Recovery Zone Bonds and Build America Bonds

Michigan Association of County Treasurers
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Craig W. Hammond, Dickinson Wright PLLC
248.433.7256 • chammond@dickinsonwright.com

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American Recovery and Reinvestment Tax Act of 2009
An Overview

A. The Economic Stimulus legislation known as the American Recovery and Reinvestment Act of 2009 enacted in February contains a number of groundbreaking provisions that benefit states, counties and local governments by enhancing their ability to finance projects and providing other benefits. Most of the new bond initiatives only apply to bonds issued in 2009 and 2010.

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American Recovery and Reinvestment Tax Act of 2009
An Overview

B. New or Expanded Types of Bonds and Other Provisions of Interest to Counties.

1) Build America Bonds
2) Recovery Zone Economic Development Bonds
3) Recovery Zone Facility Bonds
4) New Clean Renewable Energy Bonds
5) Qualified Small Issue Private Activity Bonds for Manufacturing Facilities
6) Qualified Energy Conservation Bonds
7) Increase in Bank Qualified Limit to $30,000,000 per calendar year
8) Creation of 2% De Minimis Rule to enable banks in certain circumstances to realize "bank qualified" yields even for non-bank qualified obligations.

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Build America Bonds (BABs)

A. BABs are a new type of tax credit bond that is available to any state or local unit of government with authority to issue tax exempt bonds (including Counties).

B. Any program that is eligible for tax exempt bonding may instead be financed as a BAB, subject to a few exceptions below. The BABs would be issued pursuant to existing state law bonding authority.

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Build America Bonds (BABs)

C. A BAB is a taxable obligation that provides a federal subsidy through tax credits. The two principal types of BABs are referred to as Build America Bonds (Direct Payment) and Build America Bonds (Tax Credit). An issuer of BABs can elect to keep the tax credit and receive a payment from the federal government or give the tax credit to the lender (bondholder) and receive a lower interest rate on the bonds.

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Build America Bonds (BABs)

1. Direct Payment BABs. If the Issuer elects to keep the tax credit, the federal government will pay the Issuer 35% of the interest cost that the Issuer pays. Such payment is to be paid contemporaneously with the interest payment date of the bonds.

(a) For fixed rate bonds, the IRS is establishing procedures which would involve the issuer filing a new 8038-CP prior to the relevant interest payment date and such amount would be paid contemporaneous with the interest payment date.

(b) For variable rate bonds, the 8038-CP would be filed within 45 days after the interest payment date and paid on a reimbursement basis.

2. Tax Credit BABs. The Issuer can elect to give the tax credit to the lender (the bondholders) equal to 35% of the interest payable on the interest payment date. Such credits would accrue as of the date of the interest payment and may be used to offset federal tax liability of the bondholder.

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Build America Bonds (BABs)

D. Restrictions on Build America Bonds

1) For Direct Payment BABs, 100% of the bond proceeds must be used for capital expenditures (other than proceeds used to fund a reserve fund and to pay issuance costs subject to a 2% limit). Direct Payment BABs are not available for refundings or working capital borrowings
2) Tax Credit BABs can be used for refundings or working capital borrowings and there is no limitation on amount of issuance costs to be paid from bond proceeds.
3) BABs cannot be used for private activity bonds (meaning bond proceeds cannot be used by or loaned to private parties). Common examples of private activity bonds include private hospitals, private colleges, housing bonds and industrial development bonds.
4) May be issued only in 2009 and 2010.

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Build America Bonds (BABs)

E. Which choice is better?

1) Build America Bonds (Direct Payment) are resulting in lower net interest costs than traditional tax exempt bonds, at least for larger financings that can attract taxable investors.
2) So far no activity in Michigan for issuance of Tax Credit BABs (i.e. if Direct Payment BABs not available then Issuers are electing to issue traditional tax exempt obligations).
3) May have composite issues with traditional tax exempt bonds for early maturities and/or for refunding components and Direct Payment BABs for later maturities and/or new money components.
4) Consult with your financial advisor and bond counsel when structuring your county borrowing about your options. BAB market is evolving.

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Build America Bonds (BABs)

F. What are the risks to Issuer of a future change in tax law impairing Direct Payment Option to Issuer?

1) The ability to change the law in a manner that could adversely affect the tax benefit applies to traditional tax exempt bonds and BABs, but with traditional tax exempt bonds the risk is borne by the bondholders.
2) Refundable credits payable to an issuer of Direct Payment BABs are treated as an overpayment of tax. This is intended to make the payment obligation a "permanent appropriation" but also makes the payment subject to offset for certain liabilities the issuer may have to the federal government.
3) Political risk should be reduced as more state and local units of government issue BABs.

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Build America Bonds (BABs)

G. Other considerations

1) Securities laws applicable to traditional tax exempt bonds also apply to BABs.
2) Because Direct Payment BABs are taxable obligations, the municipal market will expand to include investors who previously did not purchase tax exempt municipal bonds, such as pension funds, insurance companies, foreign buyers and others.
3) BABs are not counted towards an issuer's bank qualified tax exempt bond limitations.

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Recovery Zone Economic Development Bonds (RZEDBs)

A. Recovery Zone Economic Development Bonds are a new category of tax credit bond which allows state or local units of government to finance qualified economic development projects for public infrastructure improvements and certain other governmental purposes located in designated Recovery Zones.

B. RZEDBs are subject to the same rules as Build America Bonds, with the same election available to the Issuer to either keep the tax credit or give it to the bondholders, except that the tax credit is 45% rather than 35%. So Congress has given a greater federal subsidy to encourage economic development in designated Recovery Zones.

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Recovery Zone Economic Development Bonds (RZEDBs)

C. RZEDBs can be issued to finance any "qualified economic development purpose," which consists of expenditures for the purposes of promoting development or other economic activity in a Recovery Zone, including:

1) capital expenditures paid or incurred with respect to property located in a recovery zone;
2) expenditures for public infrastructure and construction of public facilities; and
3) expenditures for job training and educational programs.

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Recovery Zone Economic Development Bonds (RZEDBs)

D. A Recovery Zone means any area:

1) designated by the issuer as having significant poverty, unemployment, rate of home foreclosures or general distress;
2) designated by the issuer as economically distressed by reason of the closure or realignment or a military installation pursuant to the Defense Base Closure and Realignment Act of 1990; or
3) designated as an empowerment zone or renewal community.

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Recovery Zone Economic Development Bonds (RZEDBs)

E. Unlike empowerment zones created in the 1990's which had limited and fixed districts, recovery zones are much more flexible by allowing the county to determine whether the project will be located in an area having "significant poverty, unemployment, rate of home foreclosures or general distress." There is no fixed criteria that must be demonstrated to meet this requirement and no limitation on the number of recovery zones that can be created (except as may be limited by the amount of volume cap allocation available to the County as described below).

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Recovery Zone Economic Development Bonds (RZEDBs)

F. Volume Cap Limitation of RZEDB's

1) The $10 billion nationwide volume limitation for RZEDBs was allocated amount among the States in the proportion that each such State's 2008 State employment decline bore to the aggregate of the 2008 State employment declines for all of the States, with certain minimum distributions. Same formula was then used to reallocate locally to Counties and Cities with populations in excess of 100,000 within each State.
2) RZEDB allocations have been made to Michigan Counties.

G. Federal Davis-Bacon Act prevailing wage rules apply to projects financed with RZEDBs.

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Recovery Zone Facility Bonds (RZFBs)

A. Recovery Zone Facility Bonds are a new tax-exempt private activity bond ("PAB"), which can be issued to finance certain capital projects for the benefit of private companies located or to be located in a designated Recovery Zone which meet the following requirements:

1) at least 95% of proceeds of such issue are to be used for recovery zone property;
2) the obligation is issued by a State or local government pursuant to a RZFB volume cap allocation; and
3) the issuer designates the obligation as a recovery zone facility bond.

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Recovery Zone Facility Bonds (RZFBs)

B. "Recovery zone property" is depreciable property that satisfies the following requirements:

1) the property was constructed, reconstructed, renovated, or acquired by purchase by the taxpayer after the date on which the designation of the recovery zone took effect. This is more restrictive than the customary 60 day look back from the date the issuer adopts its inducement resolution normally applicable to PABs.
2) the original use of which in the recovery zone commences with the taxpayer (subject to an exception for certain substantial renovations where taxpayer will increase its adjusted basis in property by 100% within two years of acquisition date); and
3) substantially all of the use of which is in the recovery zone and is in the active conduct of a qualified business by the taxpayer in such zone.

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Recovery Zone Facility Bonds (RZFBs)

C. A qualified business means any trade or business except (i) residential rental property and (ii) any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility primarily used for gambling, or any store the principal business of which is the sale of alcoholic beverages for off premises consumption.

D. The normal PAB requirements continue to apply: 120% weighted average maturity of bonds, public approval and hearing requirements, 2% costs of issuance limitation, etc.

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Recovery Zone Facility Bonds (RZFBs)

E. The primary differences between RZFBs and RZEDBs are:

1) RZFBs are tax exempt private activity bonds used to make loans to private companies, similar to industrial development bonds, but much broader category of eligible projects. Not a tax credit bond.
2) Same criteria for establishing Recovery Zones.

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Recovery Zone Facility Bonds (RZFBs)

F. The volume cap allocation for RZFBs is $15 billion nationally. Allocations have been made to Counties.

G. County Economic Development Corporations and the Michigan Strategic Fund are the primary issuers of private activity bonds in the state of Michigan. They have existing statutory authority to issue RZFBs for the purpose of making loans to conduit borrowers.

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Recovery Zone Facility Bonds (RZFBs)

H. The designation of a Recovery Zone for which encompasses the project location and allocation of volume cap by the County to the EDC or the borrower or any other issuer of the Bonds will need to be done through a board resolution of the County Board of Commissioners. The Recovery Zone may be an entire city, township, etc. No limitations on the size or number of recovery zones so long as County Board determines that criteria for Recovery Zone has been established.

I. This is not free money. Borrowers need to be creditworthy and projects must make economic sense. The bonds will provide a lower cost of financing, but generally the bond issues need to be at least $2.5 million to justify the issuance costs of the financing.

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Frequently Asked Questions

Can the County Board designate the entire County as a Recovery Zone?

A. Possibly. County Board of Commissioners must adopt a resolution designating a Recovery Zone for any project location in order for project costs to qualify. Costs incurred prior to the date of Recovery Zone designation will not qualify. The ARRA does not restrict the size or number of Recovery Zones, so if the County Board of Commissioners reasonably determined that all areas of the County satisfy the criteria for a Recovery Zone then it would be permissible. Many counties will likely act on a project by project basis and designate Recovery Zones by local municipality when there is a reason to act.

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Frequently Asked Questions

Does the County have to be issuer of Recovery Zone Bonds?

A. No. The County can allocate the volume cap allocation to any eligible issuer, conduit borrower or any other ultimate beneficiary. For governmental projects, this may include any governmental unit within the County. For private activity bonds, this would include EDC's or the state issuers.

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Frequently Asked Questions

Can RZEDB allocation be used for a bond issue that benefits a private user?

A. No. Only RZFB allocation can be used for private activity bonds.

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Frequently Asked Questions

Can RZ bonds be used to finance the acquisition of land?

A. No. Recovery Zone property must be depreciable property. Land costs are excluded.

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Frequently Asked Questions

When does the allocation expire?

A. December 31, 2010.

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About Craig W. Hammond

Craig Hammond is a member of Dickinson Wright PLLC, resident in the Bloomfield Hills, Michigan office. Mr. Hammond specializes in public finance, banking and economic development law, with more than twenty years of experience representing issuers, lenders, underwriters and borrowers in connection with tax exempt bond financings in the government and nonprofit corporation sectors. He received his J.D. (cum laude) from the University of Michigan Law School, 1988, and his B.A. (cum laude) from Williams College, 1985.

For additional information, contact Craig Hammond in Bloomfield Hills at **(248) 433-7256** or **chammond@dickinsonwright.com**.

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