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Congressional leaders reach agreement on American Recovery and Reinvestment Tax Act

By Gary Bornholdt

In our January 23, 2009 *Alert*, we described the municipal bond provisions in the version of the American Recovery and Reinvestment Tax Act of 2009 introduced in the House of Representatives. The Act subsequently passed the House and the Senate, albeit in slightly different forms. Late on February 11, 2009, Congressional leaders reached agreement on a compromise version of the Act. Congress is expected to take final action on the Act as soon as today.

The Act creates several new tax-exempt and tax-credit bond programs, and expands and modifies existing tax-credit bond programs. The Act also makes several changes to the tax treatment of certain tax-exempt bond investments. With limited exceptions, the provisions in the Act related to tax-exempt bonds and tax-credit bonds apply only to bonds issued through 2010.

New tax-exempt bond and tax-credit bond programs

Taxable governmental bonds: Build America Bonds

The Act creates a new type of tax-credit bond that pays investors both taxable interest and a federal tax credit equal to 35 percent of that taxable interest (Build America Bonds).

Through December 31, 2010, state and local governments may elect to issue Build America Bonds in lieu of a tax-exempt governmental bond. Importantly, issuers of Build America Bonds may elect to receive a rebate from the IRS of 35 percent of the interest paid on the bonds in lieu of investors receiving the tax credit.

Build America Bonds may be issued only for those purposes for which tax-exempt governmental bonds may be issued under present law. In addition, the tax rules that apply to tax-exempt governmental bonds (e.g., private-use restrictions, arbitrage, etc.) also would apply to Build America Bonds.

Build America Bonds for which an issuer has made the election to receive the 35-percent interest rebate option may only be used for capital expenditures, issuance costs, and reserve funds.

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New tax-exempt private activity bond: Recovery Zone Facility Bonds

The Act authorizes the issuance of $15 billion in a new category of tax-exempt private activity bonds (Recovery Zone Facility Bonds) for use in areas designated as Recovery Zones. The Act generally defines Recovery Zones as areas designated by state and local governments as having significant poverty, unemployment, or home-foreclosure rates.

Generally, property eligible for depreciation that is actively used in a business may be financed with the proceeds of Recovery Zone Facility Bonds, provided the property is acquired after the date on which a Recovery Zone designation took effect.

The $15-billion volume limitation for Recovery Zone Facility Bonds would be allocated to the states in proportion to their respective 2008 job losses, with suballocations to counties and large municipalities within a state also made on the basis of relative job losses. Recovery Zone Facility Bonds must be issued before January 1, 2011.

New taxable bond: Recovery Zone Economic Development Bonds

The Act authorizes the issuance of $10 billion in a new category of taxable bonds similar to Build America Bonds (described above). Recovery Zone Economic Development Bonds would pay interest at a taxable rate and the federal government would provide issuers with direct payments equal to 45 percent of the interest on the bonds (compared to 35 percent for Build America Bonds).

Recovery Zone Economic Development Bonds may be issued for purposes that promote development or economic activity in a Recovery Zone. The bonds also are subject to the present-law rules that apply to tax-exempt governmental bonds (e.g., private-use restrictions, arbitrage, etc.).

The $10 billion volume limitation for Recovery Zone Economic Development Bonds would be allocated to the states in the same manner as Recovery Zone Facility Bonds. Recovery Zone Economic Development Bonds must be issued prior to January 1, 2011.

New tax-credit bond: Qualified School Construction Bonds

The Act creates a new category of tax-credit bonds to finance the construction, rehabilitation, or repair of public school facilities, "Qualified School Construction Bonds." Similar to existing tax-credit bonds, the credit rate for Qualified School Construction Bonds 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 Act authorizes $11 billion annually in Qualified School Construction Bonds for 2009 and 2010, with 60 percent of that authority allocated to the states in proportion to the respective amount of local educational grants received by each state under the Elementary and Secondary Education Act. The remaining volume would be allocated to the largest local educational agencies in the nation (as determined by the Treasury in coordination with the Department of Commerce and the Secretary of Education).

The Act also provides an additional $200 million in annual Qualified School Construction Bond authority for 2009 and 2010 that is allocated to Indian tribal schools by the Secretary of the Interior.

New tax-exempt bond: Tribal Economic Development Bonds

Present law treats bonds issued by Indian tribal governments as tax-exempt only if substantially all of the proceeds of such bonds are used for "essential governmental functions" or certain manufacturing facilities.

The Act authorizes the Treasury (in consultation with the Department of Interior) to allocate $2 billion in Tribal Economic Development Bonds. Tribal Economic Development Bonds generally may be issued for the same purposes as tax-exempt bonds issued by state and local governments. Thus, the essential governmental function requirement that applies to bonds issued by tribal governments under present law generally would not apply to Tribal Economic Development Bonds. The Act also would permit tribal governments to issue tax-exempt private-activity bonds. Tribal Economic Development Bonds could not, however, be used for certain gaming facilities or facilities located outside an Indian reservation.

Modifications to existing tax-exempt bonds and tax-credit bonds

Increase to New Clean Renewable Energy Bonds limitation

New Clean Renewable Energy Bonds (New CREBs) are a type of tax-credit bond that may be used to finance certain renewable energy facilities (generally, facilities that qualify for the production tax-credit under the Internal Revenue Code). The Act increases the amount of New CREBs that may be issued from $800 million to $2.4 billion.

Increase to Energy Conservation Bonds limitation

Energy Conservation Bonds are a type of tax-credit bond that may be issued for broadly defined qualified conservation purposes. The Act increases the amount of Energy Conservation Bonds authority from $800 million to $3.2 billion. The Act also clarifies that permitted uses of Energy Conservation Bonds include making loans and grants to individuals for green community programs. For example, states may issue these tax-credit bonds to finance loans to individual homeowners to retrofit existing housing with energy conservation properties.

Extension of Qualified Zone Academy Bonds authority

Present law authorizes the annual issuance of $400 million in Qualified Zone Academy Bonds (QZABs) in 2008 and 2009. QZABs are a type of tax-credit bond that may be used for certain school expenditures (but new construction is prohibited).

The Act extends QZAB issuance authority through 2010 and increases the annual volume limitations for 2009 and 2010 to $1.4 billion.

Expand definition of "manufacturing facility"

Present law permits the issuance of tax-exempt private-activity bonds for certain manufacturing facilities. In addition, facilities that are directly related and ancillary to a manufacturing facility may be eligible for financing, but only if not more than 25 percent of the net proceeds of a bond issue are used to provide such facilities.

The Act expands the definition of manufacturing facilities to include facilities that are used in the manufacturing, creation, or production of intangible property (that is, any patent, copyright, formula, process, design, know-how, format, or other similar item).

In addition, the Act provides that facilities that are functionally related and subordinate to a manufacturing facility are treated as a manufacturing facility and the 25-percent-of-net-proceeds restriction does not apply to such facilities.

The modifications to the manufacturing definition only apply to bonds issued after the date of enactment and before January 1, 2011.

Modifications to high-speed rail requirements

Present law permits the issuance of tax-exempt private-activity bonds for certain high-speed rail facilities. Generally, a facility is eligible for this financing only if such a facility uses vehicles that are reasonably expected to operate at speeds in excess of 150 miles per hour between scheduled stops.

The Act modifies the requirement that high-speed rail facilities use vehicles that are reasonably expected to operate at speeds in excess of 150 miles per hour. Instead, under the proposal, such facilities must use vehicles reasonably expected to attain a top speed in excess of 150 miles per hour. This provision is effective for bonds issued after the date of enactment of the Act and does not expire.

Amendments to tax treatment of investors in tax-exempt bonds

Bank deductibility of interest related to tax-exempt investments

Generally, federal tax law disallows a deduction for interest on indebtedness incurred to purchase or carry tax-exempt obligations. For financial institutions, the disallowance is based on the percentage of a taxpayer's assets comprised of tax-exempt obligations (the pro-rata rule).

In the case of obligations issued by a "small issuer" (generally, an issuer that expects not to issue more than $10 million in tax-exempt obligations within a calendar year), the general pro-rata rule does not apply and only 20 percent of the interest allocable to the tax-exempt obligations of a qualified small issuer (bank qualified bonds) is disallowed.

The Act creates a temporary 2-percent safe harbor permitting financial institutions to purchase certain tax-exempt investments without the corresponding interest expense disallowance. Under the Act, to the extent the average adjusted basis of tax-exempt obligations is 2 percent or less of the average adjusted basis of total assets, financial institutions would be permitted an 80-percent deduction for interest on indebtedness related to tax-exempt obligations. The 2-percent safe harbor would apply only to bonds issued in 2009 and 2010 (but would only apply to refunding bonds to the extent the refunded bond was issued in 2009 or 2010).

The Act increases the definition of "small issuer" for purposes of the bank-qualified bond rules from $10 million to $30 million, but only with respect to bonds issued in 2009 and 2010. In addition, the Act provides that, for purposes of determining whether an issuer meets the small-issuer exception, qualified 501(c)(3) bonds issued in 2009 or 2010 are treated as if they were issued by the 501(c)(3) organization for whose benefit they were issued (and not by the actual issuer of such bonds).

Application of AMT to private activity bonds

The alternative minimum tax (AMT) imposed on individuals and corporations is computed by adjusting a taxpayer's taxable income to take into account certain preference items and adjustments. One of the preference items taken into account for purposes of the AMT is tax-exempt interest on most tax-exempt bonds issued for private activities.

In addition, in the case of a corporation, an adjustment based on current earnings is determined, in part, by taking into account 75 percent of certain items, including tax-exempt interest, that are excluded from taxable income but included in the corporation's earnings and profits (the ACE

Adjustment). This ACE Adjustment applies to interest on tax-exempt governmental bonds, as well as interest on most private-activity bonds.

Under the Act, interest on private-activity bonds issued in 2009 and 2010 is not a preference item for purposes of the AMT. This rule would not apply to a refunding bond unless the refunded bond was issued after December 31, 2003.

In addition, under the Act, the ACE Adjustment would not apply to bonds issued in 2009 and 2010. This rule would not apply to a refunding bond unless the refunded bond was issued after December 31, 2003.

Application of federal prevailing wage requirements to tax-credit bonds

Under the Act, federal prevailing wage requirements under the Davis-Bacon Act apply to projects financed with the following types of tax-credit bonds:

- New Clean Renewable Energy Bonds
- Energy Conservation Bonds
- Qualified Zone Academy Bonds
- Qualified School Construction Bonds
- Recovery Zone Economic Development Bonds

If you have any questions or require further information regarding these or other matters, please call your regular Nixon Peabody contact or feel free to contact one of the attorneys listed below:

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