SWEEPING CHANGES IN BOND LEGISLATION ENHANCE THE BENEFITS TO BOTH ISSUERS AND PURCHASERS OF §144 AND §54AA BOND FINANCING

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I. INTRODUCTION.

Government programs abound to encourage and assist small and mid-size entities to access the same bond markets as multi-national corporations. The American Recovery and Reinvestment Act of 2009 (The Act) Effective February 17, 2009 greatly enhanced the usefulness of bond financing to entities and introduced a number of changes which will impact tax projections and reporting for those purchasing bonds issued during 2009. The most notable change for bond purchasers is the issuance of Build America Bonds, a new type of credit bond which preparers are likely to encounter for the first time when preparing 2009 tax projections.

Mid-sized entities are encouraged by State's Treasurers offices to issue private activity bonds (PABs)[2] in order to finance construction and retro-fitting of certain existing commercial property.[3] Yet many CPA's and most entities remain unaware that they can tap this low cost funding source. Once the process is demystified, CPA's can recommend bond funding with confidence. The primary advantage to the entity is low interest rates, long repayment terms and flexibility. The principal advantage to the CPA is the chance to solidify the relationship with the client by providing creative cost saving alternatives to traditional financing. As of September 15th, 2009, the interest rates on private activity bonds (PAB) was approximately .35% while the interest rate on taxable bonds is approximately .75%.[4] The borrower also pays a percentage for the letter of credit. Depending on the borrower's credit worthiness the rate is approximately 1.0% to 2.0% . Taxable bonds, with slightly higher interest rates can be issued when the project does not qualify for the PAB program. In some cases financing relies on a combination of PAB and taxable bond financing. The interest rate is floating rate tied to LIBOR with a spread and overtime the rate has fluctuated between 3.0% and 5.0%.

The PAB program and the taxable bond program are very accessible for your clients. Generally, when the offering is three million dollars or more a bond offering is economically feasible. The loans are generally backed by a letter of credit from a bank and are utilized for refinancing or construction of real estate and manufacturing, and equipment. The PAB's are issued through the appropriate department of the State Treasurer's office or another agency or

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[2] Private activity bonds are also known as conduit bonds and industrial development bonds.

[3] In 2003 $200 billion in tax exempt bonds were issued, 22% of which were PAB's. Between 1991 and 2003 PAB's accounted for 27% of total annual tax exempt bond issuances. Acting Deputy Assistant Secretary for Tax policy Eric Solomon Testimony before The Subcommittee On select Revenue Measures OF the Committee on Ways and Means.

[4] CoAmerica Bank

state. Some programs specifically set aside a portion of the state's total bond program for small entities.

Terms defined

- Insurer – the Company or entity is the issuer of the bond.
- Bond, Bank and Corporate Council – Prepare all necessary documentation.
- Underwriter – markets the security.
- Qualified Small Issue Industrial Development Bonds §144 - an issuer that anticipates issuing no more than $30 million dollars of bonds in each calendar year.
- Unified State Volume Cap [5] - a limit on the total dollar volume of bonds allocated to each state. States further allocate the volume caps among types of projects.
- Special purpose tax preferred bonds – bonds designated for a special purpose such as providing funding to small businesses for the acquisition, construction or installation of qualified pollution control waste disposal facilities.

II. SWEEPING CHANGES IN THE RECENTLY ENACTED STIMULUS BILL ENHANCE THE BENEFITS OF BONDS

Effective February 17, 2009, The American Recovery and Reinvestment Act of 2009 greatly enhanced the usefulness of PAB's.

- The tax act removed PAB's issued during 2009 and 2010 from the list of AMT preference items. The repeal also applies to refunding bonds only if the refunded bonds were issued after December 31, 2003.
- Interest on tax-exempt bonds issued during 2009 and 2010 will not be taken into account in computing the adjustment to corporate AMT based on ACE.
- Build America Bonds. A new type of credit bond was established. Build America Bonds, which provide bondholders with a federal tax credit of 35%-45% of taxable interest on these bonds.
- Recovery Zone bonds and Recovery Zone Facility Bonds. (a form of Build America Bonds) These bonds will be issued as taxable bonds. Recovery zones are determined based on unemployment and poverty levels. The federal government will reimburse the issuer 45% of the interest paid making the true cost of interest potentially lower than even tax exempt bonds.
- Manufacturing bonds – the rules have been loosened. The definition of Manufacturing has been expanded to include intangible property, including facilities for research and experimentation, software companies and process companies.
- Manufacturing bonds – Former regulations limited spending on non-integral activities to 25%, in effect prohibiting financing of warehouse, distribution, parking, washrooms and plant management facilities. Current law eliminates the limit as long

[5] The 2009 volume limits for exempt facility bonds under § 142(k)(5), the § 42(h)(3)(C)(ii), and the private activity bond volume cap under § 146, are derived from the estimates of the resident populations of the 50 states, the District of Columbia and Puerto Rico, which were released by the Bureau of the Census on December 27, 2007.

as the facilities are on the same site as the manufacturing facility and functionally related.
- The Act requires projects funded under the Recovery Zone Economic Development Bonds and several other bond programs be subject to the Davis Beacon prevailing wage laws.

A. Step one: Understand the different types of bonds available.

Private activity bonds – defined

Interest on debt incurred by States or local governments[6] (municipal or state bonds) is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds.[7] PAB's bonds are a form of municipal bond and are exempt from federal taxation.[8] Interest on bonds that nominally are issued by State or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person is called a "private activity bond" (PAB). [9] [10] Under the Internal Revenue Code, tax-exempt PAB's include financing for manufacturing facilities, non-profit organizations[11], and Enterprise zones.[12] Through December 31, 2008 the interest on PAB's other than a qualified 501(c) (3) bond is a Federal minimum tax preference item[13]. As of January 31, 2009 the tax act of The American Recovery and Reinvestment Act of 2009 removed PAB's issued during 2009 and 2010 from the list of AMT preference items.

<u>Governmental bonds</u>

State and local governments issue tax exempt bonds to finance a wide range of public infrastructure including schools, roads and sewage facilities. There are two basic kinds of bonds, governmental bonds if the proceeds are used to carry out governmental functions and bonds that have private involvement in excess of certain limits. The second type of bond is

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[6] Hereafter called municipal, muni or state bonds.
[7] JCX-39-99 Joint committee on taxation June 22, 1999
[8] IRC §103 and IRC§141.
[9] JCX-39-99 Joint committee on taxation June 22, 1999
[10] Private activity bonds are also referred to as "conduit bonds" because the code includes several exceptions permitting states or local governments to as conduits providing tax-exempt financing.
[11] Tax advisors to religious institution clients or educational, community groups and health facilities associated with religious groups should carefully review the intended bond use to insure the bond will finance only expenditures that would give some type of economic benefit to the community. Construction of a new museum to conserve and display archeological artifacts from Jerusalem would probably be acceptable. Construction of a facility to refurbish and display Torah scrolls would likely violate the First amendment clause respecting the separation of church and state. See Steele v. Nashville Industrial Development Board, 6th Cir., 8/14/02 for further research.
[12] JCX-39 Joint committee on taxation June 22, 1999. Present law provides two tests for determining whether a State or local government bond is in substance a private activity bond §141 (b) & (c) Private activity test more than 10% of the bond proceeds are used by a private business, or more than 10% of the debt service is secured by an interest in property to be used in a private business use. Private loan test – an amount exceeding the lesser of (1) 5% of bond proceeds or (2) $5million is used to finance loans to private persons.
[13] IRC §56(b)(1)(C)(iii)

classified as Private Activity Bonds. PAB's are also subject to volume cap limitations under §146.

Tax credit bonds

Tax credit bonds provide a Federal tax credit to replace the taxable interest on the bonds. Instead of having cash coupons, tax credit bonds provide tax credits which are added the investors taxable income then subtracted from the taxpayers income tax liability.

Example (1) - if the taxable interest rate is 5%, a $10,000 bond would yield $500.00 in tax credits. If the taxpayer were in the 35% tax bracket she would include $500.00 in income and pay an additional $175.000 in tax. She would then take the $500.00 credit against her total tax liability, for a net reduction in liability of $325.00.

Due to the tax benefits of municipal and tax credit bonds, taxpayers are willing to accept a lower interest rate and the issuer benefits by funding project at lower interest rates.

Taxable Bonds

When PAB's are unsuitable, taxable bonds are available. The rates are lower than those available from a financial institution but higher than tax-exempt bonds. The process is similar to issuing PAB's

B. Step two: Determine if the borrower qualifies

Bonds are backed by the borrower's credit. The borrowing entity will obtain a letter of credit from a commercial lender. The letter of credit ensures that the bonds can be readily sold. Clients who can qualify for traditional financing can typically qualify for the letter of credit. Standard practice is for lenders require three years of financial statements, preferably audited, and a one year forward cash flow projection.

The borrower will have to qualify for the letter of credit. In today's credit market lenders generally require a down payment of twenty-five percent or more at close of escrow.

The Bond Indenture will specify amounts to be set aside n a reserve account for payment of both principal and interest. Accountants generally advise their clients to sweep this account annually to reduce the principal remaining on the bond issuance.

C. Step three: Determine if the project qualifies

Taxable bonds are issued to finance the purchase of facilities for service, distribution or other entities.

Tax exempt bonds consist primarily of bonds to finance manufacturing facilities, recycling facilities and 501(c) (3)'s.

Small Business Pollution Control Tax Exempt Bond Financing Program (SBAF) provides funding for qualified pollution control, waste disposal and resource recovery facilities.

A firm specializing in the management of bond offerings should be brought in at this point to clarify the current bond program's requirements and tailor the search for appropriate property to the bond requirements. Many states and localities have created mechanisms which permit them to offer additional incentives such as reduced issuance costs for qualified small recycling facilities.

D. Step Four: Issuance

The bond manager advises the CPA and his client as to which financial institution is currently offering the most advantageous rates. In addition the bond manager negotiates the best possible rates with bond council, underwriters and other professionals.

A declaration of official intent or an inducement resolution is obtained. An inducement resolution is an agreement in principal by an issuer for a proposed project and includes a decision to locate in a specific jurisdiction and other project specific information. Bonds may finance "qualifying costs". Costs qualifying costs only if the inducement resolution is made not more than 60 days after the costs are spent. Bond council determines that the placement meets the requirements of a bond transaction. Bond council will negotiate and decide upon the necessary documentation.

Volume caps - Depending upon the state and bond program the issuer, may have to compete for an allocation of the states quota. Often the competition is held by lottery. Additional, procedural steps maybe necessary to obtain an allocation of the states quota. Historically California has had sufficient capacity to issue PAB's making this step unnecessary.

TEFRA hearing - A notice is published informing the community of the nature and location of the property. At least fourteen days after publication a TERFA hearing is held. Following the hearing the elected official or legislative body with jurisdiction over the project must approve the bond offering.

E. Taxable bonds

When a client's project does not meet the requirements of a PAB funding is available in the taxable bond market. Taxable and tax-exempt bonds may be used in tandem to meet the funding needs of an entire project.

Bond placement - the user then 'places' the bond through an underwriter who markets the security.

III. BOND OWNERSHIP.

Bond interest is typically sourced to the recipients' state of residence and the interest on in-state bonds is exempt from state and local taxation. In response, all major brokerage houses and investment firms offer single state bond funds designed to exempt the resultant interest from state taxation. The client's PAB will typically become part of one of these in-state bond funds.

In a seminal ruling, Kentucky v. Davis, the Supreme Court upheld Kentucky's preferential tax treatment on its own instate bonds while taxing out of state bonds. Justice Souter delivered the opinion in favor of Kentucky's scheme but set aside the examination of private activity bonds for another day.[14]

The majority of states exclude the interest from municipal and PAB's from taxation if the investor lives in the state where the bonds was issued, but do not exclude out-of-state bonds from taxation. [15] Mechanically some states achieve this result by requiring a state adjustment to add out of state muni bond interest back to federal taxable income. [16] Effectively this tax treatment favors in-state municipal bonds which are exempt from both federal and state taxation. Private activity bonds are differentiated from other municipal bonds because they benefit not a traditional government function or a public facility, but a private enterprise which the State has determined benefits the residents of the State. As such it is unclear whether the exception afforded municipal bonds would be extended to in/out of state taxing schemes of states should the issue reach the Supreme Court.

IV. OWNERSHIP & REPORTING OF BUILD AMERICA BONDS –TAX CREDIT BONDS.

The American Recovery and Reinvestment Act of 2009 established two new kinds of bonds, the Build America Bond (BAB) and the Qualified School Construction Bond (QSCB). Other tax credit bonds such as Clean Renewable Energy Bonds (CREB) and Midwest Tax Credit Bonds (MTCB), have been issued since 2005. Because these bonds were designed to attract investors that would not normally buy tax-exempt bonds; preparers may encounter these bonds for the first time when preparing 2009 tax projections. As BAB's are available only to finance governmental projects and exclude PAB qualifying projects only the ownership of these bonds will be addressed.

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[14] Department of Revenue of Kentucky, et al., petitioners v. George W. Davis, et ux. 128S. Ct. 1801
"an agreement was raised by one of the Davises' amici focuses on so called 'private activity', 'industrial –revenue', or 'conduit' bonds, a subset of municipal bonds used to finance projects by private entities. These bonds are often (but not always) exempt under the Kentucky scheme. Amici contend that Kentucky's exemption of these bonds, at the very least, plainly violates the Commerce Clause. See Brief for Alan D. Viardi et al. as Amici Curiae 25-26. This argument, however, was not considered below, was never pressed by the Davises themselves, and is barely developed by amici. Moreover, we cannot tell with certainty what the consequences would be of holding that Kentucky violates the Commerce Clause by exempting such bonds; we must assume that it could disrupt important projects that the States have deemed to have public purposes. Accordingly, it is best to set this argument aside and leave for another day any claim that differential treatment of interest on private-activity bonds should be evaluated differently from the treatment of municipal bond interest generally."

[15] 42 States would have to change their municipal bond income tax law to eliminate in-state bias. Brief of the National Federation of Municipal advisors as Amicus Curia.

[16] Indiana exempts all municipal bond interest. Utah exempts its own muni bonds and the bonds of state which do not tax Utah state bonds. Iowa, Oklahoma, and Wisconsin, tax all out of state bonds but exempt only a portion of in-state bonds.

Tax credit bonds are suitable investments for low income taxpayers, IRA accounts, and foreign investors as the mechanics of the Federal subsidies will show.

Tax credit bonds provide a Federal tax credit to replace the taxable interest coupon on the bonds.[17] Instead of having cash coupons, tax credit bonds provide tax credits which are added the investors taxable income then subtracted from the taxpayers income tax liability on form 8912. The credit allowed may be limited to the taxpayer's tax liability. Tax credits generated by pass through entities are limited to the tax attributable to income from the entity generating the credit. Certain tax credit bonds allow the taxpayer to deduct the unused credit in the next tax year instead of the current year.[18]

Example (1) – (BAB): Tax Credit Bond If the taxable rate is 10 percent, a $1,000 bond would yield $100 in tax credits. If the investor were in the 35 percent tax bracket, he would include $100 in income and pay an extra $35 in tax (before the credit). He would then take the $100 credit against his total tax bill, for a net reduction in tax liability of $65.[19]

Example (2) – Taxable bond: The investor who received $100 in taxable interest from a corporate bond would pay $35 in tax would have $65 in hand after taxes.

Example (3) – Municipal bond: The investor who purchases a typical municipal bond would receive the interest on the bond and pay no tax on the interest. The market typically adjusts the municipal bond rate down to compensate. In this example the bond rate would be 6.5 percent and the taxpayer would receive $65 of interest regardless of their bracket.

Since 1986, the average spread between long-term tax exempt bonds and high quality corporate bonds has been 21%.[20] The top marginal personal income tax rate fluctuated between 28 to 39.6 percent during that period.

Example (1a) – (BAB) Tax Credit Bond: If the taxable rate is 10 percent, a $1,000 bond would yield $100 in tax credits. If the investor were in the 28 percent tax bracket, he would include $100 in income and pay an extra $28 in tax (before the credit). He would then take the $100 credit against his total tax bill, for a net reduction in tax liability of $72.

Example (2a) – Taxable bond: The investor who received $100 in taxable interest from a corporate bond and paid $28 in tax would have $72 in hand after taxes.

Example (3a) – Municipal bond: The investor who purchases a typical municipal bond would receive the interest on the bond and pay no tax on the interest. The market typically

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[17] Additional guidance on the mechanics of calculating and claiming the credit can be found in the instructions to form 8912. The tax credit rate for CREB, GTCB, MTCB and QZAB bonds is published at www.tresurydirect.gov/govt.rates/rates/irstcb.come IRS Tax Credit Bond Rates.

[18] Instructions to form 8912 page 4 part II.

[19] www.ustres.gov/press/releases/js4121.htm Acting Deputy Assistant Secretary for Policy Eric Solomon Testimony before The Subcommittee on Select Revenue Measures of the Committee On Ways and Means.

[20] Acting Deputy Assistant Secretary for Policy Eric Solomon Testimony before The Subcommittee On Select Revenue Measures of the Committee On Ways and Means

adjusts the municipal bond rate down to compensate. In this example the bond rate would be 6.5 percent and the taxpayer would receive $65 of interest regardless of their bracket.

Therefore, tax credit bonds should appeal to taxpayers in lower tax brackets who, none the less, have tax liabilities from other income sources. Taxpayers who have reduced their tax liability to zero through net operating losses or other means should be advised to avoid purchasing tax credit bonds.

V. CONCLUSION.

As advisors to our clients we must look beyond tax planning to encompass planning for the entire financial health of our clients. Our clients look to us for guidance on new and complex issues. Private activity bonds are a safe and proven financing tool which belongs in every practitioner's tool box. The path from facility purchase decision to funding via a municipal bond offering can be seamlessly negotiated once we make the decision to look beyond our own comfort zone.

Bond ownership can effectively reduce the taxpayer's liability when the proper bond or bond fund is purchased. Tax credit bonds are appropriate for taxpayers whose tax profile did not favor holding traditional tax exempt bonds.

The Economic Recovery and Reinvestment Act created a window of opportunity for tax preparers proactively advise clients to include BAB's in their portfolio. By removing PAB's from the list of tax preference items, The Act improved the economics of bond issuance. The climate has never been better to understand and use bonds to help your clients to succeed.