HOUSE FISCAL AGENCY

MEMORANDUM

DATE: April 21, 2010

TO: All Interested Parties

FROM: Ben Gielczyk, Fiscal Analyst and Mark Wolf, Senior Fiscal Analyst

RE: House Bill 6045

Tax Credit Bonds

In general, there are three types of tax-preferred bonds used by states and local governments: (1) tax-exempt bonds, (2) tax-credit bonds, and (3) direct-pay tax-credit bonds. Tax-exempt bonds (the predominant type) pay interest to the bondholder that is exempt from federal income tax. Tax-credit bonds provide bondholders with a tax credit, rather than paying them interest payments. Direct-payment tax-credit bonds, require the federal government to make direct payments to the bond issuer (e.g. state or local government) based on the issuer's interest payments to bondholders. Tax-credit bonds subsidize the issuer's borrowing costs.

For most tax-credit bonds, the bondholder (taxpayer) holding a bond on certain days of the year ("credit allowance date") is entitled to a tax credit equal to face amount of the bond multiplied by a "credit rate". The credit rate is determined by the U.S. Treasury, Bureau of the Public Debt, and is set a rate that allows the bond to be issued without discount and with interest cost to the issuer. Whereas the interest received from traditional tax-exempt municipal bonds is not includible in a bondholder's (taxpayer's) gross income, the tax-credit received is includible.[1]

Qualified Energy Conservation Bonds

Qualified Energy Conservation Bonds (QECBs) are form of tax credit bond that may be issued by states and local units of government to finance certain energy conservation purpose. The QECBs enable states, local governments, and tribal governments to issue interest-free financing for qualified energy conservation projects, including (1) capital expenditures to reduce energy consumption in public buildings by 20%, implementing green community programs[2] and rural development involving the production of electricity from renewable energy; (2) research expenditures related to cellulosic ethanol and other non-fossil fuels, capture and sequestration of carbon dioxide, improved efficiencies in the production of non-fossil fuels; (3) mass commuting facilities; (4) demonstration projects to promote the commercialization of green building technologies, the conversion of agricultural waste to a useful energy source, advanced battery technologies, and others.[3]

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[1] For a review of tax-credit bonds see, Steven Maguire, *Tax Credit Bonds: A Brief Explanation*, Congressional Research Service, RL34629, August 20, 2008, available publicly at [http://assets.opencrs.com/rpts/RL34629_20080820.pdf]. See also, Steven Maguire, *Tax Credit Bonds: Overview and Analysis*, Congressional Research Service, R40523, April 16, 2009, available publicly at, [http://assets.opencrs.com/rpts/R40523_20090416.pdf]. See, also, *Subsidizing Infrastructure Investment with Tax-Preferred Bonds*, Congressional Budget Office and Joint Committee on Taxation, October 2009, [http://www.cbo.gov/ftpdocs/106xx/doc10667/10-26-TaxPreferredBonds.pdf]. See, also, *Tax-Credit Bonds and the Federal Cost of Financing Public Expenditures*, Congressional Budget Office, July 2004, [http://www.cbo.gov/ftpdocs/56xx/doc5624/07-08_TaxCreditBonds.pdf].

[2] The term "green community programs" is not defined in IRC-54D and does not appear anywhere else within the Energy Improvement and Extension Act of 2008.

[3] For an overview of QECBs and other tax-subsidized bonds used for energy projects see, *Tax-Subsidized Financing Options for Energy Projects and Programs*, Orrick, Herrington, and Sutcliffe, LLP, [http://www.orrick.com/fileupload/2084.pdf].

The Energy Improvement and Extension Act of 2008 (PL 110-343) first authorized the issuance of $800.0 million in QECBs nationwide.[4] This bond cap was increased to $3.2 billion with the enactment of the American Recovery and Reinvestment Act of 2009, PL 111-5.[5] The national bond cap volume is allocated to the states by the U.S. Department of Treasury, with Michigan's QCEB allocation totaling $103,780,000.[6] The state allocation is then allocated to "large local governments" - i.e. those with a population of 100,000 or more.[7]

As with other types of municipal bonds, issuers of QECBs repay the principal on a regular repayment schedule. Each month the U.S. Treasury, Bureau of the Public Debt sets the maximum maturity for QECBs priced during that month.[8] As a type of tax credit bond, the bondholder (purchaser) of a QECB is entitled to a tax credit equal to the "credit rate" multiplied by the face value of the bond. The credit, in the case of QECBs, is equal to 70% of the rate the rate, published by the Bureau of the Public Debt, that would permit the issuance of such bonds without discount and interest cost to the issuer. This credit is includable in the bondholder's gross income when determining federal tax liability. Under the Hiring Incentives to Restore Employment Act, PL 111-147, issuers of QECBs are permitted to make an irrevocable election (before the issuance date) allowing for a direct interest subsidy from the federal government payable to the issuer, in lieu of providing the tax credit that would otherwise be available to bondholders.[9] This change is said to improve the attractiveness of QECBs to bondholders.

Qualified School Construction Bonds

Created by Section 1521 of the American Recovery and Reinvestment Act of 2009 (ARRA), the Qualified School Construction Bond (QSCB) program is a federal program which allows public schools to finance the construction, rehabilitation, or repair of a public school facility or for the acquisition of land on which a facility is to be constructed on an interest-free basis. The lender receives a Federal tax credit in place of an interest payment.

Under the Act, $11.0 million was allocated for both 2009 and 2010 for a total of $22.0 million nationally. Michigan is scheduled to receive over $296.0 million in financing. The obligations must follow specific criteria:

- The district must spend 10 percent of its allocation within 6 months and all of the allocation within 3 years of bond issuance

- Each district is capped at $15.0 million and the allocations are provided on a "first come, first serve" basis. If, after 9 months of the announcement of the allocation, there are funds remaining, the school district can apply for a waiver to exceed its $15.0 million cap.

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[4] See Division B, Title III (Energy Efficiency and Renewable Energy Provisions), Section 302, of the Tax Extenders and Alternative Minimum Tax Relief Act of 2008. The section is now codified at Section 54D of the Internal Revenue Code, 26 USC 54D.
[5] See Division B (Tax, Unemployment, Health, State Fiscal Relief, and Other Provisions), Title I (Tax Provisions), Subtitle B (Energy Provisions), Part II (Increased Allocations of New Clean Renewable Energy Bonds and Qualified Conservation Bonds), Section 1112. See, also, the Joint Explanatory Statement of the Committee on Conference, [http://appropriations.house.gov/pdf/Recovery_JS_DivB.pdf].
[6] IRS Notice 2009-29, [http://www.irs.gov/pub/irs-drop/n-09-29.pdf].
[7] For the purpose of allocating QECB authority to counties, the population of an eligible local unit is excluded from the county population in determining whether its population is greater than 100,000. The population figure used for the purpose of allocating QECB is the population as of July 1, 2007, according the U.S. Bureau of the Census.
[8] http://wwww.treasurydirect.gov
[9] See, *Technical Explanation Of The Revenue Provisions Contained In Senate Amendment 3310, The "Hiring Incentives To Restore Employment Act," Under Consideration By The Senate*, Joint Committee on Taxation, JCX-4-10, February 23, 2010, [http://www.jct.gov/publications.html?func=startdown&id=3648]

- School districts must consult with legal counsel to ensure that their proposal is in compliance with federal and state, rules, guidelines, and regulations.

- Districts must verify with bond counsel that the proceeds of the QSCBs are used for purposes permitted under federal and state law.

Recovery Zone Economic Development Bonds

The Recovery Zone Economic Development Bonds (RZEDBs) were created under ARRA as a new type of taxable governmental bond. They provide issuers with a direct 45 percent federal interest subsidy or provide bondholders with a tax credit of 45 percent of the interest payable. To qualify as a RZEDB all of the project proceeds of the issue have to be used in a designated Recovery Zone for qualified economic development purposes. The bonds may be issued for purposes of promoting development or other economic activity, which may include capital expenditures, public infrastructure construction, and job training and educational programs. Private business may not be the direct beneficiary of these bonds, but the infrastructure constructed or improved may house private business.

A Recovery Zone is a zone includes the following:

- An area designated as having significant poverty levels, unemployment, rate of home foreclosures or general distress

- An area designated as economically distressed by reason of closure or realignment of a military installation pursuant to the Defense Base Closure and Realignment Act of 1990.

- An area currently designated as an Empowerment Zone or Renewal Community.

- In Michigan, recovery zones may include, but are not limited to, renaissance zones, TIF districts, etc.

Michigan has received approximately $773.0 million of RZEDB allocation. Allocations to the counties and cities were determined by a federal formula according to relative employment declines in 2008. Local governments may return all or part of their allocation to the state to be used elsewhere for the benefit of the State. In Michigan, allocations have been made to all counties along allocations to the cities of Ann Arbor, Detroit, Flint, Grand Rapids, Lansing, Sterling Heights, and Warren.

There are numerous benefits to the RZEDBs, which include:

- Forty-five percent of interest cost comes back to jurisdiction as refundable credit to the issuer;

- Could be easier to sell due to larger investor market for taxable bonds; and

- All of the interest could be lower than traditional tax-exempt financing.

Aggregating RZEDB financings into one large bond issuance through the Michigan Municipal Bond Authority may provide cost benefits to the cities and counties included in the bond pool due to the taxable market preferring larger issues. Other benefits include

- Lower interest costs;

- Deliver proceeds quickly by accessing an assembled bond financing team; and

- Lower administrative costs over the life of the bond financing.

Projects financed with RZEDBs are subject to federal prevailing wage laws.

Recovery Zone Facility Bonds

The Recovery Zone Facility Bonds (RZFBs) were created under ARRA as a type of private activity bond which allows units of government to provide tax-exempt financing to private borrowers. A special feature of these bonds is that they can be used for commercial and industrial projects which historically would not qualify for tax-exempt financing (includes manufacturing plants, distribution centers, hotels, and research parks). Recovery Zone Facility Bonds are not subject to the $10.0 million cap on other Industrial Development Bonds (IDBs). Moreover, the $20.0 million cap applicable to other types of private activity bonds does not apply unless the taxpayer has another private activity bond program.

The bond proceeds are eligible to be used for depreciable property in a recovery zone provided the following is present:

- The recovery zone must have been designated prior to the property being constructed, renovated, reconstructed, or acquired by purchase;

- The original use of the property in the recovery zone commences with the taxpayer; and

- "Substantially all" of the property is used for a qualified business purpose by the taxpayer.

In Michigan, the primary issuers of the bonds will be county economic development corporations and the Michigan Strategic Fund. While RZFBs are not subject to the federal prevailing wage laws like the RZEDBs, if a local economic development corporation issues the bonds, the project is subject to the Michigan prevailing wage law.

Michigan has received approximately $1.2 billion of RZFB volume allocation.

Please call if you have questions about this information.