Bond Financing and the ARRA

When Stimulus Funds Aren't Enough

By Katie Schwab and Ann Sherman

Chances are high that a good number of the state's 242 incorporated cities have already applied for stimulus revenues for one or more "shovel ready" or "federally approved ready" projects. Now it's a matter of waiting to find out whether projects have been approved. If word comes that projects have been approved for grant funding that will cover the full cost, that is great news indeed! If, on the other hand, a city finds out that the grant is not sufficient or the timing of the grant is delayed, that city may need either short or long-term gap financing. Similarly, additional funds may need to be borrowed if a city starts a project and determines that the stimulus revenues are insufficient to complete the project, or the project generates the need for an additional project, or if the city wants to leverage its grant revenues.

There are several programs that cities can tap into for borrowing funds. The state has programs, such as the Special Public Works Fund, Small Scale Energy Loan Program and the Safe Drinking Water Revolving Loan Fund, that may fit an individual city's needs. USDA Rural Development also has numerous grant and loan programs that have received increased allocations from the stimulus program. USDA programs often require interim gap financing prior to the USDA purchase of the long-term debt.

To assist cities in accessing the public markets at a reasonable cost for traditional projects and the increased gap financing, the League offers its LOCAP program. LOCAP is a pooled tax exempt financing program for capital projects that is available to League members. Pooling of smaller projects saves cities on costs of issuance and creates a large enough issue size to be able to sell to investors on the public market. Projects are secured by a full faith and credit pledge of each participating city, and no city is responsible for the payment obligations of any other participating city. The timing for the LOCAP program is approximately 45 to 60 days once all application materials are received.

Changes to Traditional Bond Financings

In addition to providing grant, loan and loan guarantees, the American Recovery and Reinvestment Act of 2009 (ARRA) made changes to traditional municipal bonds rules that are helpful to cities. These changes primarily impact tax-exempt bonds and tax credits.

In the municipal market, a bond underwriter's goal is to **create demand for bonds, thereby reducing the overall interest expense for the city**. ARRA helps create demand during calendar years 2009 and 2010 in five specific ways. The first three changes are geared toward enticing financial institutions to buy more municipal bonds, broadening the pool of investors. The fourth change expands the pool of investors for qualified 501(c)(3) borrowers, and the fifth change is an incentive for higher income individuals and corporations to buy municipal bonds. These changes are as follows:

1. Increasing the limit on the amount of "bank qualified" (BQ) bonds that can be designated by an issuer from $10 million per year to $30 million per year. Thus, an issuer will be treated as a "small issuer" for BQ purposes if it issues no more than $30 million in tax-exempt bonds (excluding most private activity bonds) during the year.
2. Allows financial institutions to exclude a portion of their investments in new money tax-exempt municipal bonds.
3. Allows a pooled financing such as the LOCAP program (in which proceeds are loaned to more than one city) to exceed a pooled size of $30 million and remain BQ if all the participating city's agreements qualify as BQ.
4. Allows the "small issuer exception" to be applied to qualified 501(c)(3) bonds if the 501(c)(3) borrower would qualify as a small issuer for the year. This provision could permit smaller 501(c)(3) borrowers to borrow at BQ rates

even if the bonds are issued through a large conduit issuer, such as the Oregon Facilities Authority.

5. Removes the alternative minimum tax (AMT) penalty rate paid by investors on all new money private activity bonds issued during 2009 and 2010 and refunding bonds issued during 2009 and 2010 to refund bonds issued after 2003 but before 2009, other than qualified 501(c)(3) bonds and tax-exempt housing bonds.

Note: it is worth repeating that these new tools are only available during 2009 and 2010 without additional action from Congress.

ARRA provides **support for industrial development** in your cities by expanding the use of small issue bonds issued after the date of enactment of the legislation and through December 31, 2010 to finance manufacturing facilities. Specifically:

1. The legislation expands the definition of "manufacturing facility" to include facilities for manufacturing intangible property, used in the manufacturing, creation, or production of tangible or intangible property described in section 197(d)(1)(c)(iii) of the Internal Revenue Code of 1986, as amended. Intangible property is any patent, copyright, formula, process, design, pattern, know-how, format, or other similar item. In Oregon, this can benefit high tech companies, biotechnology and health care research, among others.
2. ARRA expands the availability of tax-exempt financing for facilities related to qualifying private manufacturing facilities. The legislation provides that the 25 percent limitation on financing "directly related and ancillary" facilities will not apply if those directly related and ancillary facilities are functionally related and subordinate to the manufacturing facility and are located on the same site as the manufacturing facility.

Tax Credits

Four provisions were created or amended by ARRA that affect tax credit bonds that cities can issue. Tax credit bonds differ from tax-exempt bonds in that a portion of the interest paid takes the form of a credit for federal income tax. In most cases, the tax credit goes directly to the bond investor, but not always (see RZEDB and Build America Bonds below). The four provisions are:

1. ARRA increases the total authorization of **Clean Renewable Energy Bonds (CREBS)** from $800 million to $2.4 billion to finance facilities that generate electricity from wind, closed-loop biomass, open-loop biomass, geothermal, small irrigation, hydropower, landfill gas, marine renewables, and trash combustion facilities. One third of the CREBs allocation will be available for qualifying projects of state, local, and tribal governments; one-third for qualifying projects of public power providers; and one-third for qualifying projects of electric cooperatives.
2. **Qualified Energy Conservation Bonds (QECB)** are tax credit bonds, the proceeds of which are used to finance state, municipal and tribal government programs and initiatives designed to reduce greenhouse gas emissions. ARRA increases the total authorization of QECBs from $800 million to $3.2 billion. At least 70 percent of any allocation must be used for government bond and not private activity bond purposes. ARRA also clarifies that an issuer can use bond proceeds for loans and grants for green community programs. In addition, QECBs that are used to provide loans, grants, or other repayment mechanisms for capital expenditures to implement green community programs will not be treated as private activity bonds.
3. ARRA authorizes $10 billion in **Recovery Zone Economic Development Bonds (RZEDB)**, a new category of tax credit bond for investment in economic recovery zones. RZEDBs are taxable, but include a tax credit equal to 45 percent of interest paid on the RZEDBs that is **payable to the issuer (in other words, this tax credit would be payable to the city)**. Proceeds of the bonds may be used to invest in infrastructure, job training, education, and economic development in "recovery zones." Recovery zones are (i) areas designated by the issuer as being areas within the boundaries of the issuer that have significant poverty, unemployment, rate of home foreclosures, or general distress; (ii) empowerment zones or renewal communities; or (iii) areas designated by the issuer as distressed by reason of the closure or realignment of certain military installations. Each state is guaranteed a .9 percent allocation of the national recovery zone economic development bond limitations; the balance will be allocated based on states' job losses in 2008 as a percentage of national job losses in 2008. That allocation would be sub-allocated to local municipalities. RZEBDs can be issued during 2009 and 2010.
4. The new "**Build America Bonds**" are taxable bonds for which a portion of the interest paid provides a **federal tax credit for either the investor or the issuer (that's you, the city)**. Issuers that issue otherwise tax-exempt governmental bonds (not private activity bonds) during 2009 and 2010 may elect to issue such bonds as taxable bonds and permit bondholders to receive a tax credit equal to 35 percent of the interest paid on the bonds.
5. For capital project bonds issued during 2009 or 2010 (as opposed to bonds issued to finance working capital needs), issuers, such as your city, may elect to receive a direct payment from the federal government equal to the subsidy that

Grants and Loans Under the Stimulus Bill

There are several types of grant, loan and loan guarantees under the Stimulus Infrastructure Programs in the American Recovery and Reinvestment Act of 2009 (ARRA). The process for applying for these programs varies, depending upon the type of project to be undertaken. In Oregon, the process for applying for stimulus revenues has been streamlined through state agencies. Additionally, the League of Oregon Cities has a link on its Web site that discusses the funding application process: *www.orcities.org/AZIndex/FederalEconomicStimulusPackage/tabid/5786/language/en-US/Default.aspx.*

would have otherwise been delivered to the bondholders through the federal tax credit for the Build America Bonds. There are several additional requirements to issue Build America Bonds to be taken into account in considering whether to proceed with this structure.

Other Provisions

Currently, tax-exempt bonds can be issued for **high-speed intercity rail facilities**. ARRA modifies the requirement that high-speed intercity rail transportation facilities use vehicles that are reasonably expected to "operate at speeds in excess of 150 mph" to read "attain a top speed in excess of 150 mph." This provision is effective for bonds issued after the date of enactment of the legislation. ARRA also appropriated $8 billion in grants to the Secretary of Transportation for capital costs with a preference given to future development of intercity high speed rail service.

ARRA created a new form of exempt facility private activity bonds, the **Tax-Exempt Recovery Zone Facility Bonds (RZFB)**, the proceeds of which must be used for "recovery zone property," including depreciable property that (i) was constructed, reconstructed, renovated, or acquired by purchase after the date of designation of the recovery zone; (ii) the original use of which commences with the taxpayer; and (iii) substantially all of the use of which is in a recovery zone and in the active conduct of a trade or qualified business of the taxpayer. There is a national limitation of $15 billion of RZFBs to be issued in 2009 and 2010. This limitation will be allocated among the states and municipalities on the same basis as for the RZEBDs described above.

ARRA increased the total amount of **New Market Tax Credits (NMTCs)** available in 2008 and 2009 from $3.5 billion to $5 billion for each year. NMTCs are available for any qualified community development entity to make qualified low income community (a population census tract with either a 20 percent or greater poverty rate or a median family income that does not exceed 80 percent of the greater of the metropolitan area median family income or statewide median family income) investments. The additional credits for 2008 will be allocated to community development entities that submitted an allocation application with respect to the 2008 calendar year and either did not receive an allocation, or received an amount less than the amount applied for. ***The current deadline for applying for a NMTC allocation is April 8, 2009.***

In conclusion, the enactment of ARRA opens up a brave new world of funding possibilities which the authors look forward to exploring with you for the benefit of cities throughout Oregon.

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