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## LOCAL GOVERNMENT

# New Markets for Local Government Debt: Build America Bonds and Recovery Zone Bonds

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Much has already been written about the American Recovery and Reinvestment Act of 2009, signed into law by President Obama on February 17 (the "ARRA"). With less than 18 months remaining for many of the temporary provisions that either created a lower cost of borrowing for traditional tax-exempt financing or lowered the cost of borrowing for municipal issuers by creating new bonding mechanisms that improve the marketability of municipal debt, now is the time for issuers to determine if the projects they need to finance can be financed by taking advantage of the provisions of the ARRA. In addition to the Build America Bonds discussed below, New Jersey issuers should be aware that the ARRA increased the "bank qualification" limitation from \$10 million to \$30 million for obligations issued by governmental and 501(c)3 issuers in 2009 and 2010.

Arguably the most interesting, most relevant to New Jersey municipal and school district issuers and the most

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successful tax provision of the ARRA is the introduction of the Build America Bonds and particularly the Build America Bonds (Direct Payment). A subset of the Build America Bonds, the Recovery Zone Economic Development Bonds, may also have a large impact on the way New Jersey issuers issue municipal debt.

### Build America Bonds

Build America Bonds (BAB) are a new type of taxable governmental bond that may either be issued as a tax-credit BAB or direct-pay BAB. The tax-credit BAB will not be addressed in the article. The other type of BAB is the Build America Bond (Direct Payment) or direct-pay BAB.

#### What is a BAB generally?

Any bond issued by a state or local government issuer can be a BAB if: (i) the obligations are issued before January 1, 2011; (ii) the interest on the obligations would otherwise have been excludable from gross income under section 103 of the Internal Revenue Code of 1986 (the "Code"); and (iii) the issuer makes an irrevocable election to designate the obligations as BABs.

**How do direct-pay BABs work?** On each interest payment date, an amount equal to 35 percent of the amount

of interest payable by the issuer on such interest payment date is paid to the issuer by the federal government in the form of a direct subsidy. There is an information return, Form 8038-CP, that the issuer needs to file with the IRS between 45 and 90 days before each interest payment date for the life of the issue in order to get the cash subsidy from the government. The IRS is working on making submission of that form electronic.

**What are the requirements for BABs?** To receive the direct subsidy, 100 percent of the available project proceeds, net of any reasonably required reserve fund, must be used for new money capital expenditures and the issuer must elect to have the direct-pay BAB option apply. Direct-pay BABs may only be issued to finance capital expenditures, including reimbursement of capital expenditures and, except as noted below, may not be used to refund outstanding obligations. The current refunding of a short-term obligation issued after February 17 will not be treated as a refunding issue. The yield on a direct-pay BAB is reduced by the credit allowed and issuers must comply with the arbitrage rebate rules. There is no volume cap or limitation on the amount of BABs that can be issued.

**What are the benefits of issuing BABs?** In every BAB transaction that

has been brought to the market, totaling over \$15 billion as of the date of this article, the economics of the transaction have shown that a taxable BAB together with the 35 percent direct subsidy is a cheaper cost of funds to the issuer than a traditional tax-exempt financing. If taxable debt is approximately 20 percent more expensive than tax-exempt debt, here, the issuer pays a 20 percent higher interest rate, but receives from the federal government 35 percent of such interest expense. In addition, the investor appetite for this product is still strong.

**What are the disadvantages of issuing BABs?** The greatest disadvantage of the BAB is that it can only be used for new money capital projects and the efficient deal size is considered to be around \$30 million. Structurally, although the market has been warming to serial bonds and 10-year par calls, those structuring concessions may result in an increase in yield. In addition, the BABs generally have no cost of funds benefit in the first 10 years of the yield curve. Although BAB transactions have been sold competitively, there is a great benefit to an issuer to be able to work with professionals who can advise as to the most appropriate structure for that issuer and to be able to provide for flexibility so that the structure can constantly be changing based on investor demand. After all, the BAB market is still evolving. Currently, New Jersey municipal and school district issuers do not have the option to issue new money bonds on a negotiated basis. Bond counselors may have different views as to how to award a competitive BAB and/or how, or if, to pledge the subsidy payments to debt service. Some issuers, counsel and rating agencies are also determining how to analyze the risk that the federal government would stop appropriating for the subsidy payments in the future or that if the federal government is late making such payment, the issuer needs to be able to afford a taxable interest rate. Lastly, because the dependency of the government to make these payments timely is still unknown, the issuer will have to provide in their budgets for the full amount of interest

payable at a taxable interest rate.

In addition to the BABs, two other kinds of bonds were created by the ARRA, Recovery Zone Economic Development Bonds (the "RZEDB") and Recovery Zone Facility Bonds (the "Recovery Facility Bonds"). In particular, the RZEDB is a financing option that can not be ignored by New Jersey issuers.

**What is a Recovery Zone Economic Development Bond?** A Recovery Zone Economic Development Bonds is a Build America Bond (direct payment) where the issuer receives a direct subsidy from the federal government on each interest payment date equal to 45 percent of the interest payable by the issuer on such date. A RZEDB needs to meet the requirements to be a BAB and must fund expenditures for purposes of promoting development or other economic activity in a recovery zone, including capital expenditures with respect to property located in a recovery zone, public infrastructure and public facilities projects and job training or education programs.

**What is a recovery zone?** A recovery zone is: (1) any area designated by the issuer as having significant poverty, unemployment, rate of home foreclosures or general distress; (2) any area 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) any area for which a designation as an empowerment zone or renewal community has previously been granted and is in effect.

**Who can issue RZEDBs?** The IRS is granting discretion to issuers to determine and designate areas as recovery zones. A RZEDB requires receipt of an allocation of volume cap. The volume cap was allocated by the IRS to the 21 counties in the state and four cities: Jersey City, Newark, Paterson and Elizabeth. The total allocation for the state was approximately \$250,000,000 and was allocated based on 2008 employment decline numbers. Issuers of RZEDBs may either be a city or county in receipt of an allocation or may be a conduit

governmental issuer issuing on behalf of an ultimate beneficiary of the allocation. The counties or cities may either use the allocation themselves or may re-allocate to ultimate beneficiaries as long as the project is for a qualified economic development purpose as described above in a recovery zone.

**What is a Recovery Zone Facility Bond?** A Recovery Facility Bond is a type of tax-exempt qualified private activity bond under the Internal Revenue Code of 1986 as amended. The ARRA added this type of 'exempt facility bond' to allow states and local governments to issue bonds for property that would usually not qualify for tax-exemption, such as manufacturing facilities, redevelopment, hotels, night clubs, etc. Recovery Facility Bonds may be issued for any construction, renovation or acquisition of depreciable property in a recovery zone, after the date of designation of the recovery zone, the use of which is in the active conduct of a qualified business. A qualified business does not include a golf course, country club, racetrack, gambling establishment, massage parlor or liquor store.

**Additional ARRA Provisions of Interest- Tax Credit Bonds:** Of additional interest to New Jersey municipal and school district issuers may be the tax-credit bonds either introduced or expanded under ARRA, including the Qualified School Construction Bonds, Clean Renewable Energy Bonds and Qualified Energy Conservation Bonds. The benefit of a tax-credit bond to the issuer is a zero percent or very low interest rate for the life of the issue. However, the tax-credit bonds have maximum maturities set by the Treasury Department and require an allocation of volume cap which allocation may or may not be currently available. Lastly, in the current market environment, tax-credit bonds have very limited investor interest. Any New Jersey issuer that has a project that may benefit from consideration of a tax-credit bond should contact bond counsel for a further discussion of the implications of issuing tax-credit bonds. ■