Tax Credit Bonds and the Recovery Act

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November 2009

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Tax Credit Bonds

The federal government uses the tax code to subsidize borrowing by state and local governments for public investment and working capital.

This subsidy has traditionally taken the form of tax exemption: the interest payable on municipal bonds is not subject to federal income taxation, which enables borrowers to offer a reduced interest rate. However, disruptions in the tax-exempt municipal bond market caused by the 2008 credit crunch have direct policymakers toward another form of tax subsidy: tax credit bonds.

Tax credit bonds are taxable bonds for which investors receive a tax credit against a certain percentage of the interest income, at a rate set by the Treasury.

The American Recovery and Reinvestment Act of 2009 (ARRA) significantly increased the scope of tax credit bonds. The Act created several new tax credit bonds, and expanded existing programs for renewable energy and education investments.

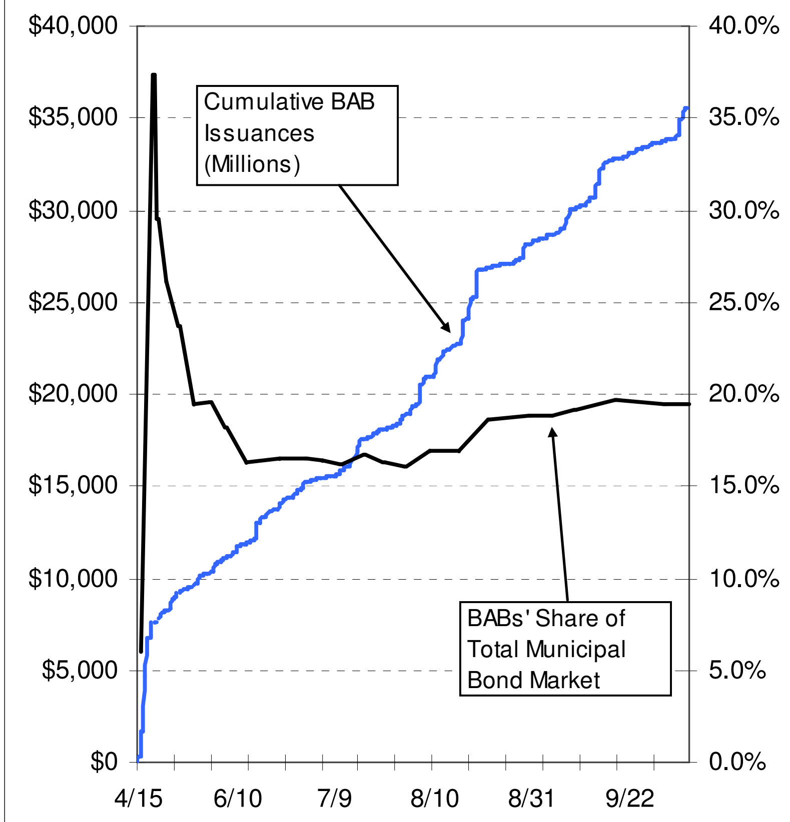
Build America Bonds

Build America Bonds (BABs) are the largest new tax-credit bond program. They allow state and local issuers to tap the taxable bond markets to finance any governmental purpose for which tax-exempt bonds could be used.

Early results suggest that BABs have reduced borrowers' interest rates by about 80-100 basis points compared to traditional tax-exempt bonds.[1]

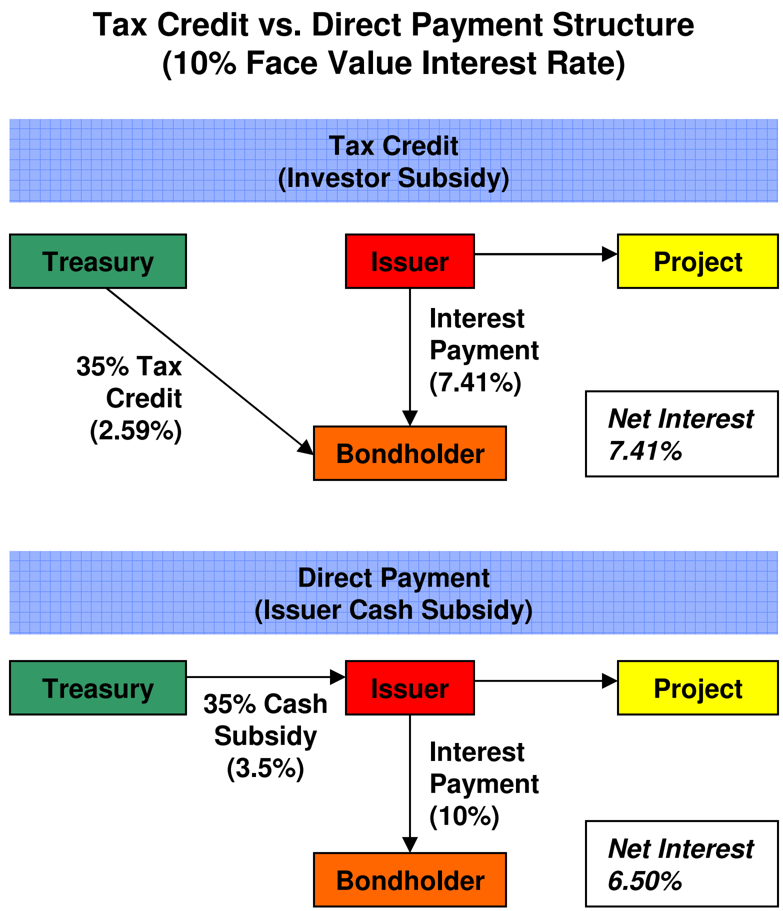
There is no volume cap on Build America Bonds. More than $55 bn have been sold since the program began in April—representing about 21.3% of the total municipal bond market.[2]

Build America Bonds and the Municipal Market, 2009[3]



Source: U.S. Treasury. October 2, 2009.

Tax Credit vs. Direct Payment BABs



Source: Mercator Advisors LLC.

ARRA authorized two types of Build America Bonds, illustrated in the diagram at left.

For Tax Credit BABs, the bondholder receives a tax credit for 35% of the interest payable (which works out to about a 26% subsidy to issuers). Direct Payment BABs, by contrast, pay 35% of the interest cost to the issuer directly.

Direct Payment BABs provide a deeper subsidy than Tax Credit BABs (35% vs. 26%), but their uses are limited to capital expenditures. Nevertheless, issuers have thus far opted exclusively for Direct Payment BABs.[4]

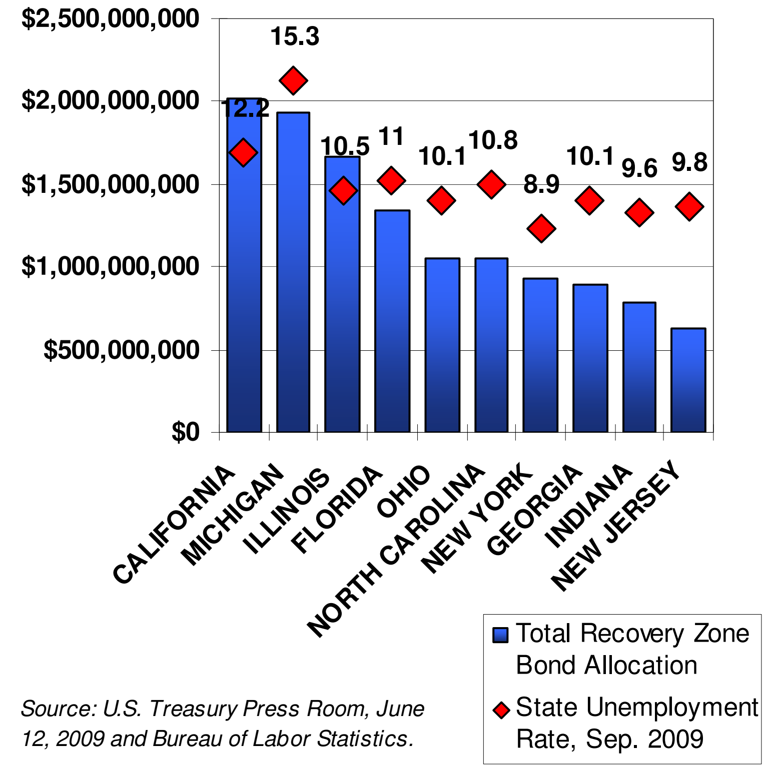
Recovery Zone Bonds

Recovery Zone Bonds are a special class of Direct Payment BABs that specifically target areas facing severe economic distress.

The Treasury credits the issuer for 45% of the interest payable on the bonds, providing a deeper subsidy than the 35% or 26% subsidy for standard BABs.

Recovery Zone Bonds are capped at $25bn: $10bn for public economic development and $15bn for private activity. They are allocated to states in proportion to their 2008 job losses.[5]

Largest Recovery Zone Bond Allocations by State[6]



Source: U.S. Treasury Press Room, June 12, 2009 and Bureau of Labor Statistics.

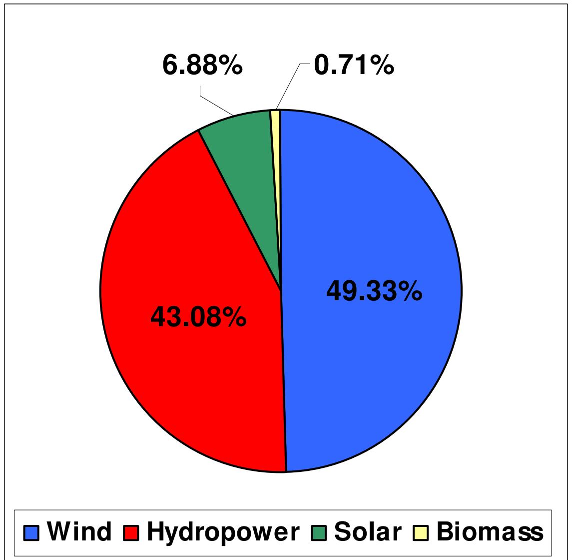
Renewable Energy Tax Credit Bonds

ARRA modifies two recently-developed tax credit bond programs for renewable energy investment.[7]

	New Clean Renewable Energy Bonds (CREBs)	***Qualified Energy Conservation Bonds***
Purpose	Renewable energy facilities investments	Public energy conservation projects
Subsidy	70% of taxable interest	70% of taxable interest
Initial Authorization	2005 at $800m	2008 at $800m
Post-ARRA Volume Limit	$2.4bn	$3.2bn
Allocation Methodology	1/3 each to individual public power providers, governmental bodies, and electricity cooperatives	Allocated to states in proportion to their population

Source: Government Finance Officers Association.

New CREBs for Public Power Providers, by Project Type[8]



Note: Public Power Providers allocated $800m New CREBs in total.
Source: U.S. Treasury Press Room, October 27, 2009.

Tax Credit Bonds for Education

The Recovery Act also includes provisions for two types of tax credit bonds for public education.[9]

	Qualified Zone Academy Bonds	***Qualified School Construction Bonds***
Purpose	Public school renovation, equipment purchases, curriculum development, personnel training	New construction, rehabilitation, or repair of public school facilities
Subsidy	100% of taxable interest	100% of taxable interest
Initial Authorization	1997 at $400m	2009 (ARRA) at $11bn
Post-ARRA Volume Limit	$1.2bn	$11bn
Allocation Methodology	Allocated to states based on respective poverty rates	60% to states based on respective federal education grants; 40% to largest individual school districts

The Road Ahead

The new and expanded tax credit bond programs are authorized for 2009 and 2010 only. However, some Congressional staffers and municipal market investors are already calling for the programs to be expanded further and extended indefinitely.[10]

Tax credit bonds have attracted new investor classes and lowered the cost of borrowing to finance public investment. According to a recent Congressional Budget Office/Joint Committee on Taxation study, replacing tax exempt bonds with tax credit bonds could provide a more efficient federal subsidy.[11] And unlike the blunt instrument of tax exemption, tax credit bonds also allow policymakers to tailor the amount of subsidy to fit the perceived public benefit of the project in question.

References

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