



STATE OF NORTH CAROLINA  
**DEPARTMENT OF STATE TREASURER**

State and Local Government Finance Division  
and the Local Government Commission

**Memorandum # 1116**

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TO: Officials of Local Governments and Public Authorities and Their Independent Auditors  
Entities Issuing Debt through the N. C. Capital Facilities Finance Agency

FROM: Tim Romocki, Director   
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SUBJECT: The American Recovery and Reinvestment Act of 2009-Debt Management Issues

Congress has recently passed the American Recovery and Reinvestment Act of 2009 (ARRA) and that act has been signed into law by the President. ARRA contains many provisions intended to improve the marketability of local government debt, make funds available for local governments and public authorities, and delay contractor withholding requirements for certain governments. Fiscal management issues related to ARRA were discussed in Memorandum No. 1115. This memorandum will discuss issues impacting debt management.

The Governor has established the Office of Economic Recovery and Investment (OERI) to oversee the use of ARRA funds by state and local governments in North Carolina. OERI will be led by Dempsey Benton, former director of the Department of Health and Human Services. OERI will serve as a clearing house for information about ARRA.

To the extent permitted under federal and State procurement and bidding laws, units should attempt to hire North Carolina companies to perform services with ARRA funds. There should be a good faith effort to use historically underutilized businesses when possible.

Any jobs created with ARRA funds must be posted with the Employment Security Commission. This requirement includes jobs created by private companies which provide contracted services for units. These contracts should include this job posting requirement as well as the requirement to report to OERI the number of jobs saved and the number of jobs created by the contract. Local units must be prepared to report the number of jobs saved and/or created by contractors with ARRA funds and any jobs created within the unit of government.

Contracts for services should clearly establish performance expectations that can be measured and that are time bound and results oriented. Contractors should submit progress reports for each project. Each unit should designate a person to oversee the contracts and approve invoices for payment under the contracts. Contracts should contain monetary penalties for failure to complete a project or reach agreed upon milestones. State agencies that pass funds through to local governments should have standard contracts available for local units to use that contain all necessary provisions. If pro forma contracts are not available, local units should ask the appropriate State agencies to review contracts before the contracts are executed.

Both the North Carolina League of Municipalities (NCLM) and the North Carolina Association of County Commissioners (NCACC) have links on their respective websites to provide more information about grants and loans and the impact of the stimulus bill on North Carolina governments. The NCLM link is <http://www.nclm.org/stimulus.htm> while the link for the NCACC is <http://www.ncacc.org/stimulus.html>. In addition, various State agencies have information about ARRA grants and loans on their websites.

### **Debt Programs and ARRA**

ARRA contains a number of provisions intended to increase the demand for tax exempt local government debt. Section 1501 of ARRA extends an exception for the de minimus 2% rules for tax exempt interest to financial institutions. Financial institutions are now permitted to deduct 80% of the interest expense incurred to purchase tax exempt debt issued in calendar years 2009 and 2010, as long as these bonds do not exceed 2% of the institution's total assets. Bank qualified bonds do not count against the 2% limit. This provision does not apply to refunding bonds issued in 2009-10 unless those bonds are refunding other bonds issued during that period.

Section 1502 of ARRA raises the bank qualified limits for borrowers for debt issued by local government and 501c(3) borrowers. That bank qualified limit is increased from \$10 million to \$30 million per calendar year. This provision also applies to bonds issued in calendar years 2009 and 2010, including debt issued to refund bonds. Taxable local government bonds do not count against this limit. This change should decrease the borrowing costs for qualifying privately placed debt.

The bank qualified amount is determined for each borrower, not by issuer. Therefore, entities that borrow through the North Carolina Capital Facilities Finance Agency will have a \$30 million bank qualified limit, rather than a single limit for the Agency to provide tax-exempt financing to qualified borrowers. This provision also applies to bonds issued by 501c(3) organizations or county industrial and pollution control facility authorities. Each 501c(3) or authority may borrow up to \$30 million of debt through the Agency or county authorities at bank qualified rates for new projects or to refund outstanding bonds.

Section 1503 of ARRA temporarily modifies the alternative minimum tax on tax exempt debt. The interest earnings on tax exempt private activity bonds will not count toward earnings when determining the alternative minimum tax for individuals and corporations. The interest earned on local government tax exempt and private activity bonds will not be included in calculating the adjusted current earnings for a corporation, and therefore, does impact the calculation of the alternative minimum tax of corporations. The earnings on local government bonds are already exempt from the alternative minimum tax for individuals.

The exceptions under Section 1503 apply to debt issued during the 2009 and 2010 calendar years and will also apply to debt issued during that period to refund bonds issued during the 2004 to 2008 calendar years.

ARRA allocates more than \$66 million for the Drinking Water Revolving Loan Fund and \$70 million for the Clean Water State Revolving Fund. Initial applications for water supply projects were due February 27, 2009. The deadlines for submitting applications for Clean Water funds, water and wastewater, were March 31, 2009, and April 3, 2009 respectively. ARRA requires that

50% of the funds be under contract within 120 days of enactment and all funds be under contract within 12 months. These funds will be subject to the Davis Bacon Act and Buy American provisions of the ARRA. A Federal agency may grant a waiver of the Buy American provisions for a project if it would be against the public interest, would increase costs by more than 25% or if there is not a sufficient supply of satisfactory materials. Funds will consist of both loans and grants. More information about these programs can be found at the following websites:

- <http://www.nccgl.net/Stimulus.html>,
- <http://www.deh.enr.state.nc.us.pws/srf/Pages/currentnews.htm>
- <http://breeze.unc.edu/p92867655/>.

Loans under these programs will require approval of the Local Government Commission (LGC). Applicants should be sure that they have submitted their audits for the fiscal year ended June 30, 2008 and received approval. Also units should have submitted their response to any audit review letters received from the LGC before applying to the LGC to issue debt. The staff anticipates a significant number of applications in the next few months. The staff is committed to processing all applications on a timely basis so that units can take advantage of available ARRA funds.

#### **New Clean Renewable Energy Bonds (CREB) and Qualified Energy Conservation Bonds (QECB)**

Sections 1111 and 1112 of ARRA have extended provisions of prior legislation (The Energy Improvement and Extension Act of 2008,--"the 2008 Act") that made the issuance of Clean Renewable Energy Bonds (CREB) available to units of local governments and have created a new category of Qualified Energy Conservation Bonds (QECB). Both may be used to help finance projects related to renewable energy projects. Both types of bonds are zero percent interest bonds. In lieu of tax-exempt interest earnings on these bonds, bondholders can receive a tax credit.

ARRA reauthorized a total of \$800 million in new CREB bonds for 2008, and authorized an additional issuance of \$1.6 billion of new CREB bonds to be used solely for renewable energy projects. These bonds may be issued for a variety of facilities that produce electric power or hydroelectric power from alternative energy sources including: wind facilities; closed or open-loop biomass facilities from agricultural livestock waste or wood waste materials; geothermal or solar energy facilities; small irrigation power facilities; landfill gas or trash combustion facilities and qualifying hydropower facilities. The allocation of new CREB bonds will be done through an application to the U. S. Treasury Department. Internal Revenue Service (IRS) Notice 2009-33 provides information on the administrative and procedural process for applying for these bonds. An application to the Treasury for the issuance of CREB bonds is available at <http://www.irs.gov/pub/irs-drop/n-09-33.pdf>. **The application deadline for new CREB bond volume cap allocations is August 4, 2009.**

For the QECB bonds, ARRA reauthorized the \$800 million of QECB bonds originally created under the 2008 Act and authorized an additional issuance limitation of \$2.4 billion for these bonds. The main difference from the CREB bonds is the definition of qualified energy conservation projects. QECB projects can relate to energy efficiency capital expenditures in public buildings; renewable energy production; implementing green community programs including loans and grants to individuals and corporations for energy efficient capital expenditures; mass commuting facilities that reduce energy consumption; several types of energy related demonstration projects;

and public energy efficiency education campaigns. Also, renewable energy facilities that are eligible for CREB bonds are also eligible for energy conservation bonds. For QECB bonds, an allocation by the U. S. Treasury has been made to each state based on relative state populations. Each state is required to further allocate a portion of its total allocation to large local governments within a state (any municipality or county with a population of 100,000 or more) also based on relative population within each state. North Carolina's total allocation for QECB bonds is \$95,677,000. Any unused allocation by a large local government may be reallocated back to the respective state. A bill has been introduced in the N. C. General Assembly to address the detailed allocation process within the State for these bonds.

### **Qualified School Construction Bonds (QSCB)**

Section 1521 of ARRA authorizes the issuance nationwide of \$11 billion in each of calendar years 2009 and 2010 of Qualified School Construction Bonds (QSCB). QSCB bonds may be issued to construct public schools, renovate and repair schools and buy land on which to build a public school.

Internal Revenue Service (IRS) Notice 2009-35 provides detailed administrative and procedural information about QSCB bonds as well as the allocations of these bonds by the IRS to each state and to certain large educational agencies within each state. North Carolina's allocation of QSCB bonds net of the allocations to large agencies for 2009 is \$187,167,000. In addition to the State's allocation, the IRS has made separate allocations to the large educational agencies in the State which include Charlotte-Mecklenburg Schools, Cumberland County Schools, Forsyth County Schools, Guilford County Schools and Wake County Schools. The separate allocations to these agencies total an additional \$88,605,000 for schools.

QSCB are tax credit bonds. Bondholders will receive a tax credit against their Federal tax liability rather than receive interest for the bonds. The Treasury now sets a daily tax credit rate that results in the bonds being issued without a discount and at zero interest rate for the issuer. The daily rate for tax credit bonds is available at:

- <http://www.treasurydirect.gov/govt/rates/irs/rates-irstcb.htm>.

Up to 2% of the proceeds of a QSCB, CREB or QECB bonds may be used to pay issuance costs. Issuers must reasonably expect to spend all available bond proceeds within three years. Available bond proceeds are proceeds of the sale plus any investment earnings, less issuance costs. If the proceeds are not expended within three years, the issuer must use the unexpended proceeds to redeem outstanding bonds within 90 days. Reimbursements of expenditures incurred after the issuer received their QSCB allocation are permitted.

### **Qualified Zone Academy Bonds (QZAB)**

In addition to the new QSCB bonds, section 1522 of ARRA increases the national limit for the existing Qualified Zone Academy Bond (QZAB) program from \$400 million to \$1.4 billion for 2009. North Carolina's allocation of QZAB bonds for 2009 is \$44,090,000 with allocations within the State made by the N. C. Department of Public Instruction. An additional \$1.4 billion is available nationally in 2010. Other than the increased allocations, there are no significant changes in the QZAB bond program.

### **Build America Bonds (BAB)**

Section 1531 of ARRA authorizes the issuance of taxable Build America Bonds (BAB) during the 2009 and 2010 calendar years. There is no issuance limit on these bonds. The purpose of these bonds is to give governments access to the taxable bond markets while incurring costs of borrowing similar to tax exempt debt. This purpose is accomplished by either issuing the bonds with a tax credit, BAB (tax credit), to the holder of the bonds or issuance as a qualified BAB bond, BAB (Direct Payment), with the Federal government paying an interest subsidy to the issuer. The issuer must make an irrevocable election to have the bonds treated as a BAB, and whether to issue a tax credit with the bonds or receive a direct interest subsidy. IRS Notice 2009-26 provides detailed information on the administrative and procedural requirements for issuing BAB bonds and IRS forms 8038-CP and 8038-G are used to request the tax credit payments and to satisfy the information reporting requirements for these bonds. These forms are available at <http://www.irs.gov/taxexempt/article/0,,id=206034,00.html>.

One option available to the issuer is to issue these bonds and allow the holder to receive both interest and an income tax credit equal to 35% of the interest paid on the bonds. With the Tax Credit BAB, it is anticipated that the rates paid on these bonds should match tax exempt rates. To qualify as a BAB, the debt must meet all the requirements for tax-exempt bonds under Section 103 of the IRS Code, may not be a private activity bond, must be issued no later than December 31, 2010, and must be issued at no more than a de minimus amount of premium. A de minimus amount is defined as .25% of par value multiplied by the number of whole years to maturity. If the issuer fails to meet these requirements, the tax credit would be lost to the holder.

Tax Credit BAB bonds may be used to refund outstanding bonds. The Tax Credit BAB bonds are subject to arbitrage requirements and the yield is determined without inclusion of the tax credit.

The other option available to the issuer is to issue the Direct BAB bonds at a taxable rate without a tax credit, and receive a subsidy from the federal government for 35% of the interest paid. Again the net borrowing costs to the issuers should approximate a tax exempt borrowing. In order to choose this option, the issuer must use 100% of the available project proceeds (APP) for capital expenditures. APP means the proceeds of the debt issue plus investment earnings, less up to 2% for issuance costs and an amount set aside for a reasonably required reserve fund. These bonds must also meet all the requirements to be tax exempt under Section 103 of the IRS Code. If the issuer fails to comply with these requirements, the Federal government will not pay the 35% interest subsidy.

Direct BAB bonds may not be issued to refund debt. The bonds are also subject to arbitrage requirements. The yield is calculated after the 35% interest subsidy from the federal government.

The 2008 Act and the ARRA significantly expand the universe of tax credit bonds. BAB, QZAB, CREB, QECB and QSCB bonds are all tax credit bonds that fall under rules generally set forth in Section 54A of the tax code. The tax credits may be stripped and sold separately. Interest on the

bonds is included in the gross income of the holder for tax purposes. The tax credit may be passed through to shareholders by Subchapter S corporations and to partners by a partnership.

**Recovery Zone Economic Development Bonds (RZEDB) and Recovery Zone Facility Bonds (RZFB)**

Section 1401 creates two types of bonds for economic development that may be issued in the 2009 and 2010 calendar year called Recovery Zone Economic Development Bonds and Recovery Zone Facility Bonds. The proceeds of the Recovery Zone Economic Development bonds must be spent for capital expenditures and public infrastructure for the purpose of promoting development or other economic activity in a recovery zone. Recovery Zone Facility Bonds can be used to finance almost any private capital investment in areas designated as "Recovery Zones." Recovery zones are areas designated by an issuer as:

- a) having significant poverty, unemployment, home foreclosure rate or general distress, or
- b) being economically distressed due to Base Realignment and Closure or
- c) being designated an empowerment zone or renewal community.

**In order to ensure that any privately owned project that could be financed through recovery zone bonds be a qualified project, it is imperative that the official designation of "recovery zones" be adopted by a local government unit before the project is begun. Otherwise, the entire project would not qualify for financing with these types of bonds.**

The Federal government will make allocations for bond issuance to the states based on employment declines. The states will then reallocate this amount to counties and large municipalities (population of more than 100,000) in proportion to each such county's or municipality's employment decline in relation to the aggregate decline of all the counties and municipalities in the State. The allocation to North Carolina and the method the State will use to make specific allocations to counties and municipalities have not yet been determined.

Recovery Zone Economic Development Bonds (RZEDO) are taxable bonds which are a form of Build America Bonds. Nationally, there is a \$10 billion limit of the bonds that may be issued. The Federal government will pay the issuer an amount equal to 45% of the interest payment due to the holder. The issuer should pay a net borrowing rate below the rate of traditional tax exempt debt. The IRS has provided initial implementation guidance in Notice 2009-26 along with Forms 8038-G and 8038-CP for initial reporting and request for interest subsidy payments, respectfully. The issuer must designate the bond as a RZEDB, and 100% of the available proceeds must be used for Qualified Economic Development Purposes in a designated Recovery Zone. Available project proceeds would include the proceeds of the issue plus investment earnings, less 2% issuance costs and an amount set aside for a reasonably required reserve fund. These proceeds would include capital expenditures for property in the zone and expenditures for public infrastructure and facilities in the zone. ARRA also allows expenditures for job training and educational purposes. It is not clear if N. C. General Statutes would permit expenditures for these non-capital purposes. Failure to meet these requirements would result in the federal government not paying the 45% interest subsidy.

Recovery Zone Facility Bonds (RZFB) are a type of private activity bond which is exempt from federal income taxes. Nationally, the limit for RZFB bonds is \$15 billion. This debt will be issued as conduit debt by county industrial and pollution control facility authorities and repaid by a private company that will be the borrower. If a private company is borrowing for facilities located in two or more counties in a single issue, the conduit issuer will be the North Carolina Capital Facilities Finance Agency. RZFB bonds are subject to all the provisions of a private activity bond, including TEFRA approval. They may be used to acquire existing property and they are not subject to the private activity bond volume cap. The bonds must be issued during the 2009 and 2010 calendar years and must be designated as RZFB bonds. In addition, 95% of the proceeds must be expended for Recovery Zone Property. Recovery Zone Property is property that qualifies for accelerated tax depreciation; the borrower acquires, constructs, reconstructs or repairs the property after the area where the property is located is designated as a Recovery Zone; the borrower is the original user of the property in the Recovery Zone and the property is for a qualified business. Businesses that would not qualify are those that would not qualify under current private activity bond rules. Examples of businesses that would not be qualified would be those for residential rental property, golf courses, country clubs, massage parlors and gambling facilities. Even with these restrictions, RZFB bonds allow a wider range of use for bond financed property than prior exempt facility bonds. The complete range of possible facilities for RZFB bonds is dependent upon the adoption of currently proposed legislation before the General Assembly.

#### **Expanded Definition of Manufacturing Facility for Qualified Private Activity Bonds**

Section 1301 of ARRA expands the definition of a manufacturing facility for qualified small issue private activity bonds, \$10 million or less, if issued in the 2009 and 2010 calendar years. Manufacturing facilities can include facilities used for the creation or production of intangible property such as patents and copyrights. Section 1301 also eliminates the 25% limit on the percentage of the bond proceeds that may be expended on facilities that are related and subordinate to the manufacturing facility if located on the same site.

The Davis Bacon Act will apply to projects financed with all forms of debt discussed in this memorandum with the exception of Build America Bonds and Recovery Zone Facility Bonds.

There are a number of issues which must be resolved by Federal agencies prior to many of these financing alternatives becoming available to local units. As additional information becomes available, we will notify our local units. Our staff is available to provide additional information to any units or authorities who may have an interest in or need for these types of financing. For more information related to debt issues, please contact Jim Baker at (919) 807-2370 or [jim.baker@nctreasurer.com](mailto:jim.baker@nctreasurer.com) or Tim Romocki at 919-807-2360 or [tim.romocki@nctreasurer.com](mailto:tim.romocki@nctreasurer.com).