

IRS Releases Guidance and Allocations for New Recovery Zone Bonds

On Friday, June 12, 2009, the Internal Revenue Service released Notice 2009-50, which provides guidance on the maximum face amount of Recovery Zone Economic Development Bonds and Recovery Zone Facility Bonds that may be issued by each state, and counties and large municipalities within each state, before January 1, 2011 under Sections 1400U-1 through 1400U-3 of the Internal Revenue Code (Code). Recovery Zone Economic Development Bonds and Recovery Zone Facility Bonds are two new types of bond programs that were enacted under the American Recovery and Reinvestment Act of 2009 (ARRA) to provide tax incentives for state and local units of government by allowing designated projects to be financed with lower borrowing costs to promote job creation and economic recovery in areas affected by employment decline. The release of Notice 2009-50 enables states and local units of government and economic development agencies to take advantage of this new program.

Background

State and local units of government have long been permitted to issue tax exempt bonds to finance municipal projects such as schools, roads, sewers, municipal buildings and other governmentally owned facilities. In addition, state and local units of government, often acting through publicly created agencies or authorities, have the ability to issue tax exempt private activity bonds to make loans to private companies to finance certain categories of privately owned facilities. Common examples of private activity bond financings include projects for health care, senior living, education, cultural institutions, small manufacturing facilities, airports, housing and solid waste disposal facilities.

The ARRA contained a number of groundbreaking provisions designed to stimulate the municipal finance market and provide additional tools to encourage economic development in distressed areas. These changes included the creation of new types of tax credit bonds called Build America Bonds and Recovery Zone Economic Development Bonds, and the creation of a new category of private activity bonds called Recovery Zone Facility Bonds. There is no limitation on the amount of Build America Bonds which a state and local unit of government can issue for qualifying projects. There is a limitation on the amount of Recovery Zone Economic Development Bonds and Recovery Zone Facility Bonds which may be issued and a process for allocating a national volume limitation, as described below.

Recovery Zone Economic Development Bonds will assist local governments by reducing borrowing costs for qualifying governmentally owned and operated facilities located in Recovery Zones. Recovery Zone Economic Development Bonds are not available for privately owned or operated facilities. Recovery Zone Facility Bonds, on the other hand, are designed to assist private companies and developers finance economic development projects located in Recovery Zones without having to qualify within the other limited categories of private activity bond financing.

Recovery Zone Economic Development Bonds are comparable to Build America Bonds except with a larger federal subsidy and additional qualification requirements. In order to understand Recovery Zone Economic Development Bonds it is necessary to describe the tax credit provisions applicable to Build America Bonds.

Build America Bonds

General. Build America Bonds are a new type of tax credit bond that are available to any state or local unit of government with authority to issue tax exempt bonds. Any program that is eligible for tax exempt bonding may instead be financed as a Build America Bond, subject to a few exceptions below. Build America Bonds are issued pursuant to existing state law bonding authority. A Build America Bond is a taxable obligation that provides a federal subsidy through tax credits. The two principal types of Build America Bonds are referred to as "Build America Bonds (Direct Payment)" and "Build America Bonds (Tax Credit)." A state or local governmental issuer ("Issuer") of Build America Bonds can elect to keep the tax credit and receive a payment from the federal government (the direct payment option) or give the tax credit to the bondholder and receive a lower interest rate on the bonds (the tax credit option).

Build America Bonds (Direct Payment). If the Issuer elects to keep the tax credit, the federal government will pay the Issuer 35% of the total interest coupon payable by the Issuer on the bonds. Such payment is to be paid contemporaneously with each interest payment date of the bonds. For fixed rate bonds, the IRS is establishing procedures which would involve the Issuer filing a new 8038-CP prior to the relevant interest payment

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date and such amount would be paid contemporaneous with the interest payment date. For variable rate bonds, the 8038-CP would be filed within 45 days after the interest payment date and paid on a reimbursement basis.

Build America Bonds (Tax Credit). The Issuer can elect to give the tax credit to the bondholder equal to 35% of the total coupon interest payable by the Issuer on the bonds, which represents a federal subsidy to the Issuer equal to approximately 25% of the total return to the investor (including the coupon interest paid by the Issuer and the tax credit). Such credits would accrue as of the date of the interest payment and may be used to offset federal tax liability of the bondholder.

Restrictions on Build America Bonds. For Build America Bonds (Direct Payment), 100% of the bond proceeds must be used for capital expenditures (other than proceeds used to fund a reserve fund and to pay issuance costs subject to a 2% limit). Build America Bonds (Direct Payment) are not available for refundings or working capital borrowings. Build America Bonds (Tax Credit) can be used for refundings or working capital borrowings and there is no limitation on amount of issuance costs to be paid from bond proceeds. Build America Bonds cannot be used for private activity bonds (meaning bond proceeds cannot be used by or loaned to private parties). Build America Bonds must be issued prior to January 1, 2011.

Traditional Tax Exempt Financing v. Build America Bonds: Which choice is better? Build America Bonds (Direct Payment) can result in greater savings than traditional tax exempt bonds in many circumstances. Recent large long term bond sales have chosen the Build America Bonds (Direct Payment) structure. Build America Bonds (Direct Payment) will result in a lower net borrowing cost than Build America Bonds (Tax Credit). Issuers should consult with their financial advisors and bond counsel to determine which alternative best meets the financing goals of the Issuer.

Risks to Issuer of a future change in tax law impairing Build America Bonds? The risk of a change in federal tax law in a manner that could adversely affect the tax benefit applies to traditional tax exempt bonds and Build America Bonds, but with traditional tax exempt bonds the risk is borne by the bondholders. With Build America Bonds (Direct Payment), that risk is borne by the Issuer. Refundable credits payable to an Issuer of Build America Bonds (Direct Payment) are treated as an overpayment of tax. This is intended to make the payment obligation of the federal government a "permanent appropriation" but also makes the payment subject to offset for

certain liabilities the Issuer may have to the federal government. The political risk of a change in tax law should be reduced as more state and local units of government issue Build America Bonds in reliance on the current legislation.

Other tax and securities law considerations. Arbitrage rules and other rules applicable to tax exempt bonds apply to Build America Bonds. Securities laws applicable to traditional tax exempt bonds will also apply to Build America Bonds.

Recovery Zone Economic Development Bonds

45% Tax Credit. Recovery Zone Economic Development Bonds are comparable to Build America Bonds (Direct Payment), except they provide for a deeper federal subsidy through a tax credit paid to Issuers in an amount equal to 45% (rather than 35% for Build America Bonds) of the total coupon interest payable to the bondholders, and they have different program requirements regarding eligible uses of proceeds for qualified economic development purposes within designated Recovery Zones as described below.

Qualified Economic Development Purpose. Recovery Zone Economic Development Bonds can be issued to finance any "qualified economic development purpose," which consists of expenditures for the purposes of promoting development or other economic activity in a Recovery Zone, including:

- capital expenditures paid or incurred with respect to property located in a Recovery Zone;
- expenditures for public infrastructure and construction of public facilities; and
- expenditures for job training and educational programs.

Recovery Zones. A "Recovery Zone" means any area:

- designated by the Issuer as having significant poverty, unemployment, rate of home foreclosures or general distress;
- designated by the Issuer as economically distressed by reason of the closure or realignment or a military installation pursuant to the Defense Base Closure and Realignment Act of 1990; or

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- designated as an empowerment zone or renewal community as in effect as of the adoption of the ARRA on February 17, 2009.

Unlike empowerment zones created in the 1990's which had limited and fixed districts, recovery zones are flexible, permitting counties and large municipalities to determine whether the project constituting the qualified economic development purpose will be located in an area having "significant poverty, unemployment, rate of home foreclosures or general distress" or satisfy the other criteria for a Recovery Zone. There is no fixed benchmark that must be satisfied to meet this requirement and no limitation on the number of recovery zones that can be created within a county or large municipality (except as may be limited by the amount of volume cap allocation available to the county or large municipality for the issuance of Recovery Zone Economic Development Bonds as described below). Any county or large municipality that receives a volume cap allocation for Recovery Zone Bonds may make designations of recovery zones in any reasonable manner as it shall determine in good faith in its discretion.

Prevailing Wages. Federal Davis-Bacon Act prevailing wage rules apply to projects financed with Recovery Zone Economic Development Bonds. As a result, persons performing work in connection with the construction of facilities financed with Recovery Zone Economic Development Bonds must be paid in accordance with federal prevailing wage laws.

Volume Limitation. There is a \$10 billion limitation nationally that applies through December 31, 2010. Recovery Zone Economic Development Bonds can only be issued if the Issuer has received a volume cap allocation from a county or large municipality that received an allocation of volume cap, as described further below.

Recovery Zone Facility Bonds

RZFB Requirements. Recovery Zone Facility Bonds are a new tax-exempt private activity bond, which can be issued to finance certain capital projects for the benefit of private companies located or to be located in a designated Recovery Zone which meet the following requirements:

- at least 95% of proceeds of such issue are to be used for recovery zone property;

- the obligation is issued by a State or local government pursuant to a Recovery Zone Facility Bonds volume cap allocation; and

- the issuer designates the obligation as a recovery zone facility bond.

"Recovery zone property" is depreciable property that satisfies the following requirements:

- the property was constructed, reconstructed, renovated, or acquired by purchase by the taxpayer after the date on which the designation of the Recovery Zone took effect. Note that this criteria is more restrictive than the customary 60 day look back from the date the Issuer adopts its inducement resolution which applies to other types of private activity bonds.
- the original use of which in the Recovery Zone commences with the taxpayer (subject to an exception for certain substantial renovations); and
- substantially all of the use of which is in the Recovery Zone and is in the active conduct of a qualified business by the taxpayer in such zone.

A qualified business means any trade or business except (i) residential rental property (as defined in Code Section 168(e) (2) and (ii) any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility primarily used for gambling, or any store the principal business of which is the sale of alcoholic beverages for off premises consumption.

The criteria for establishing a Recovery Zone is the same as described above for Recovery Zone Economic Development Bonds.

Volume Cap Limitation. There is a \$15 billion limitation nationally that applies through December 31, 2010. Recovery Zone Facility Bonds can only be issued if the Issuer has received a volume cap allocation from a county or large municipality that received an allocation of volume cap, as described further below.

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Private Activity Bond Restrictions. The normal private activity bond requirements continue to apply to Recovery Zone Facility Bonds, such as the average life of the bonds cannot exceed 120% of weighted average life of the project assets; the bonds must be issued pursuant to certain notice, public hearing and elected official approval requirements; no more than 2% of the proceeds of the bonds can be used to finance costs of issuance, etc. However, rules relating to the limitation on the acquisition of existing property are different and Recovery Zone Facility Bonds are subject to a different national limitation described below.

RZFBs v. RZEDBs. The primary difference between Recovery Zone Facility Bonds and Recovery Zone Economic Development Bonds are that Recovery Zone Facility Bonds are tax exempt private activity bonds used to make loans to private companies, similar to industrial development bonds, but with a much broader category of eligible projects. A Recovery Zone Facility Bond is not a tax credit bond and the federal subsidy is the same as available for other existing types of private activity bonds.

A point of caution: this is not free money. For Recovery Zone Facility Bonds, conduit borrowers will need to be creditworthy and projects must make economic sense or there will not be a market for the sale of the bonds.

Recovery Zone Volume Cap Allocations

Volume Cap Designations in General. The ARRA allocated a \$10 billion nationwide volume limitation for Recovery Zone Economic Development Bonds and a \$15 billion nationwide volume limitation for Recovery Zone Facility Bonds and required that such amount be allocated among the States in the proportion that each such State's 2008 State employment decline bears to the aggregate of the 2008 State employment declines for all of the States; provided that each state was guaranteed at least 0.9% of the national Recovery Zone Facility Bonds limitation. The ARRA further required that each state must reallocate its Recovery Zone volume cap allocation among its counties and municipalities with a population in excess of 100,000 ("large municipalities") in the proportion to each such county's or large municipality's 2008 employment decline bears to the aggregate of the 2008 employment declines for all the counties and large municipalities in such State.

Waivers. A county or large municipality may waive any portion of a volume cap allocation received for Recovery Zone Bonds. Upon such waiver, the State in which such county or large municipality is located is authorized to reallocate the volume

cap in any reasonable manner as it shall determine in good faith.

Local Reallocations. On June 12, 2009 the IRS published the volume cap allocations for each State and the suballocations for each county and large municipality within a State. This information is available at the following web address: www.irs.gov/taxexemptbond/index.html under the heading entitled "IRS Releases Guidance on ARRA Bond Provisions" by clicking on the subheading regarding the Recovery Zone Bond allocations.

Michigan Local Reallocations. As a result of Michigan's substantial employment loss in 2008, Michigan received the second largest Recovery Zone allocation nationally (California was first) with \$773 million Recovery Zone Economic Development Bond allocation and \$1.160 billion Recovery Zone Facility Bond allocation. The IRS has reallocated these amounts to all Michigan Counties and the Cities of Ann Arbor, Detroit, Flint, Grand Rapids, Lansing, Sterling Heights and Warren in accordance with the employment loss formula described above. Attached to this Client Alert is a copy of the local county and large municipality reallocations in Michigan published by the IRS. These allocations apply through December 31, 2010.

Eligible Issuers of Recovery Zone Bonds

Eligible Issuers of Recovery Zone Bonds include any state or local unit of government or agency or authority authorized under state law to issue bonds. An Issuer may issue Recovery Zone Bonds based on a volume cap received by the Issuer (if the Issuer is a county or large municipality) or by a conduit borrower or other ultimate beneficiary of the issue of the bonds. For example in Michigan, Recovery Zone Facility Bonds may be issued by local Economic Development Corporations (EDC's) created by a county or large municipality or by the Michigan Strategic Fund (MSF), based on an allocation received from a county or large municipality for the project. EDC's and the MSF have the statutory authority to issue bonds and make loans to private companies for the purpose of financing economic development projects. There are also other issuers in Michigan with the statutory power to issue private activity bonds for certain types of projects. In all instances, the eligible costs for qualified economic development purposes or recovery zone property, as applicable, financed with the proceeds of an issue of Recovery Zone Bonds must relate to any such purpose or property that

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is located within, or attributable to, both the jurisdiction of the issuer of the bonds and the jurisdiction of the entity authorized to allocate volume cap to an issue of bonds for the financing of such purpose or property. This means that trading in volume cap among counties and large municipalities will not be permitted, but a pooling of allocation to finance a joint project among counties or large municipalities may qualify.

The IRS guidance indicates that counties and large municipalities may use volume cap themselves or allocate such volume cap to ultimate beneficiaries in any reasonable manner as they shall determine in good faith in their discretion for use for qualified economic development purposes or recovery zone property, as applicable. We believe the exercise of that discretion will need to be made by the county board of commissioners or city council of a large municipality, as the case may be, when deciding on the designation of Recovery Zones and the awarding of allocations.

Conclusion

Recovery Zone Economic Development Bonds are a new economic development tool for state and local units of government to finance municipal projects at lower borrowing costs to promote job creation and economic recovery in areas particularly affected by employment declines. Recovery Zone Facility Bonds are a new economic development tool for counties and large municipalities looking to provide tax incentives to lower the financing costs of private economic development projects in designated recovery zones. These programs are subject to volume cap limitations and expire January 1, 2011. The demand for volume cap allocation may exceed supply and the line may begin to form quickly in many counties and large municipalities. Counties and large municipalities will have to consider how to distribute the allocation in a manner which best serves their economic development goals.

Dickinson Wright's public finance attorneys have extensive experience representing state and local units of government in connection with the issuance of tax exempt obligations and tax credit bonds for public facilities and economic development projects. Please contact a Dickinson Wright public finance attorney if you have any questions regarding the new Recovery Zone Bond program.

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Paul Wyzgoski is a public finance attorney with Dickinson Wright PLLC, which he joined in 1982. He became a partner with the firm in 1988. During almost all of his time with Dickinson Wright, Mr. Wyzgoski has served Michigan counties and their authorities as bond counsel. He has worked on a wide variety of financings on behalf of counties, including voted and non-voted general obligation bonds, revenue bonds, water and sewer contract bonds, tax increment bonds, property redevelopment bonds and notes, road improvement bonds and notes, tax anticipation notes, delinquent tax anticipation notes and installment purchase contracts. Mr. Wyzgoski is a frequent speaker to county associations on public finance topics. He graduated summa cum laude from Arizona State University with a bachelors degree in business administration, and earned his juris doctor from the University of Michigan Law School.

Area	Recovery Zone		
	Residual	Economic Development Bond	Recovery Zone Facility Bond
Michigan		773,050,000	1,159,575,000
Ann Arbor city, MI		11,511,000	17,266,000
Detroit city, MI		49,690,000	74,535,000
Flint city, MI		11,052,000	16,579,000
Grand Rapids city, MI		16,725,000	25,088,000
Lansing city, MI		9,880,000	14,821,000
Sterling Heights city, MI		11,365,000	17,048,000
Warren city, MI		11,332,000	16,998,000
Alcona County, MI		285,000	428,000
Alger County, MI		596,000	893,000
Allegan County, MI		7,556,000	11,334,000
Alpena County, MI		1,205,000	1,807,000
Antrim County, MI		1,205,000	1,807,000
Arenac County, MI		1,449,000	2,174,000
Baraga County, MI		340,000	510,000
Barry County, MI		5,031,000	7,546,000
Bay County, MI		6,612,000	9,917,000
Benzie County, MI		985,000	1,478,000
Berrien County, MI		10,858,000	16,286,000
Branch County, MI		2,651,000	3,977,000
Calhoun County, MI		9,653,000	14,479,000
Cass County, MI		3,952,000	5,928,000
Charlevoix County, MI		2,185,000	3,277,000
Cheboygan County, MI		1,663,000	2,495,000
Chippewa County, MI		1,578,000	2,367,000
Clare County, MI		1,836,000	2,754,000
Clinton County, MI		5,802,000	8,703,000
Crawford County, MI		1,106,000	1,659,000
Delta County, MI		2,253,000	3,380,000
Dickinson County, MI		1,636,000	2,454,000
Eaton County, MI	Residual	8,656,000	12,985,000
Emmet County, MI		1,452,000	2,178,000
Genesee County, MI	Residual	35,570,000	53,354,000
Gladwin County, MI		1,106,000	1,659,000
Gogebic County, MI		807,000	1,210,000
Grand Traverse County, MI		5,456,000	8,184,000
Gratiot County, MI		2,756,000	4,133,000
Hillsdale County, MI		3,082,000	4,623,000
Houghton County, MI		2,259,000	3,388,000
Huron County, MI		2,893,000	4,339,000
Ingham County, MI	Residual	13,855,000	20,782,000
Ionia County, MI		4,935,000	7,402,000
Iosco County, MI		727,000	1,091,000
Iron County, MI		755,000	1,132,000
Isabella County, MI		3,274,000	4,911,000
Jackson County, MI		11,459,000	17,188,000
Kalamazoo County, MI		18,433,000	27,649,000
Kalkaska County, MI		952,000	1,429,000
Kent County, MI	Residual	36,571,000	54,857,000
Keweenaw County, MI		129,000	193,000

Area	Recovery Zone		
	Residual	Economic Development Bond	Recovery Zone Facility Bond
Lake County, MI		689,000	1,033,000
Lapeer County, MI		7,188,000	10,782,000
Leelanau County, MI		1,279,000	1,918,000
Lenawee County, MI		8,901,000	13,351,000
Livingston County, MI		15,844,000	23,767,000
Luce County, MI		274,000	412,000
Mackinac County, MI		1,018,000	1,527,000
Macomb County, MI	Residual	46,293,000	69,439,000
Manistee County, MI		1,504,000	2,256,000
Marquette County, MI		2,992,000	4,487,000
Mason County, MI		1,339,000	2,009,000
Mecosta County, MI		2,602,000	3,903,000
Menominee County, MI		1,191,000	1,787,000
Midland County, MI		3,307,000	4,961,000
Missaukee County, MI		1,024,000	1,536,000
Monroe County, MI		13,237,000	19,856,000
Montcalm County, MI		3,000,000	4,500,000
Montmorency County, MI		604,000	906,000
Muskegon County, MI		13,890,000	20,835,000
Newaygo County, MI		3,702,000	5,554,000
Oakland County MI		103,887,000	155,831,000
Oceana County, MI		2,692,000	4,039,000
Ogemaw County, MI		1,005,000	1,507,000
Ontonagon County, MI		859,000	1,289,000
Osceola County, MI		1,383,000	2,075,000
Oscoda County, MI		1,087,000	1,630,000
Otsego County, MI		1,702,000	2,552,000
Ottawa County, MI		20,697,000	31,045,000
Presque Isle County, MI		832,000	1,247,000
Roscommon County, MI		1,449,000	2,174,000
Saginaw County, MI		16,950,000	25,426,000
St. Clair County, MI		13,520,000	20,280,000
St. Joseph County, MI		5,618,000	8,427,000
Sanilac County, MI		4,185,000	6,278,000
Schoolcraft County, MI		412,000	618,000
Shiawassee County, MI		6,263,000	9,395,000
Tuscola County, MI		5,519,000	8,279,000
Van Buren County, MI		5,404,000	8,106,000
Washtenaw County, MI	Residual	22,044,000	33,066,000
Wayne County, MI	Residual	78,259,000	117,388,000
Wexford County MI		2,286,000	3,429,000