

February 2009

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Conferees Reach Agreement on Stimulus; Bond Provisions Remain

On February 12, 2009, the American Recovery and Reinvestment Act of 2009 (the "ARRTA") emerged from conference committee. Based on the version of ARRTA posted on the [Senate Finance Committee website](#), the compromise legislation will contain many of the municipal bond and tax credit bond-related provisions in the previously passed Senate and House versions, including marketability enhancements resulting from changes to the rules governing deductions for the cost of carrying tax-exempt debt and application of the alternative minimum tax, new categories of recovery zone bonds, qualified school construction bonds, build America bonds and tribal economic development bonds, expansion of the definition of manufacturing for small issue industrial development bonds, increases in allocation for new clean renewable energy bonds, qualified energy conservation bonds and qualified zone academy bonds and application of prevailing wage law to certain categories of bonds. It is anticipated that the House and Senate will each vote on ARRTA on Friday, February 13, with the President signing by Monday, February 16. This alert describes such provisions of ARRTA.

Marketability Enhancements — Section 265 and AMT Changes

De Minimis Safe Harbor Exception for Tax-Exempt Interest Extended to Financial Institutions

Section 265(b) of the Internal Revenue Code of 1986, as amended (the "Code"), currently provides that a financial institution may not deduct that portion of its interest expense allocable to interest on tax-exempt obligations held by such institution (with the exception of qualified tax-exempt obligations described below). Under such Section, the portion of a financial institution's interest expense allocable to tax-exempt interest is determined by calculating the ratio of the average adjusted bases of tax-exempt obligations held by the financial institution to the average adjusted bases for all assets of the financial institution. ARRTA amends Section 265(b) to provide that, when calculating the ratio described above, a financial institution may disregard tax-exempt obligations of all types held by the institution that were issued in 2009 and 2010, but only to the extent that the amount of such obligations does not exceed 2% of the portion of the financial institution's interest expense allocable to tax-exempt interest. Such "tax exempt obligations" include private activity bonds and governmental bonds that are in

excess of the qualified small issuer exception described below. The financial institution will be allowed only to deduct 80% of the interest expense related to the acquisition of such tax exempt obligations, because such interest will be treated as a “financial institution preference item” under Section 291(a) (3) of the Code. It is important to note, however, that current and advance refunding obligations are not eligible for the exclusion unless the bonds being refunded were issued in 2009 and 2010.

Modification of Small Issuer Exception

As described above, a financial institution may not deduct that portion of its interest expense allocable to interest on tax-exempt obligations held by such institution (other than “qualified tax-exempt obligations”). Section 265(b) (3) currently provides that “qualified tax-exempt obligations” are tax-exempt governmental and qualified 501(c)(3) obligations issued by a “qualified small issuer” that reasonably anticipates that it will not issue in a particular calendar year more than \$10 million in aggregate principal amount of tax-exempt obligations (other than certain private activity bonds). ARRTA amends Section 265(b)(3) by increasing the \$10,000,000 threshold to \$30,000,000 for tax-exempt governmental and 501(c)(3) obligations issued in calendar years 2009 and 2010. ARRTA also provides that in the case of a qualified 501(c)(3) bond issued in calendar year 2009 or 2010, the 501(c)(3) conduit borrower will be treated as the issuer for “qualified small issuer” purposes.

Of significance, each 501(c)(3) entity will be entitled to its own \$30 million limit for each calendar year. In addition, ARRTA amends Section 265(b)(3)

to provide that any composite, pooled or other conduit financing issue may be treated as a qualified tax-exempt obligation if the proceeds are used to make loans to one or more ultimate borrowers each of whom would separately qualify for the small issuer exception. Qualified tax-exempt obligations continue to be treated as “financial institution preference items” under Section 291(a) (3) of the Code, and therefore the financial institution can deduct 80% of its interest expense allocable to such obligations. It appears that the current refunding and deemed designation rules under Section 265 will continue to apply, subject to the \$30 million limit.

AMT Changes

ARRTA provides that private activity bonds issued in 2009 and 2010 are not subject to the alternative minimum tax (“AMT”). In other words, for purposes of individual and corporate AMT, interest on private activity bonds issued in those years will be accorded the same treatment as for governmental bonds, and will not be treated as a tax preference item. Additionally, for purposes of corporate AMT, interest on all tax-exempt bonds issued in 2009 and 2010 will not be an adjustment to current earnings. For these provisions related to the AMT, a refunding bond is treated as issued on the date of the refunded bond; therefore, a refunding bond will qualify for such treatment only if the refunded bond is issued in 2009 or 2010.

Tax Credit Bonds for Qualified School Construction

Section 1521 of ARRTA adds a new category of tax credit bonds that is to be codified in Section 54F of the Code and partially governed by the rules found in Code Section 54A. This

category of tax credit bonds is entitled “Qualified School Construction Bonds” (“QSCB”). Under the provisions, 100% of the “available project proceeds” (as described in our [summary of the tax credit bond provisions](#) included in the 2008 bailout legislation) of such issue are to be used for the “construction, rehabilitation, or repair of a public school facility or for the acquisition of land on which such a facility is to be constructed with part of the proceeds of such issue.”

The QSCB must be issued by a state or local government within the jurisdiction of which the school is located, and the issuer must designate the bond as a QSCB.

The allocation for QSCB is \$11 billion for each of calendar years 2009 and 2010 — a total of \$22 billion in allocation. There is an additional \$200 million in each of those years for Native American schools, and Indian tribal governments shall be treated as issuers for such purposes. Treasury will allocate to the states based upon the amounts a state is eligible to receive under Elementary and Secondary Education Act of 1965 for the fiscal year prior to the calendar year of allocation. The states will then reapportion such amounts within their respective states. ARRTA reserves 40% of the total allocation for large local education agencies,¹ and the allocation methodology is the same as for the state allocation above. Accordingly, a

¹ A large local education agency must be among the 100 local education agencies with the largest number of children aged 5 through 17 from families living below the poverty line, or one of not more than 25 educational agencies (excepting those in the preceding clause) that the Secretary of Education determines are in need of assistance based upon a low level of construction for school resources, a high level of enrollment growth or such other factors the Secretary deems appropriate.

state's allocation is reduced based upon the amount apportioned to the large local agencies. Any unused large local agency allocation may be reallocated by such agency to the state. Moreover, possessions of the United States other than Puerto Rico will receive allocation based upon a formula taking into account individuals below the poverty line living in the possession versus all such individuals in all states and possession. The amounts allocated to possessions will reduce the allocations to states and large local education agencies. Unused allocation may be carried over, and ARRTA does not place a limit on the years to which it may be carried over.

Tax Credit Build America Bonds and Refundable Credit Option

Section 1531 of ARRTA adds a new incentive for certain types of taxable governmental bonds. The incentive is to be codified in Section 54AA of the Code and entitled "Build America Bonds" ("BABs"). The credit is subject to limits and carryover provisions similar to those for credits under Code Section 54A (as described in our summary referenced above under the heading "*Tax Credit Bonds for Qualified School Construction*"). The credit on a BAB is includible in gross income.

The BAB must be issued before January 1, 2011, and (but for Code Section 54AA) qualify as a governmental bond under Section 103 of Code and not be a private activity bond. The issuer must designate the bond as a BAB. Moreover, the BAB must not have more than a *de minimis* amount of premium over the stated principal amount of the obligation.

The holder is entitled to a credit based upon a calculation that takes into

account the amount of interest payable on the bond. The amount of the credit is 35% of the interest payable by the issuer on an interest payment date that is defined as "any date on which the holder of record of the taxable governmental bond is entitled to a payment of interest under such bond."

Section 1531 of ARRTA also provides that an issuer may elect to receive a credit in lieu of the holder receiving a credit under new Code Section 6431. This is the so-called "refundable credit option." If the election is made, Treasury will pay to the issuer (or conduit borrower, generally) on each interest payment date an amount equivalent to the amount of the credit. To qualify, 100% of the available project proceeds (net of any amounts placed in a reasonably required reserve fund) must be spent on capital expenditures, and the issuer must elect this option. ARRTA requires Treasury to pay to the issuer the amount of the credit on or about each interest payment date. This provision applies to bonds issued before January 1, 2011.

A BAB is not treated as federally guaranteed for purposes of Code Section 149(b) by reason of the tax credit or the refundable credit. For the non-refundable credit, yield is determined without regard to the credit. For the refundable credit, yield is reduced by the credit.

Section 1531 of ARRTA provides that any state's laws must treat the interest on the qualifying taxable bond and the refundable credit as being exempt from federal income tax unless the state enacts a law to the contrary after enactment of ARRTA into law.

Recovery Zone Bonds and Tribal Economic Development Bonds

Section 1401 of ARRTA creates recovery zone bonds that include recovery zone economic development bonds and recovery zone facility bonds. Each type of bond must be designated as such by the issuer and must be issued before January 1, 2011.

There is an allocation of \$10 billion and \$15 billion for recovery zone economic development bonds and recovery zone facility bonds, respectively. The allocation will be apportioned among the states with each state receiving at amount of allocation determined according to a ratio of a state's 2008 employment losses to such losses for all states. The 2008 losses are the difference between the number of individuals employed in December 2007 over December 2008. Under the allocation rules, each state is guaranteed to receive at least .9 percent of the allocation in each category. Each state shall apportion the allocation within the state among counties and large municipalities according to a ratio of their employment losses versus the state's losses. For a "large municipality" within a county, the municipality's losses will not be included in the county's losses. A "large municipality" means a municipality with a population of more than 100,000.

A recovery zone is either an area (i) designated by the issuer, with significant poverty, unemployment, rate of home foreclosures or general distress, (ii) 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 (iii) with an effective designation as an empowerment zone or renewal community.

A recovery zone economic development bond shall entitle the issuer to a credit under new Code Section 6431 (described above under the heading “Tax Credit Build America Bonds and Refundable Credit Option”), except that the credit shall be 45% instead of 35%. The bond requires 100% of available project proceeds (net of any amounts placed in a reasonably required reserve fund) to be used for one or more qualified economic development purposes. Such purposes are described as “expenditures for purposes of promoting development or other economic activity in a recovery zone” and include capital expenditures paid or incurred with respect to property in the zone, expenditures for public infrastructure and construction of public facilities and expenditures for job training and educational programs.

A recovery zone facility bond is included within the meaning of an exempt facility bond under Section 142 of the Code. At least 95% of the “net proceeds” (as defined in Section 150 of the Code) of the bond must be used for “recovery zone property”, which is defined as property that is to which Section 168 of the Code applies, was constructed, reconstructed or acquired by purchase by the taxpayer after the zone designation took effect, had an original use in the zone commenced by the taxpayer, and is substantially all used in the zone and is used in the active conduct of a “qualified business” by the taxpayer in such zone. A “qualified business” is any trade or business except rental of residential property or a business involving a facility described in Code Section 144(c)(6)(B) (*i.e.*, gambling, alcohol sales, country clubs, *etc.*). Furthermore, the limitations on acquisition of existing property (*i.e.*,

rehabilitation expenditures) found in Code Section 147(d) shall not apply. Moreover, the volume cap rules under Code Section 146 shall not apply.

ARRTA creates a new category of tribal economic development bond, with an allocation of \$2 billion. The Treasury Secretary shall administer the allocation as it shall determine in consultation with the Secretary of the Interior. A bond qualifies if it is exempt from taxation as a state or local-issued bond under Code Section 103 so long as specified types of gaming are not occurring and the facility is not located outside an Indian reservation. The Indian tribal government must designate the bond as a tribal economic development bond. Treasury is required to conduct a study and report on it to Congress within one year of the enactment of this provision.

Small Issue Manufacturing Bonds

ARRTA amends Section 144(a) to expand the purposes for which the proceeds of small issue manufacturing bonds issued before January 1, 2011 can be used to include the creation or production of “intangible property,” defined as “any patent, copyright, formula, process, design, pattern, knowhow, format, or other similar item” described in Section 197(d)(1)(C)(iii) of the Code. In addition, a “manufacturing facility” financed with proceeds of qualified small issue bonds issued before January 1, 2011 can include functionally related and subordinate facilities, as further described in Treasury Regulations Section 1.103-8(a)(3). The concept of ancillary and related facilities (with the 25% limitation) will not apply to such bonds.

New Clean Renewable Energy Bonds (“New CREBs”), Qualified Energy Conservation Bonds (“QECBs”) and Qualified Zone Academy Bonds (“QZABs”)

Sections 1111 and 1112 of ARRTA increase the current allocations for each of New CREBs and QECBs from \$800 million to \$2.4 billion and \$3.2 billion, respectively. For QECBs, ARRTA provides that the implementation of green community programs (which is one of many qualified purposes for QECBs) includes “the use of loans, grants, or other repayment mechanisms to implement such programs.” Moreover, QECBs issued for capital expenditure to implement green community programs shall not be treated as private activity bonds solely because proceeds are to be used for such loans or grants to implement green community programs. This treatment is significant because it enables such QECBs to be eligible for the governmental portion of the QECB allocation. Each of the New CREBs and QECBs were created in the “Energy Improvement and Extension Act of 2008” that was included in the bailout package enacted on October 3, 2008. Please see our summary referenced above under the heading “*Tax Credit Bonds for Qualified School Construction.*”

For the QZAB program, Section 1522 of ARRTA increases the 2009 QZAB allocation from \$400 million to \$1.4 billion and extends the program into 2010 with allocation for that year to be \$1.4 billion. The October 2008 bailout package included legislation entitled “Tax Extenders and Alternative Minimum Relief Act of 2008” that reauthorized and extended the existing QZAB program by adding \$400 million in allocation for each of calendar years 2008 and 2009.

Each of the New CREB, QECB and modified QZAB programs are governed by Section 54A of the Code, which was added in the “Heartland, Habitat, Harvest and Horticulture Act of 2008.” Code Section 54A makes significant changes to the statutory framework that governs the existing CREBs (Code Section 54) and that previously governed QZABs (Code Section 1397E). Those changes include, among others, introduction of a reserve fund option that generally allows for equal annual installments that are not treated as retiring a portion of the bond (subject to yield limitations), a three-year temporary period for expenditure of “available project proceeds,” a 2% limitation on financing costs of issuance from the proceeds of the tax credit bond, stripping of the tax credits and carryover of the tax credits. A more detailed discussion of these matters is included in our summary referenced above under the heading “*Tax Credit Bonds for Qualified School Construction.*”

rates for common jobs. In many cases, the contractor must request a “wage determination” from the Branch of Construction Wage Determination, a sub-agency within DOL.

Application of Davis-Bacon Act Prevailing Wage Standards

Section 1601 of ARRTA subjects certain categories of bonds to the prevailing wage standards under the Davis-Bacon Act of 1931. Those bonds are New CREBs, QECBs, QZABs, QSCBs and recovery zone economic development bonds. In general, prevailing wage rules require the contractor to consult with the Department of Labor (“DOL”) to determine the appropriate wage rate for the particular jobs under the contract. DOL has certain fixed

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