



MEMORANDUM

This Memorandum discusses the key provisions of the American Recovery and Reinvestment Act of 2009 (“ARRA”) and the Internal Revenue Service guidance issued to date dealing with build America bonds, Recovery Zone Economic Development Bonds, and Qualified School Construction Bonds, as well as the expanded authority provided by ARRA to issue other types of qualified tax credit bonds.

I. Build America Bonds

General Requirements. ARRA creates a new category of taxable bonds called “build America bonds” (“BABs”) that can be issued in 2009 and 2010. BABs can be used for any purpose that, under current law, can be financed with governmental tax-exempt bonds. Thus, projects of non-profit or private entities that can be financed on a tax-exempt basis only with either qualified 501(c)(3) bonds or other types of qualified private activity bonds would not be eligible for financing with BABs. An issuer must make an affirmative election to treat what would otherwise be tax-exempt governmental bonds as BABs. BABs can be issued by any issuer of tax-exempt bonds, including municipalities, school districts and conduit issuers of governmental bonds.

There are two types of BABs created by ARRA: the first (referred to here as “Tax Credit BABs”) entitles bondholders to a tax credit equal to 35% of the interest paid on the bonds. The second type (referred to here as “Direct Payment BABs”) provides, in lieu of a tax credit, a federal subsidy payment to the issuer of the bonds equal to 35% of the interest paid on the bonds.

Tax Credit BABs. As indicated above, the holder of a Tax Credit BAB is entitled to a tax credit equal to 35% of the interest paid on the bonds. This credit applies for purposes of both the regular income tax and the alternative minimum tax. Any unused portion of the credit can be carried over to subsequent tax years. The amount of the credit is calculated based only on the actual stated interest rate (coupon) on the bonds, and not any OID or market discount that may be treated as interest for tax purposes. In addition, as is the case with all tax credit bonds, the tax credit itself is includable in gross income for tax purposes, thus reducing the all-in tax benefit of the credit.

Due to the inclusion of the tax credit in income, the tax credit is best viewed as the means by which the federal government is effectively paying a portion of the interest on the bonds. This is illustrated by the following example: If an issuer’s taxable (non-BAB) bond sold at par pays \$1,000 in interest annually, the equivalent Tax Credit BAB sold at par should pay \$741 in interest annually. This results in a tax credit of \$259 dollars (35% of \$741), and the total amount included in the bondholder’s income will be \$1,000, the sum of the \$741 in interest paid plus the \$259 tax credit.

Direct Payment BABs. Direct Payment BABs provide, in lieu of a tax credit, a subsidy payment to the issuer of the bonds in an amount equal to 35% of the interest payable on the bonds. This option is only available for BABs that the issuer has elected to treat as Direct Pay BABs. Unlike Tax Credit BABs, Direct Payment BABs can only be used to finance capital expenditures. Further, the IRS has indicated that Direct Payment BABs can only be issued for new money capital financings only and not for refundings of bonds issued prior to the date of enactment of ARRA. For this purposes, however, new money would include a reimbursement of a capital expenditure originally paid or incurred after the effective date of ARRA (2/17/09), provided the normal reimbursement rules

(i.e., adoption of a declaration of intent and reimbursement within the allowable time period) are otherwise complied with. In addition, the financing of a short-term financing incurred after the ARRA effective date to original finance a capital expenditure paid after such effective date is also permissible with Direct Payment BABs

On a Direct Payment BAB that pays \$1,000 interest annually, the bondholder will have \$1,000 of taxable income and the bond issuer will receive, contemporaneously with the interest payment on the bonds, a subsidy payment from the federal government of \$350. The IRS has indicated that an issuer of fixed rate Direct Payment BABs can elect to have the subsidy payment be made directly to the bond trustee or paying agent for the purpose of funding a portion of the associated interest payment on the bonds, thus reducing the issuer's cash flow burden to pay the bond interest by a like amount (in the above example to \$650). See **"Payment Procedures for Direct Payment BABs and RZEDs"** below.

2. Recovery Zone Economic Development Bonds

Recovery zone economic development bonds ("RZED Bonds") are a type of Direct Payment BAB that can be issued before January 1, 2011, the proceeds of which are used to finance "qualified economic development purposes" which are defined as the promotion of development or other economic activity in a recovery zone, including capital expenditures and working capital expenditures to promote development or other economic activity within a recovery zone, including capital expenditures paid or incurred with respect to property located in a recovery zone, expenditures on public infrastructure, the construction of public facilities, and expenditures for job training and educational programs). As is the case with BABs generally, RZED Bonds may only be issued for projects or purposes for which tax-exempt governmental bonds could be issued under current law. Further, as is the case for Direct Payment BABs, RZEDs can be issued only new money financings and not for refundings of bonds issued prior to the date of enactment of ARRA. For this purpose, a new money financing could include reimbursement of capital expenditures originally paid or incurred after the effective date of ARRA (2/17/09) to the same extent as applies to Direct Payment BABs.

By issuing Direct Payment BABs as RZED Bonds, the issuer is entitled to federal subsidy payments of 45% of the interest payable on the bonds. As is the case for Direct Payment BABs generally, these subsidy payments can be made directly to the bond trustee or paying agent for the bonds to apply to pay the interest on the bonds. See **"Payment Procedures for Direct Payment BABs and RZEDs"** below.

The national limitation on the amount of RZED Bonds that can be issued is \$10 billion. This limitation is allocated among the states based upon their relative decline in employment in 2008, with each state being allocated a minimum of 0.9% of the national limitation (\$135 million). Each state's allocation is then entirely sub-allocated among counties and "large municipalities" (defined as municipalities with populations of more than 100,000) in proportion to the 2008 employment declines in such counties and municipalities.

IRS Notice 2008-50 sets forth the allocations to the states. Sub-allocations to counties and large municipalities are set forth at <http://www.irs.gov/taxexemptbond/index.html> under the heading "IRS Releases Guidance on ARRA Bond Provisions".

"Recovery zones" are defined as including: (i) any area designated by an issuer as having significant poverty, unemployment, rate of home foreclosures or general distress, (ii) any area designated by the issuer as economically distressed due to the closure or realignment of a military installation pursuant to the Defense Base Closure and Realignment Act of 1990, or (iii) any area which has been designated as an empowerment zone (e.g. Syracuse, Yonkers and New York City) or a renewal community (e.g. Buffalo-Lackawanna, Jamestown, Niagara Falls, Rochester, and Schenectady). Since the designation of recovery zones is largely to be made by each individual issuer, there is a fair amount of flexibility as to where and what types of projects can be financed with these bonds.

Projects financed with RZED Bonds are subject to Davis-Bacon prevailing wage rules.

3. Payment Procedures for Direct Payment BABs and RZEDs.

On April 3, 2009 the IRS issued Notice 2009-26, which sets forth the procedures applicable for 2009 with respect to federal subsidy payments payable on Direct Payment BABs and RZED Bonds. In order to request for a federal subsidy payment with respect to the interest payable on a Direct Payment BAB on an RZED Bond on a particular interest payment date, the issuer must file new Form 8038-CP. The IRS will start accepting the forms for processing by May 1, 2009. The IRS will be prepared to make timely payments with respect to interest payments dates occurring on or after July 1, 2009.

The payment procedure varies depending on whether the bonds are fixed rate or variable rate. For fixed rate bonds, the federal subsidy payment will be made on contemporaneous basis to the applicable interest payment date, provided the Form 8038-CP for such interest payment date is filed with the IRS no later than 45 days and no earlier than 90 days prior to applicable interest payment date. In the Form 8038-CP the issuer can designate that the payment be made directly to the trustee or paying agent for the bonds. For variable rate bonds the federal subsidy payments will be made on a reimbursement basis only. The issuer must aggregate all federal subsidy payments on a quarterly basis and file for reimbursement in arrears for interest paid during the quarter. In the case of a variable rate issue, the due date for filing the Form 8038-CP is 45th day after the last interest payment date within the quarterly period for which reimbursement is requested.

The IRS has indicated that in future years it will likely set up a system for making the federal subsidy payments using an economic platform similar to SLGs.

4. Expansion of Qualified Tax Credit Bonds

ARRA extends and expands the legislative authority for several existing types of qualified tax credit bonds (qualified zone academy bonds, new clean renewable energy bonds, and qualified energy conservation bonds) and creates a new type of qualified tax credit bond called qualified school construction bonds.

a. General Rules Applicable to All Qualified Tax Credit Bonds

A qualified tax credit bond is a type of taxable bond that entitles the bondholder as of each quarterly credit allowance date (March 15th, June 15th, September 15th and December 15th) to a tax credit equal to 25% of the annual credit determined for that bond. The annual credit is established by multiplying the applicable credit rate for the bond by its outstanding face amount. The "credit rate" is determined by the Secretary of the Treasury on the date the bonds are initially sold. For some types of qualified tax credit bonds the credit rate is equal to the rate that will permit the bonds to be sold at par without any interest cost to the issuer, thus resulting in the issuer receiving a 100% interest subsidy from the federal government. For other types of qualified tax credit bonds the credit rate is only 70% of the rate that would allow the bonds to sold at par with a zero interest cost to the issuer, thus resulting only a 70% interest subsidy to the issuer. The credit rate is determined based on general assumptions as to the credit quality of different classes of issuers, and may take into account general market yield indexes and credit ratings. The credit rate is published daily by the Bureau of the Public debt on its TreasuryDirect web site (http://www.treasurydirect.gov/govt/rates/irs/rates_qtcb.htm). During April, 2009 the credit rate has ranged between 7.57% and 7.94%. As of April 29th, the credit rate was 7.92%

The tax credit received by the holders of qualified tax credit bonds may be taken against both the ordinary federal income tax and the alternative minimum tax. The amount of the tax credit is included in gross income as interest income.

In order to constitute a qualified tax credit bond, the issuer must reasonably expect as of the issue date that 100% of the “available project proceeds” of the bonds will be spent on qualifying projects (determined by type of qualified tax credit bond) within 3 years of the date of issuance. “Available project proceeds” are the sale proceeds of the bonds less costs of issuance (not to exceed 2%) plus interest earnings on the sale proceeds. In the event all of the available project proceeds are not spent within 3 years, the bonds will still be considered qualified tax credit bonds if the issuer applies the unspent proceeds within 90 days to redeem bonds.

The proceeds of qualified tax credit bonds may be applied to reimburse a prior expenditure, provided the original expenditure was paid after the date on which the issuer received a volume cap allocation with respect to the bond issue, and provided a prior to the payment of the original expenditure the issuer declared its intent to reimburse the expenditure with the proceeds of a qualified tax credit bonds, and reimbursement is made within 18 months of the date of the original expenditure.

The maturity date of qualified tax credit bonds is the date determined by the Secretary of the Treasury that results in the present value of the obligation to repay the principal of the bonds being equal to 50% of the face amount of the bonds, using as a discount rate the average annual interest rate on tax-exempt bonds with maturities of 10 years or more that are issued during the month the qualified tax credit bonds are issued. During April, 2009 required maturity set by Treasury was 14 years.

b. Qualified School Construction Bonds

ARRA creates a new type of qualified tax credit bond called “qualified school construction bonds” (“**QSCBs**”). In order to qualify as QSCBs, a bond issue must satisfy the following three requirements: (1) the “available project proceeds” (see definition above) must to be used for construction, rehabilitation or repair of a public school facility, including the acquisition of equipment to be used within the financed facility or for the acquisition of land on which the financed facility will be constructed, (2) the public school is located within the jurisdiction of the state or local government issuing the bonds and (3) the issuer designates the bonds as qualified school construction bonds. Refunding bonds cannot be issued as QSCBs.

The national volume cap on QSCBs is \$11 billion for each of the years 2009 and 2010. Forty percent (\$4.4 billion) of the national volume cap is to be allocated to certain large school districts including the 100 school districts with the highest number of children from families below the poverty level and up to an additional 25 school districts determined by the Secretary of Education as being in particular need of assistance (based upon low levels of resources for school construction, a high level of enrollment, and other factors as considered by the Secretary of Education). The remaining portion of the volume cap for each year (after deducting certain special allocations to US possessions other than Puerto Rico) is to be allocated among the states (which for this purposes includes the District of Columbia and all any possession of the US) in the same proportions that the states are allocated aid under Section 1124 of the Elementary and Secondary Education Act of 1965 for the most recent prior fiscal year. Any unused portions of a state’s allocation can be carried forward to the next year.

Of the total volume cap, New York State received an allocation \$192 million for reallocation to issuers within the State. In addition, the only school districts in New York that received a direct allocation of volume cap were New York City (\$699.872 million), Buffalo City School District (\$34.37 million) and Rochester City School District (\$29.535 million).

Projects financed with QSCBs are subject to Davis-Bacon prevailing wage rules.

c. Qualified Zone Academy Bonds

ARRA extends the authority to issue qualified zone academy bonds (“QZABs”) through the end of 2010 and increased the annual volume cap on these types of bonds from \$400 million to \$1.4 billion. The volume cap is to be allocated among the states in accordance with their respective populations that are below the poverty line. New York’s 2009 QZAB volume cap allocation is \$90,020,000.

QZABs can be used to finance, with respect to qualifying schools or school programs, the rehabilitation, repair and equipping of a public school facilities, the development of course materials, and the training of teachers and other school personnel.

Projects financed with QZABs are subject to Davis-Bacon prevailing wage rules.

d. New Clean Renewable Energy Bonds.

ARRA increases the national limitation on New Clean Renewable Energy Bonds (“New CREBs”) from \$800 million to \$2.4 billion. The nationwide limitation is to be allocated to qualifying projects by the Secretary of the Treasury. New CREBs can be issued to finance capital expenditures incurred by state or local governmental body, a municipal utility, or cooperative electric company with respect to a “qualified renewable energy facilities”. These include: wind facilities, closed-loop biomass facilities, open-loop biomass facilities, geothermal or solar energy facilities, small irrigation power facilities, landfill gas facilities, trash burning electric generation facilities, qualified hydropower facilities, and marine and hydrokinetic renewable energy facilities.

Projects financed with New CREBs are subject to Davis-Bacon prevailing wage rules.

e. Qualified Energy Conservation Bonds

ARRA increases the national limitation qualified energy conservation bonds from \$800 million to \$3.2 billion. The national limitation is allocated among the states in proportion to their respective populations. Each county and municipality in a state having a population of 100,000 or more is allocated a portion of such state’s allocation determined by multiplying the state’s allocation by the percentage of the state’s population located in such county or municipality. At least 70% of the allocation provided to each such county and municipality and at least 70% of the allocation retained by the state must be applied to bonds that are not private activity bonds. For qualified energy conservation bonds that are private activity bonds, all of the available project proceeds must be spent on capital expenditures.

Qualified energy conservation bonds can be issued to finance any of the following:

- (i) capital expenditures incurred for purposes of reducing energy consumption in publicly-owned buildings by at least 20%, implementing green community programs, rural development involving the production of electricity from renewable energy resources, or any of the facilities that are eligible for the production tax credit (other than Indian coal and refined coal facilities);
- (ii) expenditures with respect to research facilities or research grants to support research in: (a) the development of cellulosic ethanol or other nonfossil fuels, (b) technologies for the capture and sequestration of carbon dioxide produced through the use of fossil fuels, (c) increasing the efficiency of existing technologies for producing nonfossil fuels, (d) automobile battery technologies or other technologies to reduce fossil fuel consumption in transportation, and (e) technologies to reduce energy use in buildings;
- (iii) mass commuting facilities and related facilities that reduce the consumption of energy, including expenditures to reduce pollution from vehicles used for mass commuting;

- (iv) demonstration projects designed to promote the commercialization of (a) green building technology, (b) the conversion of agricultural waste for use in the production of fuel, (c) advanced battery manufacturing technologies, (d) technologies to reduce peak use of electricity, or technologies for the recapture and sequestration of carbon dioxide emitted from burning fossil fuels to produce electricity; and
- (v) public education campaigns to promote energy efficiency.

Projects financed with qualified energy conservation bonds are subject to Davis-Bacon prevailing wage rules.