



Issue Brief: TAXABLE TAX-CREDIT BONDS PROGRAMS

Updated April 2010

Background

Tax credit bonds are taxable instruments that may be issued by state and local governments and governmental entities for a wide array of purposes. Unlike tax-exempt bonds, where the investor is able to exclude tax-exempt interest from gross income of their federal tax return (and on many state returns), tax credit bonds allow investors to receive a tax credit at a rate set by the Department of the Treasury on their federal tax returns. The bond issuer maintains the responsibility to pay the principal on the bonds. In essence, these programs provide an interest-free loan to the issuer. Additionally, in 2008, Congress amended the tax credit bond rules to permit tax credits to be sold separately from the related bond in what is known as “stripping” the tax credit in order to make these instruments more attractive to investors.

Congress generally authorizes specific amounts of available funds for each tax credit bond program. The formula for how the authorization is allocated is usually set for each state by the Treasury or, for some programs, the Treasury approves specific projects for which tax credit bonds will be issued. Until 2009, the authorization for many of these programs had been small compared to the total volume of the tax-exempt bond market.

In 2009 and 2010, Congress not only substantially increased the size of many of these programs, but it also introduced a new type of tax credit bond where the federal government reimburses the issuing government a set percentage of the interest costs that the issuer incurred when issuing these taxable bonds rather than giving the investor a tax credit. In the *American Recovery and Reinvestment Act of 2009 (ARRA)*, Congress authorized two of these types of taxable bonds -- Build America Bonds and Recovery Zone Economic Development Bonds - that may be issued in 2009 and 2010. Additionally, in March 2010, President Obama signed the Hiring Incentives to Restore Employment (HIRE) Act, which allows the issuer, rather than the investor, to receive the tax credit as a subsidy payment for most tax credit bond programs.

Governments who are new to tax credit bonds should talk with their bond counsel and financial advisors about the intricacies involved with issuing these instruments and how the issuance process and ongoing compliance differs from tax-exempt bonds.

More information about each of these programs is listed below. Technical and allocation information from the Treasury and IRS may be found at –<http://www.irs.gov/taxexemptbond/article/0,,id=206034,00.html>.

Issuer Subsidized Tax Credit Bond Programs

Build America Bonds (BABs)

Build America Bonds may be issued by state and local governments in lieu of tax-exempt governmental bonds for any governmental purpose. There is no authorization limit associated with BABs – any government may issue BABs in 2009 and 2010 for those projects where governments may otherwise issue governmental tax-exempt bonds. BABs allow the issuer to receive a rebate from the federal government equal to 35% of the interest paid on the bonds for the lifetime of the bond instead of giving investors the tax credit. While Congress did include a provision that allows the issuer to give the investor the tax credit, rather than receive the subsidy payment themselves, it is unlikely that any governments will choose to do so. However, while the issuer-subsidized option is available for bonds issued in 2009 and 2010, bonds issued where the investor is given the tax credit do not have a sunset date. It is important to note that all of the rules that apply to tax-exempt bonds also apply to BABs.

Recovery Zone Economic Development Bonds

This new program, again included in ARRA, authorizes \$10 billion in taxable bonds, similar to BABs, for purposes to promote development or economic activity within a Recovery Zone. A Recovery Zone is determined by a government's unemployment, poverty and home foreclosure rates, as determined by the Treasury. The bonds must be issued by Dec. 31, 2010. The unique characteristic of Recovery Zone Development Bonds is that there is no option for the investor to receive the tax credit, and the issuer receives a payment from the federal government equal to 45% of the interest on the bonds.

Schools

Qualified School Academy Zones (QZABs)

QZABs were created in 1997 to improve schools located in empowerment zones, enterprise communities, or in districts where 35% of the students qualify for free or reduced-price school lunches. At least 85% of the bond proceeds must be used for rehabilitating or repairing public school facilities, providing equipment, developing course materials, or training teachers and other school personnel. QZABs cannot be used for new school construction. Bondholders receive an annual tax credit rate set by the Treasury Department in lieu of tax-exempt interest while the bond is outstanding. Congress has authorized \$1.4 billion annually to be used in 2009 and 2010 for the program. As indicated above, the tax credit may be stripped and sold separately from the bond. The money is authorized to each state, based on their portion of population below the poverty line. States are then responsible for allocating the available tax credit bonds to specific local governments.

The passage of the HIRE Act now allows the issuer to receive a subsidy payment equal to the full interest costs of the bonds, instead of giving the investor the tax credit.

Qualified School Construction Bonds (QSCBs)

In ARRA, Congress created a new tax credit bond program to finance the construction, rehabilitation or repair of public school facilities. These bonds may be used for new construction projects. As with QZABs, the bondholder (or the purchaser of a stripped tax credit) receives an annual tax credit – at a rate set by the Treasury Department – in lieu of tax-exempt interest while the bond is outstanding. ARRA authorizes \$11 billion annually for the program for the years 2009 and 2010. States receive 60% of this authority, based on the respective amount of local education grants each state receives under the *Elementary and Secondary Education Act*. The other 40% is allocated to the largest educational agencies in the nation, as determined by the Secretaries of the Treasury, Commerce and Education.

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Energy

Clean Renewable Energy Bonds (CREBs)

CREBs are used to finance qualified energy production projects, including facilities for wind, bio-mass, geothermal and solar energy, trash combustion, refined coal production, and certain hydropower facilities. A total of \$2.4 billion is available for CREBs issuance to be divided equally among electric cooperatives, public power systems and other state or local governmental units. To qualify, state and local governments and other entities must receive approval from the Treasury on their proposed projects. CREB investors receive an annual tax credit – equal to 70% of the tax credit rate set by the Treasury Department – while the bond is outstanding in lieu of tax-exempt interest.

The passage of the HIRE ACT now allows the issuer to receive a subsidy payment equal to 70% of the

bonds' interest costs, instead of giving the investor the tax credit.

Qualified Energy Conservation Bonds (QECCBs)

This program, created in 2008, allows governments to issue bonds and use the proceeds to reduce energy consumption in publicly-owned buildings, implement green community programs, produce electricity from renewable energy resources for rural areas, build research facilities and provide grants to support development of “green” technologies, reduce pollution from mass commuter vehicles, and advance other green technologies and infrastructure. A total of \$3.2 billion has been authorized for the program, which is allocated to each state in proportion to its population. ARRA expands the use of QECCBs to allow governments to make loans to individuals for green community programs – for instance, financing loans for homeowners to retrofit their homes with energy conservation products.

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Outlook in 2010

Congress is looking to extend the Build America Bond program to allow for the bonds to be issued after Dec. 31, 2010, when the program expires. It is likely that such action would result in a lower subsidy payment than the current 35%. Additionally, GFOA is monitoring regulatory actions on these programs, including IRS post-issuance compliance initiatives and the fact that the subsidy payments that the federal governments sends to state and local governments may be offset by an amount that those governments may owe the federal government in areas not related to the bonds.

Resources

- GFOA Advisory, Issuing Build America Bonds, 2010.
- GFOA Public Policy Statement, *Federal Tax Policy and Preserving the Tax-Exempt Status of Municipal Bonds*, 2005.
- Congressional Research Service, *Tax Credit Bonds – A Brief Explanation*, 2008.
http://assets.opencrs.com/rpts/RL34629_20080820.pdf