel, and office facilities. The "2% limit" on payment of costs of issuance out of tax-exempt bond proceeds still applies.

Hospitality Projects, Other Non-Manufacturers, and Large Manufacturing Projects. Recovery Zone Facility Bonds ("**Facility Bonds**") also open some new financing doors. Facility Bonds are private activity bonds (essentially, a new type of "exempt facility" bonds). A Facility Bond is any bond issued as part of an issue of bonds if: (1) 95% or more of the net proceeds of such issue are to be used for recovery zone property, (2) the bond is issued during the Recovery Period, and (3) the bond issuer designates such bond as a Facility Bond. There are no capital expenditure limits, and no requirement that Facility Bonds finance manufacturing facilities! In order to qualify as recovery zone property that can be financed with Facility Bonds, the property must meet these conditions: (i) consist of depreciable property (not land), that was constructed, reconstructed, renovated or acquired by purchase by a taxpayer/borrower after the date on which the designation of the Recovery Zone (defined below) took effect; (ii) its original use in the Recovery Zone (defined below) commences with the taxpayer/borrower; and (iii) substantially all of its use is in the active conduct of a qualified business by the taxpayer/borrower. A "qualified business" is any trade or business except for the rental of residential rental property (i.e., multifamily) or the operation of any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any alcohol "package store." Thus, Facility Bonds permit the tax-exempt financing of projects which historically would not qualify (*e.g.,* large manufacturing plants, distribution centers, hotels, research parks, etc.). Facility Bonds and ED Bonds (see below) can be issued only by counties and large cities (100,000 population or more). This is because the Recovery Act only allocates the related types of bond issuance "volume cap" to counties and large cities, and no way has been provided for them to transfer their respective volume cap limitations to small municipalities or to development authorities or other local authorities. We are awaiting new regulations that will address volume cap allocations and perhaps related issues, including permitted transfers.

Facility Bonds crack a new door for the financing of private economic development projects. They can be used to finance any project that a private party uses in a qualified trade or business, regardless of whether or not the project is privately-owned or publicly-owned. However, legal and financing "infrastructure" has to be developed in order to swing that door wide open. For example, clarification of the allocation system is needed. (I am a member of a group convened by the Georgia Department of Community Affairs to work on the allocation process. I will post more information about this as it becomes available on the "What's New" page of the danmcrae.info website).

Meanwhile, here is an immediate word of advice for Georgia's counties and large cities- Act now to get ready for Facility Bonds and ED Bonds! You will soon be getting an allocation of volume cap for them, and you need to be ready to deploy these new financing techniques for the good projects that are ready to go forward in your community, particularly competitive projects.

Another issue, which also applies both to Facility Bonds and to ED Bonds (see below), is the process for the county or city to designate an area as a "**Recovery Zone**" (only assets whose use is substantially within a Recovery Zone can be financed using these bonds). If the area is within a federal empowerment zone or renewal community, it automatically qualifies. If not, then the bond issuer must designate it as a Recovery Zone, based on findings related to poverty, unemployment, home foreclosures, or general (or BRAC-related) distress. IRS guidance on this issue is needed and is expected to be forthcoming, but is not available yet. Meanwhile, our empowerment zones and renewal communities should be planning on how best to use their "head start" with these new bonds.

Finally, <u>how</u> Facility Bonds are issued is itself an issue. They can be issued on a conduit basis (only the company responsible for repayment), or (state law permitting) on a non-conduit basis. But, because of the present allocation rules noted above, they cannot be issued by a development authority! Under Georgia law, a county or city can issue Facility Bonds to finance a private project, if it is the type of project that the county or city otherwise has the power to finance. However, proper structuring is essential, particularly when incentives are being provided for the project. Regardless of whether or not there are changes in the volume cap allocation system, with economic development projects, a proper structure is likely to provide a role for development authorities.

<u>Projects Eligible for Cash Refunds and/or Tax Credits; Public Projects.</u> In these economic times, the public sector is generally even more willing to assist with economic development projects that create or preserve jobs, and that generate investment. And, local governments have their own projects that need financing. But, local governments are strapped for cash, just like the private sector. So, where does the money come from? Well, how about the federal government? The Recovery Act created a couple of new types of bonds that I call "**refund bonds**" because they allow

the issuer to get cash payments from the federal government. "Build America Bonds" ("**BAB**s") are one type of these refund bonds. With BABs, if an issuer is issuing governmental purpose bonds which meet the requirements for tax-exempt financing, but the issuer instead elects, under the BABs rules, to issue the bonds on a taxable basis, then it can opt either (i) to pass through to the bond investor a federal income tax credit equal to 35% of the interest received, or (ii) to have the federal government make cash payments to the issuer equal to 35% of the interest it pays on such bonds (bonds with that option are sometimes called "**direct pay**" bonds). Recovery Zone Economic Development Bonds ("**ED Bonds**") are another type of these refund bonds. ED Bonds are a very similar to BABS. In fact, ED Bonds might be called "**Super-BABs**", because the cash payment to the issuer rises to 45% of the interest paid. Like the AMT change, the marketability and interest rate on BABs and ED Bonds benefit from an expanded universe of investors who typically don't buy tax-exempt bonds for their portfolio; *e.g.*, pension funds and foreign investors. BABs can be used for any governmental purpose, whereas ED Bonds can be used for capital expenditures within the Recovery Zone (including land and depreciable property), expenditures for public infrastructure and construction of public facilities, or expenditures for job training and educational programs, as well as costs of issuance and a debt service reserve. ED Bonds aren't private activity bonds, and they have to be issued for projects eligible for tax-exempt governmental purpose bonds. However, the public property being financed by either type of these refund bonds can serve a private project. Moreover, with both types of refund bonds, it's the cash flow to the issuer from the federal government that raises the intriguing possibility of "bootstrapping" the financing of projects with BABs or ED Bonds, using this federal cash for purposes of grant programs (in accordance with applicable law, naturally). These refund bonds can only be issued during the Recovery Period. ED Bonds require an allocation of the related bond volume cap, and are for recovery zone property as noted above. BABs don't require an allocation, and have no federal geographical restriction. In a recent private placement of direct-pay BABs to finance parking, parks and recreation, a city had to pay an all-in interest rate of only 3.78%, compared to a tax-exempt quote of 4.10% all-in.

<u>Renewable Energy and "Green" Projects.</u> The Recovery Act increased the amount of volume cap for "Qualified Energy Conservation Bonds" ("**Energy Conservation Bonds**"), which are a type of tax-credit bonds that can be issued for "qualified conservation purposes" including, among other things, financing research in such areas as nonfossil fuels (e.g., cellulosic ethanol); car batteries; carbon capture; etc. The Recovery Act also increased the amount of volume cap for New Clean Renewable Energy Bonds ("**New CREB**s"), which are a type of tax-credit bonds that can be issued to finance certain renewable energy facilities (generally, facilities that qualify for the federal production tax credit). New CREBs can be used by governments, public power providers, and nonprofit REA utilities.

So, that's a short course in how to get the most for your project out of the Recovery

Act. Next time in *Quick Takes*, we will continue the theme of how to get projects done in this economy. We will focus on financings in which the public sector actually provides funding or support in some way. The next issue is called: "P3 Bonds: Public Money for Private Projects."

If you have any questions or comments on Stimulus Bonds, please do not hesitate to let me know.

Meanwhile, for more information-

GO TO http://danmcrae.info/whitepapers.asp
For White Paper- June 2009 – "Stimulus Bonds"
For White Paper- June 2009 – "Bonds 101"
AND GO TO http://danmcrae.info/whatsnew.asp
for updates on an allocation system for Recovery Bonds.
The "Current Bond Rates" page at danmcrae.info is updated weekly. This week's version is what you see below.

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CURRENT BOND RATES
EFFECTIVE JUNE 4, 2009 **Interest Rates:** **tax-exempt-** **floating: 0.36%**

taxable-	**fixed:**	**3.29%** (eff. 05/29/09)
	floating:	**1.40% - 2.50%**
	fixed:	**3.71%**

General notes:
1. Rates are posted weekly. These rates are for the effective date indicated above, or as otherwise indicated. For intra-week rates, Contact Dan.
2. These are interest rates on revenue bonds that are variable rate demand bonds; i.e., floating. These can be synthetically fixed via interest rate swaps, as noted below.
3. Tax-exempt rates are for industrial development revenue bonds (IDB's") that are subject to the AMT and are 7 day general market quotes.
4. Taxable rates are for taxable IDB's or for taxable "corporate bonds".
5. Fixed rates are for 10 year terms via swaps.
6. All rates are market extracted and approximations, and are not guaranteed.
7. These rates do not reflect all-in costs; e.g., annual letter of credit fees are not included.