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By Jeff Small
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Yesterday's headline calling out California's sale of nearly $7 billion in general obligation bonds for public works projects, brings forward the opportunity that is also offered to schools through the Emergency Economic Stabilization Act of 2008 ("Bail-Out Legislation") and the American Recovery and Reinvestment Act of 2009 ("ARRA").

This federal legislation is designed to invest over $25 billion in public education nationwide through the use of tax credit bonds, and billions more for other public projects, including schools. Proceeds from tax credit bonds can be used for the acquisition, construction and modernization of school facilities as well as equipment and renewable energy projects such as solar.

The big benefit to schools from tax credit bonds is that they allow districts to save money on interest costs when issuing debt such as general obligation bonds, certificates of participation, lease-purchase agreements, and tax and revenue anticipation notes. Investors receive federal tax credits in exchange for lower or no interest payments.

Currently, tax credit bonds can have a maturity of 14 to 15 years, and pay investors a tax credit rate of 7.95 percent. Daily changes of the term and tax credit rate can be found at a web link listed below.

For a traditional investor of tax-exempt debt issued by a school district, the new tax credit bonds are attractive. For example, let's assume that an investor is looking to purchase a 15 year, tax-exempt bond at an interest rate of 5.50 percent and is in the 35 percent tax bracket. This translates to a taxable investment of approximately 8.46 percent [5.5 percent / (1 – 35 percent)]. Now, converting this to a tax credit bond, with the current tax credit rate of 7.95 percent, in order for an investor to obtain an equivalent return as they would see in the traditional market, a district would need to pay a very low supplemental interest rate of 0.51 percent. Thus, the investor would receive an attractive investment, similar to a traditional tax-exempt bond, and the district would borrowing money at around 0.51 percent, which is very attractive.

As an added benefit, under the federal Bail-Out Legislation, school districts are able to offset the low supplemental interest rate by earning interest on district debt payments. When the district makes payments, they can be set aside in a sinking fund escrow account held through the maturity date on the tax credit bond, which can be 14 to 15 years. This account is then used on the maturity date to repay investors. The district can earn interest on this escrow account up to a daily maximum earnings rate, which is currently 5 percent.

The tax credit bonds for 2009 and 2010 can be used for both new construction and refurbishing or modernizing existing facilities. School districts should consider the nature of the projects to be financed in order to determine the appropriate option. The options are:

- Qualified Zone Academy Bonds (QZABs): Used for renovation, equipment purchases, development of course materials and training teachers and personnel. Allocations will continue to be made through the California Department of Education subject to new guidelines that are in the process of being revised.

- Qualified School Construction Bonds (QSCBs): Used for the construction, rehabilitation, or repair of public school facilities for the acquisition of land on which a public school facility will be constructed. Allocations will likely be made through the Office of Public School Construction, however this is currently undecided.

San Diego Unified School District is in the process of selling the first QSCBs as their allocation was pre-determined as one of the 100 largest school districts in the Country.

- Clean Renewable Energy Bonds (CREBs): Used for solar projects. Allocations made through applications submitted to the Internal Revenue Service.

- Build America Bonds (BABs): Subject to certain limitations, BABs can generally be issued for any purpose for which a tax-exempt bond can be issued such as capital expenditures, refundings, and working capital financings such as tax and revenue anticipation notes.

Unlike the above tax credit bonds, BABs involve a refundable tax credit equal to 35percent of the interest costs either paid directly to the issuer or paid to the bondholder. On April 22, the State of California was one of the first issuers of BABs as it concluded pricing on a $5.23 billion issue at a subsidized net interest rate of 4.83 percent **–** the lion's share of a total bond sale of $6.85 billion.

The California BABs were well received by the bond market. The BABs provide an optimistic outlook for reducing borrowing costs for school districts that have credit ratings that are on par or slightly below California's "A" credit rating.

Prior to 2008, issuers of tax credit bonds, such as QZABs, implemented projects with mixed results. This was due to strict QZAB requirements as well as a relatively thin and new market for QZABs.

However, as part of the federal Bail-Out Legislation, Congress enacted Section 54E of the Internal Revenue Code, which made it easier for districts to market QZABs. Moreover, the new tax credit bonds such as Qualified School Construction Bonds do not have strict program requirements such as low income or industry partner requirements.

Expectations are that with the expanded tax credit bond allocations and relaxed legal requirements, California school districts will be able to finance over $2 billion worth of school facility projects over the next two years at greatly subsidized costs. Since many of these financing techniques are new and have not yet been fully tested, it is difficult to predict actual financing costs. However, subject to daily market changes, credit quality and deal points, for QZABs, QSCBs and CREBs financing costs may range between 0-1 percent. For Build America Bonds, 5 percent is appropriate for a net effective rate indication on school district issuances.

To check daily changes in terms and rates for tax credit bonds visit:
https://www.treasurydirect.gov/govt/rates/irs/rates_qtcb.htm.

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