PUBLIC FINANCE ALERT

THE STIMULUS ACT -- BUILD AMERICA BONDS AND RECOVERY ZONE BONDS

Build America Bonds

Section 1531 of the American Recovery and Reinvestment Act of 2009 (the "Stimulus Act") adds a new Section 54AA to the Internal Revenue Code of 1986, as amended (the "Code") to provide a taxable credit bond alternative to traditional tax-exempt governmental obligations for the period from February 17, 2009 through December 31, 2010. Unlike other taxable credit bonds, which have national volume caps on the credit amount, complex procedures for allocating the credit and substantive rules that are different from those applicable to traditional tax-exempt issues under Section 103 of the Code, these Build America Bonds are bonds that meet all the general rules of Section 103 for governmental bonds (and thus do not extend to private activity bonds, including 501(c)(3) bonds). The issuer makes an irrevocable election to treat the issue as a taxable bond that carries with it a tax credit for 35% of the interest paid during the tax year. Both the credit and the interest are includable in gross income, but the credit can be applied by the holder against regular and alternative minimum tax liability and carried forward to future tax years.

What makes Build America Bonds particularly interesting, however, is the option for certain governmental bonds, referred to as Qualified Bonds, to have the benefit of the credit run to the issuer instead of the bondholders, through a direct payment to the issuer by the Secretary of the Treasury in the amount of 35% of the interest payment. To be treated as Qualified Bonds, 100% of the "available project proceeds" (proceeds from the sale, less costs of issuance not in excess of 2%, plus earnings), less the amount deposited in a reasonably required reserve, must be used to finance capital expenditures. An issuer may wish to consider this alternative for new money financings if there is a lack of appetite in the market for the credits.

The Conference Report (the "Report") for the Stimulus Act provides examples of how Congress expects these bonds to price. According to the Report, because the credit is included in the bondholder’s income, it is anticipated that issuers will issue bonds paying interest at rates approximately equal to 74.1% of comparable taxable bonds, assuming a 35% marginal tax rate. If a comparable taxable bond would pay a coupon of $1,000 and sell at par, the credit bond should carry a coupon of $741 and sell at par. The taxpayer has income of $1,000 and a credit of $259 to be applied against a tax of $350.

The Report also provides an example of a Qualified Bond. Assuming the taxable bond carries a coupon of $1,000 to sell at par, the bondholder would include the $1,000 in income, and the issuer would receive from the U.S. Treasury a payment of $350, for a net interest cost to the issuer of $650.

Build America Bonds are not treated as federally guaranteed.

There are a few technical requirements relating to pricing. The bond cannot have more than a de minimis amount of premium at issuance, and original issue discount is not treated as a payment of interest in determining the credit. For purposes of the arbitrage rules, in the case of the credit bond, the credit is not taken into account in computing yield. In the case of a Qualified Bond, the payment received by the issuer reduces the yield on the bond.

At a time when the differential between tax-exempt rates and taxable rates is narrowing in the traditional marketplace, governmental bond issuers and their financial advisors should consider whether a Build America Bond, in the form of either a credit bond or a Qualified Bond, makes economic sense as an alternative to their traditional issuances.

Recovery Zone Bonds

Section 1401 of the Stimulus Act adds two new categories of bonds, called Recovery Zone Bonds, in the new Sections 1400U-2 and 1400U-3 of the Code. The first, Recovery Zone Economic Development Bonds ("RZEDBs"), are tax-exempt governmental bonds that are a subset of the Qualified Bonds, described above. The second, Recovery Zone Facility Bonds ("RZFBs"), are exempt facility bonds for the benefit of non-governmental persons. Both types must be designated by the issuer and issued before January 1, 2011.

Both types of Recovery Zone Bonds are subject to national volume limitations, $10 billion for RZEDBs and $15 billion for RZFBs. The volume limits will be allocated first by the Secretary of the Treasury to the states based on employment decline from December 2007 to December 2008, subject to a minimum allocation to each state. Each state, in turn, will allocate its volume limitation among counties and large municipalities (over 100,000 population), based on local employment declines. Finally, at the local level, issuers are to designate Recovery Zones, areas that have significant poverty, unemployment, home foreclosures or general distress or areas that are economically distressed because of the closure of a military base. In addition, any area for which a federal designation as an empowerment zone or renewal community is in effect is also a Recovery Zone.

RZEDBs are treated as Qualified Bonds for purposes of the refundable credit that can be paid to issuers, with an increase in the payment from 35% to 45% of the interest paid. In addition to meeting all the general requirements of Section 103 of the Code, 100% of the available project proceeds, less the amount deposited in a reasonably required...
reserve, must be used for one or more qualified economic development purposes, promoting development or other economic activity in a Recovery Zone, including capital expenditures with respect to property in such zone, expenditures for public infrastructure and construction of public facilities, and expenditures for job training and educational programs.

The requirements for RZFBs are similar to those for other exempt facility bonds, 95% of the net proceeds of the issue must be used for Recovery Zone property, i.e., any property subject to depreciation under Section 168 of the Code (or would be but for Section 179 of the Code), if (i) such property was constructed, reconstructed, renovated or acquired by purchase by the taxpayer after the date the designation of the zone took effect, (ii) the original use of such property in the zone commences with the taxpayer, and (iii) substantially all of the use of the property is in the zone and is in the active conduct of a qualified business in the zone. A qualified business includes any business other than residential rental and the operation of the regularly proscribed facilities (private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling or store the principal purpose of which is the sale of alcoholic beverages off premises). RZFBs are not subject to the private activity bond volume cap, and the restriction on acquisition of existing property does not apply.