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Tax Credit Bonds

In the American Recovery and Reinvestment Act of 2009 (ARRA), the U.S. Congress significantly increased the tax credit bond program available to state and local governments and entities. This greatly expanded program—which contains the largest single authorization of tax credit bonds ever—could have major implications for mutual fund managers and their investors.

Basically, qualified tax credit bonds (TCBs) are municipal bonds, or bonds issued by certain other specified issuers for certain specified purposes that do not pay any coupon interest. Instead, they quarterly accrue phantom taxable income and tax credit equal to the amount of phantom income to holders. The tax credit is determined by the Secretary of the Treasury at issuance. The rate of credit is intended to be set such that the bonds need not be sold at a discount (for a price less than the face value) or with interest cost to the issuer. The government entity selling a TCB is obligated to repay only the principal of the bond. The federal government makes “payments” to the bondholder through the tax credits. The tax credits delivered through the bonds are unlike typical tax credits because the credit is included in taxable income as if it were interest income.

TCBs are unlike tax-exempt bonds, which allow the investor to exclude interest on state and local government-issued tax-exempt bonds from the gross income on their federal return.

Until the passage of ARRA this year, TCB programs (see list in sidebar) have been small compared to the total volume of the tax-exempt bond market and have been targeted for specific purposes (e.g., assistance to rebuild specific geographic areas due to natural disasters like Hurricane Katrina and the like). The stimulus law authorizes an additional \$27.4 billion of tax credit bonds in 2009 and 2010.

ARRA Tax Credit Bond Provisions

- **Build America Bonds.** Under the ARRA, issuers can elect to issue either taxable tax-credit in lieu of tax-exempt bonds for governmental purposes for bonds issued in 2009 and 2010. The taxable bond option allows issuers either to receive a 35% reimbursement of interest paid from the federal government or to provide a tax credit to investors equal to 35% of coupon interest. All of the tax laws applicable to tax-exempt bonds apply to the taxable tax-credit governmental bonds.
- **Recovery Economic Zone Bonds (REZBs).** This new program authorizes \$10 billion in taxable bonds, similar to Build America Bonds, for purposes of promoting development or economic activity within a Recovery Zone. A Recovery Zone is determined by a government’s unemployment, poverty and home foreclosure rates. The bonds must be issued by December 31, 2010. The unique characteristic of REZBs is that there is no option for the investor to receive a tax credit, but instead the issuer would receive a direct payment from the federal government equal to 45% of the coupon interest on the bonds.
- **Qualified School Construction Bonds (QSCBs).** These TCBs may be used to finance new construction, rehabilitation or repair of public school facilities. The Act authorizes \$11 billion annually for 2009 and 2010. Similar to existing tax-credit bonds, the credit rate for QSCBs is required to be set by the Secretary of the Treasury at a rate that permits issuance of such bonds without discount and interest cost to the qualified issuer. The



bondholder (or the purchaser of a stripped tax credit) receives an annual tax credit—at a rate set by the Treasury Department—in lieu of tax-exempt interest while the bond is outstanding.

- **Qualified School Academy Zone Bonds.** QZABs are taxable bonds created in 1997 to improve schools located in empowerment zones, enterprise communities or in districts where 35% of the students qualify for free or reduced-price school lunches. At least 85% of the bond proceeds must be used for rehabilitating or repairing public school facilities, providing equipment, developing course materials, or training teachers and other school personnel. QZABs cannot be used for new school construction. Bondholders receive an annual tax credit set by the Treasury Department in lieu of tax-exempt interest while the bond is outstanding. Congress has routinely reauthorized \$400 million for this program, and the Act replaces that amount with \$1.4 billion annually in 2009 and 2010.

- **Clean Renewable Energy Bonds (CREBs).** The Act authorizes a total of \$2.4 billion (an increase of \$1.6 billion) for Clean Renewable Energy Bonds used to finance renewable energy facilities. The authorization is subdivided into thirds: 1/3 for state/local/tribal governments; 1/3 for qualifying projects of public power providers; and 1/3 for qualifying projects of electric cooperatives. CREBs are used to finance qualified energy production projects, including facilities for wind, bio-mass, geothermal and solar energy, trash combustion, refined coal production, and certain hydropower facilities.

- **Qualified Energy Conservation Bonds (QECBs).** This program, created in 2008, allows governments to issue bonds and use the proceeds to reduce energy consumption in publicly owned buildings, implement green community programs, produce electricity from renewable energy resources for rural areas, build research facilities and provide grants to support development of “green” technologies, reduce pollution from mass commuter vehicles, and advance other green technologies and infrastructure. A total of \$3.2 billion (an increase of \$2.4 billion) has been authorized for the program, which is allocated to the states in proportion to the population of the state. ARRA expands the use of QECBs to allow governments to make loans to individuals for green community programs—for instance, financing loans for homeowners to retrofit their homes with energy conservation products.

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Despite the billions of dollars authorized, issuers of municipal securities have not issued many of these bonds. Congress has authorized \$400 million in Qualified School Academy Zone Bonds (QZABs) annually for the last ten years, capped by an additional \$1.4 billion in 2009 and 2010 as part of the stimulus package. But according to Thomson Reuters, only \$1.587 billion of QZABs have been issued during the entire history of the program—less than half of the available authorization. Similarly, over \$1 billion of Clean Renewable Energy Bonds (CREBs) have been authorized by Congress since they were created in 2005, along with \$1.6 billion more in the stimulus law, but only \$51 million of CREBs have been sold in eight transactions, Thomson Reuters data show.

To date, the biggest obstacle to the wide acceptance of TCBs has been establishing a consistently reliable market. For example, in the past Congress has placed differing restrictions on programs, requiring the Treasury to write new rules when a new TCB program is authorized. In some cases, too, the Treasury has changed the rules over time, leaving issuers and investors confused about the requirements. In addition, the rules of each TCB program tend to have slight differences between them, which works against the commodization of the concept of the tax credit.

With the 2009 stimulus bill, however, Congress has laid the foundation for development of a dependable market by broadly expanding the amount of TCBs that can be issued and by adopting a consistent framework for TCBs.

Importantly, as part of the ARRA, Congress enacted a provision in the IRS code to allow funds to pass through the TCB tax credit, very similar to the ability of global and international funds to pass through foreign tax credits or municipal bond funds to pay tax-exempt interest dividends. Additionally, ARRA permits stripping credits from TCBs, thus opening the door for the development of new derivative instruments based on TCBs.

Build America Bonds

Of the TCBs now available, those with the most market potential for investment managers may be Build America Bonds (BABs). This new program, a key component of the ARRA authorization, enables state and local governments to issue taxable tax credit bonds in lieu of tax-exempt governmental bonds. BABs provide the issuer with the option of receiving a direct cash payment from the federal government or having it give a tax credit to investors. The payment and tax credit would each be equal to 35% of interest paid on the bonds.

BABs can be used for any governmental purpose. There is no national volume cap associated with BABs; any government may issue BABs between February 19, 2009 and December 31, 2010 for those projects where they may otherwise issue tax-exempt bonds (other than private activity bonds). All rules that apply to tax-exempt bonds also apply to BABs; e.g., private-use restrictions and arbitrage rebate regulations.



BABs provide a deeper federal subsidy to state and local governments (i.e., equal to 35% of the taxable borrowing cost) than traditional tax-exempt bonds and because of this federal subsidy payment, state and local governments will have lower net borrowing costs. This feature should make such BABs attractive to a broader group of investors than typically invest in more traditional state and local tax-exempt bonds.

Considerations

In their analysis, fund managers considering designing a new tax credit bond fund or adding TCBs to their current offerings should take into account the following points:

- **Sunset provision**—The TCBs, specifically BABs, authorized in the stimulus package carry a sunset issuance date of December 31, 2010, a very limited timeframe. A fund will have to debate developing a TCB offering knowing it will be soon be considerably different, and investors may reconsider the tax advantages of a TCB if they will no longer be issued within in less than two years.
- **Benchmarking**—Accurate, reliable benchmarking may also be an issue for a portfolio. Is a TCB benchmarked against municipal bonds or against taxable bonds? How does an investor evaluate a TCB fund against others? What, in short, is comparable?

- **Investor tax reporting**—Accounting and reporting systems and procedures must be developed by funds to track tax attributes, including tax credits, and to report to investors.

Despite these potential difficulties, with the combination of more tax credit bonds coming to market and the mechanism for an investment company to pass through the tax credits, we may see more interest by existing funds in investing in these bonds and in the creation of new funds that invest primarily in them, particularly if the 2010 issuance sunset is subsequently extended.