CDIAC # 09-05

THE AMERICAN RECOVERY *and* REINVESTMENT ACT OF 2009

FINANCING OPPORTUNITIES FOR CALIFORNIA'S PUBLIC AGENCIES

A Partnership of

THE CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION *and*
CALIFORNIA INFRASTRUCTURE AND ECONOMIC DEVELOPMENT BANK

“ My administration is committed to working with President Obama to develop strategies to revitalize our economy, put the nation on a path to energy security and help our citizens during this difficult time. ”

-GOVERNOR ARNOLD SCHWARZENEGGER

INTRODUCTION

In response to the national recession and global credit crunch, Congress authorized new incentives for state and local governments to issue bonds. The authorization, provided under the American Recovery and Reinvestment Act (Recovery Act) of 2009, is for a limited time and is intended to expedite economic recovery in the US. California governments may have access of up to $50 billion in incentives for the next 18 months.*

Many of the instruments are unusual in their marketability, as they are intended to attract a different kind of investor for municipal bonds. Other instruments are revisions to existing federal bond programs. In any event, federal regulations and application procedures are rapidly developing and timelines for accessing the federal incentives are short. This guide is intended to help state and local debt managers identify those Recovery Act programs best suited to their particular situation, and to help them make a timely application.

The Recovery Act made general changes to conditions under which municipal governments may issue debt, created new bond instruments and extended existing bond programs. This guide discusses each of these changes, specifically:

- **PAGE 5: GENERAL CHANGES TO THE PUBLIC FINANCE MARKET.** Describes the tax and regulatory changes contained in the Act to

*Does not include approximately $35 billion in tax benefits.

improve the municipal debt market. These changes can affect all types of debt issued by state and local governments.

- **PAGE 9: NEW BOND PROGRAMS.** The Recovery Act authorized a new bond instrument, Build America Bonds, that have unique incentives for increasing municipal debt affordability. It also authorized Recovery Zone Bonds, a new instrument intended to increase the amount of debt finance available in economically stressed geographic areas.
- **PAGE 13: TAX-CREDIT BOND PROGRAMS.** Current law affords education and energy programs access to tax credits. The Recovery Act provided new incentives for the use of these tax credit programs for the purpose of expanding economic activity.

OVERVIEW OF THE AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009

The Recovery Act signed into law by President Obama on February 17th, 2009, includes measures to modernize infrastructure, enhance energy independence, expand educational opportunities, preserve and improve affordable health care, provide tax relief, and protect those in greatest need. The Obama Administration expects that the Recovery Act will create or save three to four million jobs, 90 percent of them in the private sector. It will provide more than $150 billion to low-income and vulnerable households – spurring increased economic activity that will save or create more than one million jobs.

These measures proposed in the Recovery Act were deemed necessary by our nation's leaders to help the millions of families and communities who have been upended by the economic crisis. Passage of the Recovery Act is intended to do more than provide short-term stimulus; by modernizing health care, improving schools, modernizing infrastructure, and investing in the clean energy technologies, the Recovery Act will lay the foundation for a robust and sustainable 21st century economy.

CALIFORNIA FEDERAL ECONOMIC STIMULUS TASK FORCE

The Governor created the California Federal Economic Stimulus Task Force (Task Force) to navigate federal funding, and to ensure efficiency, accountability and transparency of Recovery Act funding coming into the state. This Task Force is working with President Barack Obama's administration to help cities, counties, non-profits, and others in California to access available funding, ensure that the funding funneled through the state is spent efficiently and effectively, and maintain a website that tracks stimulus dollars. The state estimates that it currently stands to receive approximately $85 billion from the Recovery Act – approximately $50 billion in education, infrastructure and other spending, and $35 billion in tax benefits.

RESOURCE

RECOVERY ACCOUNTABILITY AND TRANSPARENCY BOARD
www.recovery.gov

CALIFORNIA FEDERAL ECONOMIC STIMULUS TASK FORCE
www.recovery.ca.gov
(916) 322-4688

GENERAL CHANGES TO THE PUBLIC FINANCE MARKET

The numerous municipal bond initiatives contained in the Recovery Act reflect some of the biggest changes to revenue bond financing since the 1986 Tax Bill. The Recovery Act provides significant assistance to state and local governments for initiatives relating to economic development, education, infrastructure, transportation, and renewable energy. These changes, although temporary, expand the availability and marketability of various types of governmental bonds opportunities for public agencies in calendar years 2009 and 2010.

The US Department of Treasury and the Internal Revenue Service (IRS) are responsible for executing the tax provisions of the Recovery Act and preparing guidance for implementation of the municipal bond programs, as well as others made by the Recovery Act. At this time guidance is not available for every program affected by the Recovery Act. Below is a summary of the Recovery Act provisions that impact the municipal market:

DELAYS WITHHOLDING ON GOVERNMENT PAYMENTS. The Recovery Act delays implementation of the three percent withholding on government payments law. This law mandates that governments that spend more than $100 million a year on goods and services withhold three percent from most payments made to a vendor or contractor and remit that money to the IRS. The Recovery Act changes the effective date of this law to January 1, 2012.

INCREASES BANK QUALIFIED DEBT LIMIT. The Recovery Act increases the small issuer bank qualified debt limit exception from $10 million to $30 million. This increase is intended to restore bank demand and provide some stability to the municipal bond market by bringing this group of institutional investors back into the market.

PROVIDES INCENTIVES FOR BANKS TO PURCHASE ALL TYPES OF BONDS. Since 1986, banks have been able to deduct only the carrying costs of bank-qualified bonds. The Recovery Act allows banks to deduct 80 percent of the carrying costs of purchasing all types of newly issued bonds, up to two percent of the bank's total assets.

ELIMINATES AMT ON PRIVATE ACTIVITY AND GOVERNMENTAL BONDS. The interest on private activity bonds and some governmental bonds is not deductible for individuals and corporations, who must pay the alternative minimum tax (AMT). The Recovery Act eliminates the application of the AMT on bonds issued in 2009 and 2010, and the refunding of bonds that were initially issued after December 31, 2003.

Note: In addition to the two-year reprieve of AMT application on private activity bonds included in the Recovery Act, legislation to permanently exempt the application of the AMT on private activity bonds has been introduced in both the Senate (S. 138) and the House of Representatives (H.R. 425).

The latest guidance, forms and information on the Recovery Act bond provisions are available online at the IRS website, **www.irs.gov**.

“The funding will help secure thousands of jobs for workers and millions of dollars in revenues for businesses which depend on infrastructure projects. And with the Build America Bonds, we're providing this much-needed economic stimulus at a substantial savings for taxpayers.”

-BILL LOCKYER, CALIFORNIA STATE TREASURER
ON CALIFORNIA'S SALE OF $5.23 BILLION
OF BUILD AMERICA BONDS

NEW BOND PROGRAMS (TAXABLE AND TAX-EXEMPT)

BUILD AMERICA BONDS (BABS)

This new program authorized by the Recovery Act allows state and local governments to issue taxable bonds in 2009 and 2010 to finance any capital expenditures for which they otherwise could issue tax-exempt governmental bonds. Under the Recovery Act issuers can elect to issue either taxable tax credit or tax-exempt bonds for governmental purposes. The taxable tax-credit bond option would allow issuers to receive a 35 percent reimbursement of interest paid from the federal government OR provide a 35 percent tax credit to investors.

The subsidies take the form of either tax credits provided to holders of the bonds or refundable tax credits paid to state and local governmental issuers of the bonds. There is no volume limitation on the amount of BABs that can be issued during this period. These are new taxable bond options for public issuers and all tax laws applicable to tax-exempt bonds would apply to the taxable bonds.

This new program is intended to assist state and local governments in financing capital projects at lower borrowing costs and to stimulate the economy and create jobs. BABs with different levels of Federal subsidies and program requirements are described below:

BUILD AMERICA BONDS (DIRECT PAYMENT). Provide a Federal subsidy through a refundable tax credit paid directly to the state or local governmental issuer by the Treasury Department and the Internal Revenue Service (IRS) in an amount equal to 35 percent of the total coupon interest payable to investors in these taxable bonds. The level of the 35 percent Federal interest subsidy by Direct Payment is deeper than the corresponding approximately 25 percent Federal interest subsidy on

BABs (Tax Credit) as described below. The Direct Payment subsidy can cut interest rates to below rates of tax-exempt securities.

BUILD AMERICA BONDS (TAX CREDIT). Provide a Federal subsidy through Federal tax credits to investors of BABs in an amount equal to 35 percent of the total coupon interest payable by the issuer on taxable governmental bonds (net of the Tax Credit), which represents a Federal subsidy to the state or local governmental issuer equal to approximately 25 percent of the total return to the investor (including the coupon interest paid by the issuer and the Tax Credit). If the tax credit to investors option is taken, the Tax Credit may be stripped from the underlying bonds.

For more information, view IRS Notice 2009-26 at **www.irs.gov**.

RECOVERY ZONE BONDS

This is a new category of private activity bond that has been created for use in "recovery zones," which are designated areas with significant unemployment, poverty and home foreclosure rates. The bonds, which must be issued before January 1, 2011, would have to be used for economic development within a "recovery zone," defined as an area "having significant poverty, unemployment, home foreclosures, or general distress" or an area currently defined as an empowerment zone. Borrowing authority under this bond program would be allocated among states on the basis of relative job loss in 2008, with greater authority going to states that lost proportionately more jobs. Authority within each state would be allocated among metropolitan areas and counties on a similar basis. Each state would receive at least 0.9 percent of the aggregate allocation for each of the two types of Recovery Zone Bonds.

Similar to BABs, Recovery Zone Bonds also have tax-exempt and taxable program components, as described below:

RECOVERY ZONE ECONOMIC DEVELOPMENT BONDS. A taxable bond option available to public agencies to promote economic development in a defined recovery zone. These are government bonds to be issued for governmental purposes of promoting development or other economic activity including public infrastructure and construction of public facilities or job training and educational facilities. In this program, the issuer is the sole recipient of the Federal subsidy (a percentage of the interest cost); the issuer cannot choose to give the tax credit to the investor. The subsidy amounts to a refundable credit equal to 45 percent of interest costs. This program is similar in structure to the Direct Payment of BABs; however only $10 billion in bonds has been authorized for this purpose. Recovery Zone Economic Development Bonds must be issued in 2009 and 2010.

RECOVERY ZONE FACILITY BONDS. A new category of exempt facility bonds for the acquisition of property within a recovery zone for the use of a "qualified business." A qualified business is defined to include any trade or business except residential rental facilities or other specifically listed "bad projects," for example golf courses, massage parlors, and gambling facilities. Counties and large municipalities can issue these bonds for projects that would not historically qualify for tax-exempt financing; for example, large manufacturing plants, distribution centers, hotels, and research parks can be financed with these bonds. The Recovery Act authorized $15 billion Recovery Zone Facility Bonds to be issued by January 1, 2011.

Recovery Zone Facility Bonds may be issued for any depreciable property:

(a) that was acquired after the date of designation of a recovery zone,

(b) the original use of which occurs in the recovery zone; and,

(c) substantially all of the use of the property is in the active conduct of a qualified business.

There is no prohibition on acquiring existing property. State private activity bond volume limits do not apply to Recovery Zone Facility Bonds.

For more information, view IRS Notice 2009-26 at **www.irs.gov** (RZED Bonds only).

RESOURCES

INTERNAL REVENUE SERVICE
www.irs.gov

US DEPARTMENT OF TREASURY
www.ustreas.gov

TAX-CREDIT BOND PROGRAMS

Passage of the Recovery Act significantly expanded the available tax-credit bond programs for state and local public agencies. Under a tax-credit bond program, a public agency issues a taxable bond, and the investor receives a tax credit at a rate set by the Treasury.[1] These programs are intended to provide an interest-free loan to the public agency issuer, since they are only responsible for paying the principal of the bond. In 2008, Congress amended the tax credit bond rules to permit tax credits to be sold separately from the related bond; a "stripping" provision would increase the benefits and marketability of tax credit bonds.

Tax credit bond programs have typically been small compared to the total volume of the tax-exempt bond market and have been targeted for specific purposes, such as rebuilding after natural disasters like Hurricane Katrina. While the Recovery Act increases annual allocation amounts and creates a new program, these changes are currently limited by time and must be issued before January 1, 2011. The new and expanded programs are focused on education and energy.

[1] These bonds are not like tax-exempt bonds, which allow the investor to exclude interest on state and local government-issued tax-exempt bonds from gross income on their federal return.

QUALIFIED SCHOOL CONSTRUCTION BONDS. Created as a new category of tax credit bonds to help fund school construction, rehabilitation, repair, and land acquisition. The Recovery Act authorizes $22 billion to be issued under this program ($11 billion allocated initially in 2009 and the remainder allocated in 2010). Under the program, 100 percent of bond proceeds, including investment earnings, must be spent on qualified purposes within three years of bond issuance. Up to two percent of bond proceeds can be used to pay issuance costs, but cannot be used for a reserve fund.

This is a zero-interest bond program that allows the bondholder to receive a return on investment as a credit against its federal tax liability. Effectively, the federal government is providing interest-free loans to schools and districts to finance school construction efforts. It is estimated that these bonds will save schools nearly $10 billion in taxes over the next 10 years. As an issuer of a qualified school construction bond, the county/school district would pay the principal only to the bondholder. The rate of the federal tax credit is set by the Treasury Department (tax credit = principal x credit rate).

Based on the Recovery Act, 40 percent of the annual allocation will be distributed to the 100 local education agencies (LEAs) with the most students living in poverty and the remaining 60 percent to other LEAs based on the distribution of Title I Part A Basic Education Grants. For 2009, $4.4 billion was allocated to the 100 LEAs with the most students living in poverty and the remaining $6.6 billion was allocated to state education agencies to be distributed to the other LEAs within each state.[2] California received a state allocation of $773.5 million.

For more information, view IRS Notice 2009-35 at **www.irs.gov**.

QUALIFIED ZONE ACADEMY BONDS (QZABS). An existing tax credit bond program for financing school renovations, equipment purchases, developing course material, and training teachers and personnel at a "qualified zone academy." In general, a "qualified zone academy" is any public school (or academic program within a public school) that is located in a federally designated empowerment zone or enterprise community (per US Housing and Urban Development designation), and is designed to cooperate with businesses to enhance the academic curriculum and increase graduation and employment rates. None of the proceeds can be used for new construction or land acquisition, how-

[2] IRS Notice 2009-35.

ever. Schools are also eligible to take advantage of the QZAB program if at least 35 percent of students enrolled are eligible for free or reduced priced school lunches.

The Recovery Act increased bond allocations from $400 million annually to $1.4 billion for federal fiscal year (FY) 2009 and $1.4 billion for FY2010. QZABs offer a federal tax credit in lieu of interest investors solely to the investor (not the public agency). In order to utilize the QZAB program, a school district must have written commitment for a 10 percent match from a private business.

For more information, view IRS Notice 2009-30 at **www.irs.gov**.

ENERGY

CLEAN RENEWABLE ENERGY BONDS (CREBS). Tax credit bonds allocated directly by the Treasury Department. Eligible applicants apply to the Treasury Department. The Recovery Act allocated $2.4 billion for the CREBs program, subdivided into thirds: one-third for state, local, and tribal governments; one-third for qualifying projects of public power providers; and one-third for qualifying projects of electric cooperatives. Applications for CREBs projects are currently available and must be filed with the IRS by August 4, 2009.

For more information, view IRS Notice 2009-33 at **www.irs.gov**.

QUALIFIED ENERGY CONSERVATION BONDS (QECBS). Tax credit bonds (the tax credit is provided solely to the investor) that may be used for specific "qualified conservation purposes" as outlined in the guidance. Collectively the Recovery Act allocated $3.2 billion; California was allocated $381,329,000. The limits provided in the Recovery Act apply to QECBs issued pursuant to the national bond volume cap after October 3, 2008.

For more information, view IRS Notice 2009-29 at **www.irs.gov**.

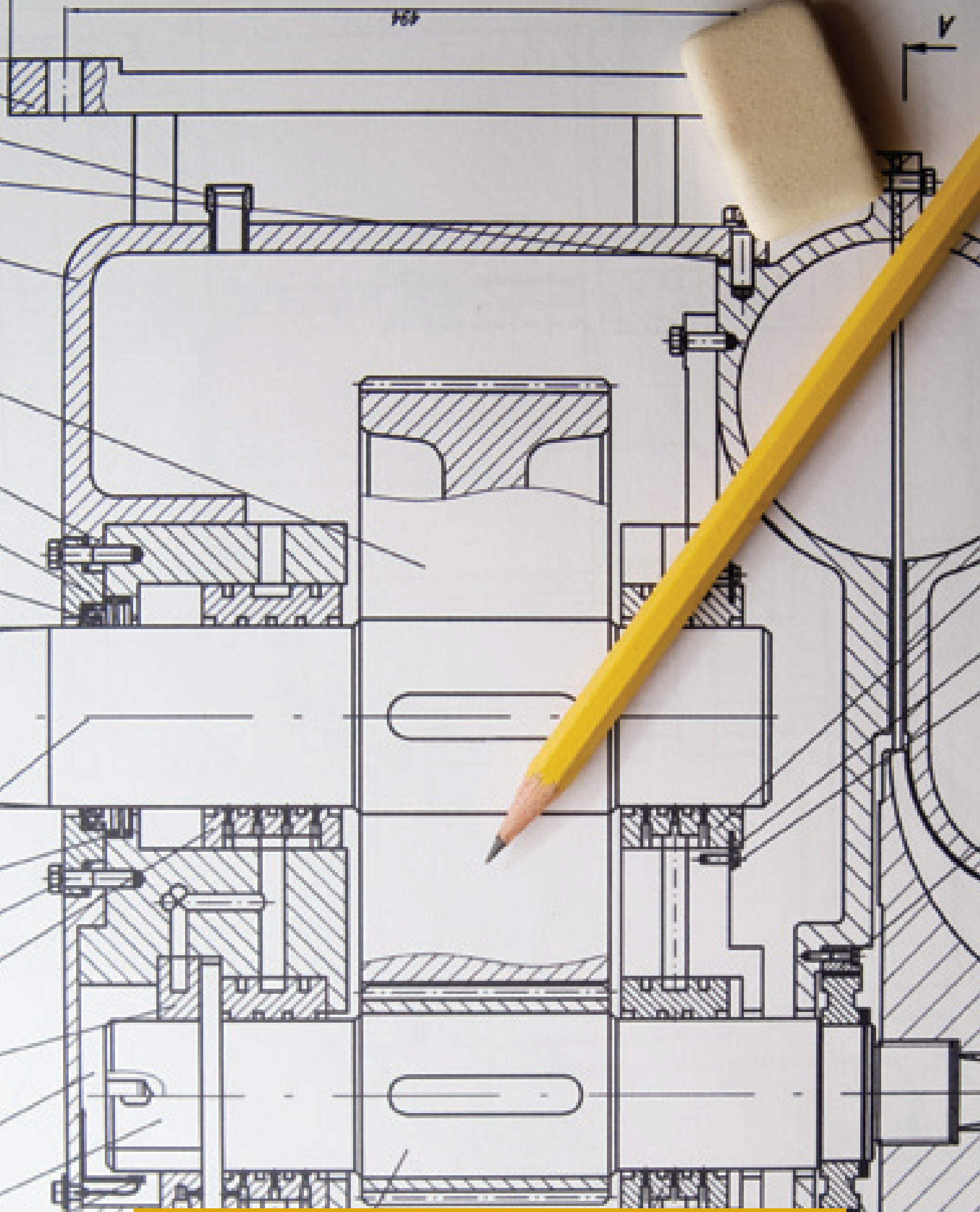
RESOURCES

NATIONAL SCHOOL BOARD ASSOCIATION
www.nsba.org

US DEPARTMENT OF EDUCATION
www.ed.gov

INTERNAL REVENUE SERVICE
www.irs.gov

US DEPARTMENT OF TREASURY
www.ustreas.gov



RESOURCE

CALIFORNIA INDUSTRIAL
DEVELOPMENT FINANCING
ADVISORY COMMISSION
www.treasurer.ca.gov/cidfac

TAX-EXEMPT BOND PROGRAM

Industrial Development Bonds (IDBs), finance small–issue manufacturing. As a result of the Recovery Act, the definition of small–issue manufacturing has been expanded to include projects involving not only the manufacture or production of tangible personal property, but also the creation or production of intangible property, such as patents, trademarks, formulas and designs.

The provisions of the Recovery Act that will enhance IDB programs include:

- elimination of the ancillary facilities limitations for all IDBs issued before 2011. This means IDB proceeds may be used to finance any assets that are functionally related and subordinate to a manufacturing, research or production facility, [e.g., a warehouse] provided that such assets are located on the same site as the core facility.
- permanent elimination of restrictions on the use of IDB proceeds to finance office space located on the same site as the core facility and deemed to be functionally related and subordinate to the core facility.
- exemption from individual and corporate alternative minimum tax (AMT) for investors who purchase IDBs.

These changes will allow manufacturers to broaden their projects to include warehouses, distribution facilities and testing facilities as well as assist high tech manufacturing businesses, such as software development and biologics. In addition, the AMT exemption can potentially broaden the investor base for IDBs. State volume cap allocation still applies to IDBs.

"We cannot overstate the importance of this effort. We are asking the American people to trust their government with an unprecedented level of funding to address the economic emergency. In return, we must prove to them that their dollars are being invested in initiatives and strategies that make a difference in their communities and across the country. Following through on our commitments for accountability and openness will create a foundation upon which we can build as we continue to tackle the economic crisis and the many other challenges facing our nation."

-MEMORANDUM TO HEADS OF DEPARTMENTS AND AGENCIES, FEBRUARY 9, 2009

ACCOUNTABILITY AND TRANSPARENCY

FEDERAL

The Recovery Act requires several governmental agencies to audit, evaluate and report on the use of programs authorized by ARRA. Together, the Recovery Accountability and Transparency Board, Government Accountability Office (GAO), Inspectors General, and state and local government auditors will ensure that the Recovery Act's $787 billion is spent properly.[3]

In addition, when signing the Recovery Act, the President directed federal agencies to provide unprecedented levels of transparency and accountability. Five crucial objectives for Federal agencies were identified, to ensure that:

- recovery funds are awarded and distributed in a prompt, fair, and reasonable manner;
- the recipients and allocation of all recovery funds are transparent to the public, and that the public benefits of these funds are reported clearly, accurately, and in a timely manner;
- recovery funds are used for authorized purposes and every step is taken to prevent instances of fraud, waste, error, and abuse;
- projects funded under the recovery legislation avoid unnecessary delays and cost overruns; and,

[3] Statement of Gene L. Dodaro, Acting Comptroller General, "Recovery Act, GAO's Efforts to Work with the Accountability Community to Help Ensure Effective and Efficient Oversight," testimony before the Subcommittee on Investigations and Oversight, Committee on Science and Technology, House of Representatives, GAO-09-672T, May 5, 2009.

- programs meet specific goals and targets, and contribute to improved performance on broad economic indicators.

At the President's direction, Federal agencies receiving Recovery Act Funds are taking critical steps to establish rigorous internal controls, oversight mechanisms, and other approaches to meet the accountability objectives of the Recovery Act.[4] To meet these objectives state, local governments and other grantees are required to report project status, spending, and job creation and retention to the public on a regular basis with periodic reports on the status of federal dollars to federal agencies and Congress. In addition, to encourage the report of abuse, fraud and waste of Recovery Act funds, federal whistleblower protections have been extended to the employees of recipients of Recovery funds. Two federal level organizations will play a pivotal role in implementing the level of accountability and transparency required by the President.

THE RECOVERY ACCOUNTABILITY AND TRANSPARENCY BOARD (BOARD). Created by the Recovery Act to coordinate and conduct oversight of funds distributed under the Act. In order to prevent abuse, fraud and waste, the Board has been equipped to assist it in the mission of providing oversight and promoting transparency regarding expenditure of funds at all levels of government. Led by a Chairman appointed by the President and ten Inspectors General as specified by the Recovery Act, quarterly and annual reports on the use of Recovery Act funds and any oversight matters will be issued as part of the Board's work. A key tool to foster greater accountability and transparency of Recovery Act funds is the Board's website, **www.recovery.gov**, which will maintain Board reports and recommendations, announcements for grant competitions, allocations of formula grants, and awards of competitive grants.

THE UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE (GAO). The GAO is required by the Recovery Act to perform bimonthly reviews of the use of funds by selected states and localities. GAO will focus its review work on 16 states, including California and the District of Columbia, which collectively represent approximately 65 percent of the US population and two-thirds of the intergovernmental federal assistance available through the Recovery Act.

4 **www.recovery.gov**

CALIFORNIA

Placing a high priority on accountability and transparency, the Governor created the the California Federal Economic Stimulus Task Force (Task Force). The Task Force is charged with tracking Recovery Act funding coming into the state, working with President's administration, helping cities, counties, non-profits, and others access available funding, ensuring that the funding funneled through the state is spent efficiently and effectively, and maintaining a website that is frequently and thoroughly updated for the public to be able to track stimulus dollars. In addition, with the state receiving approximately $85 billion in federal economic stimulus funds--approximately $50 billion in education, infrastructure and other spending, and $35 billion in tax benefits, a Recovery Act Inspector General was appointed and charged with ensuring that Recovery Act funds are spent as intended and to identify instances of abuse, fraud and waste. The Task Force website, **www.recovery.ca.gov,** provides the public a breakdown, by issue area, of the funding the California is estimated to receive from the Recovery Act.

Given the state and federal emphasis on transparency, accountability and performance, state and local recipients can expect to sustain a thorough and thoughtful review of their use of federal stimulus funds.

RESOURCES

RECOVERY ACCOUNTABILITY AND TRANSPARENCY BOARD
www.recovery.gov

UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE
www.gao.gov

CALIFORNIA FEDERAL ECONOMIC STIMULUS TASK FORCE
www.recovery.ca.gov

The California Debt and Investment Advisory Commission (CDIAC) and the California Infrastructure and Economic Development Bank (I-Bank) have partnered to create this guide, *The American Recovery and Reinvestment Act of 2009: Financing Opportunities for California's Public Agencies*, in order to bring timely information about low-cost financing opportunities to California's public agencies.

THE CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION (CDIAC) provides information, education and technical assistance on debt issuance and public fund investments to local public agencies and other public finance professionals. The Commission was created to serve as the State's clearinghouse for public debt issuance information and to assist state and local agencies with the monitoring, issuance, and management of public debt. In addition, CDIAC also provides information, technical assistance and seminars on public investments.

THE CALIFORNIA INFRASTRUCTURE AND ECONOMIC DEVELOPMENT BANK (I-BANK) is a state financing authority that has extremely broad statutory powers to issue revenue bonds, make loans and provide credit enhancements for a wide variety of infrastructure and economic development projects and other government purposes. The I-Bank's current programs include the Infrastructure State Revolving Fund (ISRF) Program and several revenue bond financing programs.

CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION
(916) 653-3269
www.treasurer.ca.gov/cdiac

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