



Public Sector Bulletin



June 2009

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Basics of Recovery Zone Economic Development Bonds and Recovery Zone Facility Bonds

The American Recovery and Reinvestment Act of 2009 contains numerous provisions that affect bonds issued by states and political subdivisions in the form of additions and modifications to the Internal Revenue Code of 1986, as amended (the “Code”). The Code now contains Sections 1400U, 1401U and 1402U. These sections create two different, but related, new types of bonds – Recovery Zone Economic Development Bonds (“RZEDBs”) and Recovery Zone Facility Bonds (“RZFBs”) – collectively referred to as “Recovery Zone Bonds.” It is perhaps unfortunate that the names of these two financing options are so similar because the rules for their use have significant differences; however, given the similarities between them, it is not unreasonable to examine their respective features simultaneously.

Some Common Aspects

Before turning to the specifics of each type of bond, we should familiarize ourselves with the common foundational elements of both. First, each type of Recovery Zone Bond may be issued only before January 1, 2011. Second, each is subject to a nationwide annual volume cap - \$10 billion for RZEDBs and \$15 billion for RZFBs – that is first allocated among the states based upon their respective declines in employment, and then allocated to certain political subdivisions within the several states on the same basis. See [Volume Cap Issues](#), below for further discussion of volume cap matters. Third, each type of Recovery Zone Bond is subject to a two percent

limit on the amount of issuance costs that may be paid from proceeds of the bonds, although the sources for these limitations lie in different provisions of the Code. Fourth, each is subject to the arbitrage and spending rules applicable to tax exempt municipal bonds generally, although, as we will see, the RZEDB is actually a type of tax credit bond. Fifth, the rules on reimbursement of expenditures made prior to the issuance of bonds are contained in the Treasury Regulations Section 1.150-2 as with tax exempt bonds; however, any expenditure to be financed must occur after the establishment of a recovery zone by the issuer.

The requirement of a recovery zone is likewise common to each type of Recovery Zone Bond. A recovery zone is defined to be:

1. any area designated by the issuer as having significant poverty, unemployment, rate of home foreclosures or general distress,
2. any area designated by the issuer as economically distressed by reason of the closure or realignment of a military installation pursuant to the Defense Base Closure and Realignment Act of 1990, and
3. any area for which a designation as an empowerment zone or renewal community is in effect.

No certification process or federal oversight is prescribed in connection with the establishment of a recovery zone, which gives issuers

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great latitude in the creation of recovery zones. In addition, no limitation exists on the number of zones that may be created within the jurisdiction of the issuer; conceivably, one could encompass the entire territory of the issuer, or multiple zones within the issuer's boundaries.

Basic Features – Recovery Zone Economic Development Bonds

RZEDBs are Build America Bonds (“BABs”) and thus are a type of tax credit bond. That is, the issuer elects that the interest on the bonds will be includible in the gross income of the holders, *i.e.*, not “tax exempt.” BABs permit the issuance of taxable bonds for projects that would otherwise qualify for tax-exempt financing. Issuers may either permit the holders to receive a tax credit on the interest received or elect to receive a subsidy from the Treasury equal to the credit. The principal appeal of RZEDBs to issuers is that, instead of the 35 percent credit applicable to the interest on conventional BABs, the credit associated with a RZEDB is upped to 45 percent. The issuer may elect that the holders of the bonds receive this credit, making the bonds more attractive to investors than other taxable investments, or it may choose to receive the credit in the form of a direct subsidy from the federal government in the form a payment on each interest payment date in an amount equal to 45 percent of the interest payable on such date.

Since RZEDBs are BABs they, by definition, are governmental bonds. In order to be a RZEDB, in addition to being a BAB and being designated as a RZEDB by the issuer, 100 percent of the excess of the “available project proceeds” (sale proceeds less issuance costs not in excess of two percent, plus investment earnings) over the amount deposited in a reasonably required reserve fund must be used for one for more “qualified economic development purposes.” Stated somewhat differently, not more than two percent of the proceeds may be used for the payment of issuance expenses. The remainder of the proceeds, after funding a reasonably required reserve fund (if any), plus investment earnings on the sale proceeds, must be applied to a qualified economic development purpose.

A qualified economic development purpose in this context is defined to be expenditures for purposes of promoting development or other economic activity in a recovery zone, including:

1. capital expenditures paid or incurred with respect to property located in such zone,
2. expenditures for public infrastructure and construction of public facilities, and
3. expenditures for job training and educational programs.

Two points are worth noting in connection with this definition. First, the enumerated purposes are preceded by “including” as opposed to a more limiting term, such as “consisting of.” This implies that activities other than those specifically listed can constitute qualified economic development. Indeed, Notice 2009-50, released on June 12, 2009, describes the definition as “broad” and including “working capital expenditures to promote development or other economic activity in a recovery zone” even though working capital expenditures are not expressly mentioned in the enabling provision. It seems clear that the list of three purposes is not exclusive, and that the definition should be read broadly, however, the outer bounds of what is permitted to be financed is not clear.

The second point worth noting is that the phrase “located in such zone” does not appear in (2) above, with respect to public infrastructure and construction of public facilities. While it is clear under Notice 2009-50 that the proceeds must be spent for a qualified economic development purpose within the jurisdiction of the issuer, it is apparently at least theoretically possible to issue RZEDBs to fund expenditures for certain assets that are located within such jurisdiction but outside of the recovery zone (public infrastructure, public facilities) as long as development and other economic activity are promoted within a recovery zone. Whether such an interpretation can be applied reasonably and not in such a way as to effectively remove the requirement of a recovery zone remains to be seen.

Basic Features – Recovery Zone Facility Bonds

RZFBs are tax exempt, private activity bonds. According to Notice 2009-50, they are to be treated as exempt facility bonds. In order to be a RZFB, 95 percent or more of the net proceeds of the issue (sale proceeds less amounts deposited in a reasonably required reserve fund) must be used for “recovery zone property.” “Recovery zone property” is defined as property to which Section 168 of the Code would

apply (generally speaking, property subject to an allowance for depreciation), the original use of which in the recovery zone begins with the beneficiary of the financing (e.g., private borrower or lessor) and substantially all of the use of which is in the recovery zone in the active conduct of a “qualified business” by such beneficiary. “Qualified business” is defined as any business other than (i) residential rental property and (ii) any business consisting of the operation of the so-called prohibited facilities of Section 144(c)(6) (B) of the Code – private or commercial golf courses, country clubs, massage parlors, hot tub facility, suntan facility, racetrack or other facility used for gambling or stores principally for the sale of consumption of alcohol off-premises.

Unlike the situation with RZEDBs, there is no doubt that the proceeds must be spent on facilities in the recovery zone. Additionally, substantially all of the use must occur in the recovery zone. The permitted uses are quite broad – not unlike the old “industrial development bond” rules of the Internal Revenue Code of 1954, as amended, prior to the amendments made by the Tax Reform Act of 1986, but without the limitation on capital expenditures.

A consequence of being a private activity bond is that certain requirements applicable to such obligations under the Code will be apply to RZFBs as well, such as the “substantial user rule,” the limit of maturity to 120 percent of economic life, the limitation on land acquisition to 25 percent of net proceeds and the necessity for approval by an applicable elected representative following a public hearing.

Differing Features

RZEDBs and RZFBs differ in several important ways. First, as has previously been stated, RZEDBs are a type of tax credit bond – the interest is includible in gross income of the bond holder – and RZFBs are tax-exempt bonds – the interest is excludible from gross income of the holders.

Second, RZEDBs may not be used to refund existing debt. Reimbursement of expenditures financed with short term debt issued after the adoption of the American Recovery and Reinvestment Act are not considered refundings. RZFBs appear to have no limitation with respect to current refundings (i.e., issuance within 90 days of retirement of refunded issue), at least until January 1, 2011, although the limitations on financing existing assets, the substantial user rule

and the requirement that expenditures be made after the date of the establishment of the recovery zone effectively prohibit the mere refinancing of existing facilities.

Third, RZEDBs are prohibited from having “excessive” premium, defined as 0.25 percent multiplied by the number of years to maturity of the issue. No such limitation is directly applicable to RZFBs, but excessive premium can raise other issues with respect to determining the use of proceeds and computation of yield. However, its presence will not disqualify the issue from its characterization.

Finally, as indicated above, the types of projects that may be financed are different. RZEDBs can, generally speaking, be used for governmental projects of a broad nature. While the limitations imposed by the private activity bond test exist, the number of types of purposes that may be financed is large. In contrast, RZFBs must finance depreciable property located in a recovery zone and be used in a certain way (qualified business) and not in others (prohibited facilities) and subject to certain other limitations applicable to private activity bonds.

Volume Cap Issues

As indicated above, each type of Recovery Zone Bond is subject to a separate volume cap. Although the cap amounts are different, the method of allocation is substantially the same. After the first allocations to several states, amounts allocated to such states are then allocated among the counties and among municipal corporations within the state with a population of at least 100,000 (a “large municipality”). The county or municipality receiving an allocation may waive any portion made to it, in which event such allocation is available to the state to reallocate in any manner that it deems reasonable.

Eligible issuers of Recovery Zone Bonds must be any political subdivision for purposes of Section 103 of the Code. Such issuers may issue Recovery Zone Bonds received by the issuer itself or for a conduit borrower or other ultimate beneficiary of the bonds. A county or large municipality may issue bonds and designate them as RZEDBs or RZFBs, as applicable, for use of the volume cap by an ultimate beneficiary, including such county, large municipality or other entity. In addition, another eligible issuer may issue RZEDBs or RZFBs, as applicable, for use of the volume cap by an ultimate beneficiary, including such

county, large municipality or other entity based on an allocation from the county or municipality. All of the costs financed must relate to the applicable purpose or property located within or attributable to the jurisdiction of the issuer of the bonds and the jurisdiction of the entity authorized to allocate volume cap.

An example of how this could function is as follows. Assume that a large municipality and a county each receive an allocation of volume cap for RZFBs. They may each allocate cap to a private beneficiary for a project within a recovery zone established by an economic development authority authorized to issue bonds. The authority can use the cap allocated from both the municipality and the county simultaneously to issue bonds for the project, provided that the recovery zone is located within the jurisdiction of both the county and the municipality.

Conclusion

Recovery Zone Bonds provide additional options to governmental issuers and private borrowers in the promotion of economic development. Whether and to what extent projects are able to benefit from RZEDBs or RZFBs will be a function of the strength of the credit behind such projects, as well as the ingenuity of issuers and their advisors as they seek to comply with the requirements of the Code and provide new economic opportunities.

For additional information on RZEDBs, RZFBs or other project finance issues, please contact Bill Conard with Bricker & Eckler at 614.227.2351/ wconard@bricker.com.

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