

## Bond Financing and The Stimulus Bill

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The American Recovery and Reinvestment Act, sometimes referred to as the Stimulus Bill, was signed by the President in February. The Act made a number of temporary changes in the law to make governmental bond financing more available to states, other political subdivisions, charities, manufacturers and other borrowers and to make the purchase of bonds attractive to potential investors. Generally, these changes will apply only to bonds issued in 2009 or 2010, so borrowers who wish to take advantage of the changes will have a limited window in which to take action.

### **Marketability Enhancements.**

**Bank-Qualified Bonds.** A bank or other financial institution is generally not permitted to deduct the interest that it pays to the extent that the interest is allocable to tax-exempt bonds held by the institution. While the Internal Revenue Code uses a somewhat more complicated formula for making this allocation, the basic thrust is to disallow the interest costs incurred to carry tax-exempt bonds in the institution's portfolio.

The disallowance of the interest deduction will not apply in the case of bond that is a qualified tax-exempt obligation, commonly referred to as a "bank-qualified bond". A bank-qualified bond is a tax-exempt bond issued to finance public facilities or facilities for the benefit of a 501(c)(3) organization (a charita-

ble organization) that meets certain conditions. One of these conditions is that the issuer of the bond must be a qualified small issuer, which requires that the issuer not anticipate issuing more than \$10,000,000 of municipal purpose and 501(c)(3) bonds during the calendar year. Certain issuers will be aggregated in determining whether this dollar limit is exceeded. For example, bonds issued or expected to be issued by a city will have to be counted in determining whether the city's industrial development authority will exceed the limit.

The effect of this disallowance has been to discourage financial institutions from buying tax-exempt bonds, other than the limited amount of bank-qualified bonds that could previously be issued. In order to bring banks into the market to a larger extent, and thereby make the sale of bonds easier and possibly cheaper for borrowers, the Act made the following changes:

- The \$10,000,000 qualified small issuer limit has been increased to \$30,000,000.
- In the case of a 501(c)(3) bond, the charitable borrower will be treated as the issuer of the bond for purposes of determining whether the limit is exceeded. As an example, if no more than \$30,000,000 of tax-exempt

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bonds are issued for the benefit of a particular 501(c)(3) college during 2009, the bonds can be bank-qualified bonds even though the authority that is issuing the bonds and the locality that created the authority will issue more than \$100,000,000 of tax-exempt bonds during 2009.

- The interest deduction will not be disallowed for non-bank-qualified bonds held by a financial institution to the extent that the average adjusted basis of the bonds constitute less than 2% of the average adjusted basis of all the assets of the institution.
- In the case of a pooled issue, the portion loaned to a governmental entity or a 501(c)(3) organization will be treated as a separate bond issue for purposes of determining whether the \$30,000,000 limit is exceeded.

**Alternative Minimum Tax (AMT).** The interest on many tax-exempt bonds has been an item of tax preference for purposes of calculating a bondholder's alternative minimum tax. This does not apply to bonds issued for the benefit of a governmental entity or a 501(c)(3) organization. The Act made the following change:

- None of the interest on any tax-exempt bonds will be treated as an item of tax preference for AMT purposes (although the interest may have to be taken into account for AMT calculations as a part of a corporate bondholder's adjusted current earnings).

**Manufacturing Bonds.** Subject to a number of conditions and limitations, the interest on bonds issued to finance privately-owned manufacturing facilities (also known as qualified small issue bonds) has been exempt from federal income taxation. The Act has relaxed the requirements relating to manufacturing facilities in two useful respects.

- Until now, qualified small issue bonds could only be used to finance facilities used in the manufacturing or production of *tangible* personal property. The Act provides that the term will also include a facility used in the creation or production of any *intangible* property that is a patent, copyright, formula, process, design, pattern, knowhow, format or other similar item. This would permit tax-

exempt financing for facilities used for the creation of such items as computer software.

- Prior to the Act, the Internal Revenue Code has provided that no more than 25% of the net proceeds of a tax-exempt bond issue could be used to provide facilities that were "directly related and ancillary" to a manufacturing facility. Under the Act, up to 100% of the proceeds can now be used to finance any facility that is "functionally related and subordinate" to a manufacturing facility and is located on the same site as the manufacturing facility. This would expand the possibility of financing such related facilities as warehouses and would permit the financing of such facilities as on-site sales offices that could not previously be financed on a tax-exempt basis.

**New Types of Bonds.** The Act permits the issuance of several new types of tax-advantaged bonds that can be issued only in 2009 or 2010. The new types of bonds include the following:

- **Build America Bonds (Tax Credit).** These are bonds issued to finance or refinance capital expenditures and working capital for governmental entities. The interest on these bonds would be taxable. In addition to the taxable interest paid on the bond, the holder of such a bond would receive a credit against its income taxes each year in an amount equal to 35% of the interest payable on the bond during that year.
- **Build America Bonds (Direct Payment).** These bonds may be issued only to finance new capital expenditures (and not for refinancings or to finance working capital). Like the tax credit bonds, direct payment bonds pay taxable interest. Instead of a tax credit being provided to the bondholder, however, the issuer of a direct payment bond will be entitled to receive a direct subsidy payment from the federal government equal to 35% of the interest paid on the bond. As the holders of direct payment bonds would not receive a tax credit, they would require a higher interest rate than would be paid on tax credit bonds.
- **Recovery Zone Economic Development Bonds.** These are the same as Build America Bonds (Direct Payment), except that the proceeds of the

bonds must be expended to promote development or other economic activity in a recovery zone. The proceeds may be used for capital expenditures for facilities in a recovery zone and for job training and educational purposes. A recovery zone would include (1) an area designated by the bond issuer as having significant poverty, unemployment, rate of home foreclosures or general distress, (2) an area designated by the issuer as distressed by reason of the closure or realignment of a military installation, or (3) an area that has been designated as an empowerment zone or a renewal community. For a Recovery Zone Economic Development Bond, the subsidy to the issuer would be increased to 45% of the interest payable.

- **Recovery Zone Facility Bonds.** These are tax-exempt bonds substantially all of the proceeds of which are used for property located in a recovery zone. The property must be used in the active conduct of a trade or business other than the rental of residential property or certain other proscribed businesses.
- **Qualified School Construction Bonds.** These are taxable bonds the holder of which is entitled to an annual federal income tax credit determined under a formula set forth in the Internal Revenue Code. The proceeds of these bonds must be used for the construction, rehabilitation or repair of public school facilities or the acquisition of land for such facilities.

There are dollar limits on the amount of Recovery Zone Economic Development Bonds, Recovery Zone Facility Bonds and Qualified School Construction Bonds that can be issued nationally each year. The issuer of such bonds must receive an allocation of a portion of the applicable national limit in order to issue the bonds on a tax-advantaged basis.

Even though the interest on Build America (Tax Credit) Bonds, Build America Bonds (Direct Payment), Recovery Zone Economic Development Bonds and Qualified School Construction Bonds is taxable, those bonds are still required to satisfy many of the Internal Revenue Code requirements that apply to tax-exempt bonds, including arbitrage requirements.

**Qualified Zone Academy Bonds.** The Internal Reve-

nue Code has provided that Qualified Zone Academy Bonds (QZABs) could not be issued after 2008. The Act allows these bonds to also be issued during 2009 or 2010. These are tax credit bonds the proceeds of which are to be used for rehabilitation, repair, equipment purchases and teacher training for certain public schools deemed to be qualified zone academies. As with other types of bonds, QZABs must meet certain of the rules that apply to tax-exempt bonds and are subject to a volume limit.

Should you have any questions concerning the bond provisions of the Act, please contact Al Knighton (540-983-7632) or George Clemo (540-983-7728).



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