

## The American Recovery and Reinvestment Act of 2009

On February 13, 2009, both the House and Senate agreed to the conference report of H.R. 1, the American Recovery and Reinvestment Act of 2009 (the "Act"). The President signed the Act into law on Tuesday, February 17, 2009. The Act contains a number of tax provisions affecting the issuance of tax-exempt obligations, tax credit obligations and hybrid tax credit obligations. These provisions are outlined below.

### Interest Expense Disallowance - Financial Institutions

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The Act provides that tax-exempt obligations issued in 2009 or 2010 (in an amount up to two percent of a financial institution's average adjusted bases in all its assets) receive a more favorable treatment in determining the disallowance of a financial institution's interest expense deduction allocable to tax-exempt interest. For purposes of this provision, a current or advance refunding bond will be treated as issued on the issue date of the refunded bond (or in the case of a series of refundings, the original bond).

### Bank Qualification

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The Act (i) raises the qualified small issuer limit on the amount of obligations issued in a year for bank qualification purposes to \$30,000,000 of tax-exempt obligations issued in each of the calendar years 2009 and 2010 from the pre-Act limit of \$10,000,000; (ii) allows issuers to designate up to \$30,000,000 of tax-exempt obligations issued in each of the calendar years 2009 and 2010 as qualified tax-exempt obligations, increased from the pre-Act limit of \$10,000,000; and (iii) for obligations issued in calendar years 2009 and 2010, increases the limit applicable to the face amount of certain bank-qualified bond issues to \$30,000,000 from the pre-Act limit of \$10,000,000.

In addition, the Act provides that a 501(c)(3) organization for whose benefit qualified 501(c)(3) bonds are issued is treated as the "issuer" during calendar years 2009 and 2010 for purposes of the bank qualification provisions. The Act also allows certain composite, pooled or other conduit financing issues ("qualified financing issues") issued during 2009 or 2010, the proceeds of which are used to make or finance loans to states or political subdivisions or 501(c)(3) organizations, to be bank qualified, depending on the status of their separate portions. Tax-exempt obligations issued in 2009 and 2010 as part of a qualified financing issue are treated as bank qualified tax-exempt obligations if the bank qualification requirements are met with respect to each portion of the issue, determined by treating each portion as a separate issue issued by the state or political subdivision or a 501(c)(3) organization to which such portion relates.

## Alternative Minimum Tax

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The Act provides that interest on private activity bonds issued during 2009 and 2010 will not be treated as an item of tax preference for purposes of the alternative minimum tax. In addition, interest on obligations issued in 2009 and 2010 will not be used to compute the adjustment to the corporate alternative minimum tax that is based on current earnings. For purposes of both these rules, a refunding bond is generally treated as issued on the date of issuance of the refunded bond (or in the case of a series of refundings, the original bond). However, the rule in the preceding sentence does not apply to a refunding bond issued to refund any bond issued after December 31, 2003 and before January 1, 2009.

## Expansion of Availability of Industrial Development Bonds to Facilities Manufacturing Intangible Property

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The Act includes a provision that expands the facilities that qualify for financing with proceeds of small issue private activity bonds. Prior to enactment of the Act, proceeds of those bonds could only be used for facilities for the manufacture or production of “tangible personal property.” In addition, no more than 25 percent of the proceeds of small issue bonds could be used for facilities that are “ancillary” to the core manufacturing process. The Act generally, for obligations issued after the date of enactment and before 2011, (i) permits small issue bonds to be used for the creation or production of certain intangible property (specifically, “any patent, copyright, formula, process, design, pattern, know-how, format, or other similar item”) and (ii) eliminates the 25 percent cap on ancillary facilities.

## Mortgage Revenue Bonds - First Time Homebuyer Credit

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The Act eliminates the prohibition on the receipt of the first-time homebuyer credit for the purchase of any residence financed by an issue of tax-exempt qualified mortgage bonds. The Act raises the first-time homebuyer credit to a maximum of \$8,000, extends the credit to homes purchased through November 30, 2009, and, generally, the credit does not have to be repaid for homes purchased between January 1, 2009 and November 30, 2009.

## Increase in Volume Limitation for Current Tax Credit Bonds

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The Act increases the volume limitations for three existing types of tax credit bonds:

1. The Act increases the volume limitation for New Clean Renewable Energy Bonds (“NCREBs”) from the pre-Act volume limitation of \$800,000,000 to \$2,400,000,000;
2. The Act increases the volume limitation for Qualified Energy Conservation Bonds (“QECCBs”) from the pre-Act volume limitation of \$800,000,000 to \$3,200,000,000; and
3. The Act increases the volume limitation for Qualified Zone Academy Bonds (“QZABs”) from the pre-Act volume limitation for 2009 of \$400,000,000 to \$1,400,000,000 and extends the QZABs program to 2010 with a volume limitation of \$1,400,000,000.

## Modification of Rules for QECBs that Implement Green Community Programs

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QECBs that satisfy the private activity bond tests for private use are subject to special restrictions requiring that (i) such bonds not receive any more than 30 percent of total available volume limitation and (ii) the proceeds of such bonds and investment earnings thereon (except for costs of issuance not exceeding two percent of sale proceeds) be used only to finance capital expenditures. The Act clarifies that proceeds of QECBs may be used for “loans, grants, or other repayment mechanisms to implement such [green community] programs” and further provides that QECBs financing such green community programs are not treated as private activity bonds for purposes of the 30 percent restriction on volume limitation for private activity bonds.

## New Tax Credit Bonds for School Construction

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The Act provides for the issuance of qualified school construction bonds (“QSCBs”), a new category of tax credit bonds all of the proceeds and investment earnings of which (except for costs of issuance not exceeding two percent of sale proceeds) 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 the tax credit bond.

QSCBs may be issued by a State or local government within the jurisdiction of which a school is located. The national limitation for QSCBs is \$11,000,000,000 for 2009 and \$11,000,000,000 for 2010. There is a minimum allocation of the national limitation to each State (and other allocations of volume limitation for U.S. possessions and Indian schools). In general, however, the national limitation will be allocated among the States in proportion to amounts each State is eligible to receive under Section 1124 of the Elementary and Secondary Education Act of 1965 (20 U.S.C. 6333) for most recent fiscal year ending before such calendar year. Also, 40 percent of the national limitation will be allocated to “large local educational agencies” in proportion to amounts each agency receives under Section 1124 of the Elementary and Secondary Education Act of 1965 (20 U.S.C. 6333) for the most recent fiscal year ending before such calendar year; such allocation reduces the allocation to the State in which such agency is located. In general, a “large local educational agency” is (i) among the 100 local educational agencies with the largest numbers of children aged 5 through 17 from families living below the poverty level or (ii) one of not more than 25 local educational agencies (other than as described in (i)) that the Secretary of Education determines are in particular need of assistance, based on a low level of resources for school construction, a high level of enrollment growth or certain other factors.

## Build America Bonds

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The Act creates a new section of the Internal Revenue Code (the “Code”) that governs “Build America Bonds,” a new category of hybrid tax credit obligations. Under the Act, issuers of obligations that would otherwise be tax-exempt governmental obligations (not private activity bonds) are entitled to issue taxable obligations and either allow their bondholders to receive a federal income tax credit or receive a payment from the federal government.

Issuers will be permitted to elect to treat certain obligations that would otherwise qualify as tax-exempt obligations as taxable, in which case holders of such obligations will receive a tax credit on each interest payment date equal to 35 percent of the interest payable by the issuer on such date. The election is available for a "Build America Bond," which is defined as any obligation (other than a private activity bond) if (i) the interest on such obligation would, but for the new Code section, be excludable from gross income under Section 103 of the Code, (ii) such obligation is issued before January 1, 2011 and (iii) the issuer makes an irrevocable election to have the new tax credit Code section apply. The election is available for obligations issued after the date of enactment of the Act. A bond will not be treated as a Build America Bond if the issue has more than a de minimis amount of bond premium (determined under rules similar to those in the original discount provisions of the Code). Interest on the Build America Bonds must be included in gross income.

In addition, issuers will be permitted to elect to receive a direct payment from the U.S. Treasury with respect to Build America Bonds that are "qualified bonds" equal to 35 percent of the interest payable under such bond on each interest payment date. A "qualified bond" is defined as any Build America Bond issued as part of an issue if (i) 100 percent of the available project proceeds of such issue (generally, the sale proceeds plus investment earnings minus costs of issuance of up to two percent of the sale proceeds) are to be used for capital expenditures or to fund a reasonably required reserve fund and (ii) the issuer makes an irrevocable election to have the section apply. The credit will take the form of a payment by the Treasury Secretary to the issuer contemporaneously with each bond interest payment date, and the payment is in lieu of the credit allowed to bondholders (as described above) with respect to the particular bond.

## Recovery Zone Bonds

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The Act creates new sections of the Code that govern a newly created type of tax-exempt bond and a newly created hybrid tax credit bond for use, in each case, within "recovery zones." Recovery zones are areas (i) designated by the issuer as having 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 or (iii) designated as an empowerment zone or a renewal community. Nationwide there is a limit of \$10,000,000,000 of Recovery Zone Economic Development Bonds and \$15,000,000,000 of Recovery Zone Facility Bonds. These limitations are to be allocated by the federal government to the various States in proportion to employment declines from December 2007 to December 2008. Each State is subject to a minimum allocation of 0.9 percent of the nationwide limitation. The States must then reallocate their allocations among the counties and municipalities with populations over 100,000 within the States in proportion to such employment declines; the counties and municipalities may waive the allocation. All of such obligations must be issued before January 1, 2011.

Recovery Zone Economic Development Bonds must be obligations (other than private activity bonds) for which (i) the interest on such obligations would, but for the new Code section, be excludable from gross income under Section 103 of the Code and (ii) the issuer makes an irrevocable election to have the new tax credit Code section apply. A Recovery Zone Economic Development Bond is defined as any Build America Bond, all of the available project proceeds (generally, the sale proceeds plus investment earnings minus costs of issuance of up to two percent of the sale proceeds) of which are used for one or more qualified economic development purposes or to fund a reasonably required reserve fund. The term “qualified economic development purpose” means expenditures for purposes of promoting development or other economic development in a recovery zone, including (i) capital expenditures paid or incurred with respect to property located in such zone, (ii) expenditures for public infrastructure and construction of public facilities and (iii) expenditures for job training and educational programs. Issuers of Recovery Zone Economic Development Bonds receive, for each interest payment date, a payment equal to 45 percent of interest payable on such bonds paid directly by the U.S. Treasury to the bond issuer.

The Act creates Recovery Zone Facility Bonds, a new category of tax-exempt private activity, exempt facility bonds, which are obligations designated by the issuer at least 95 percent of the net proceeds of which are used, generally, for certain depreciable property acquired after the recovery zone designation takes effect, the original use of which in the recovery zone commences with the taxpayer (except in the case of certain renovations), and substantially all of the use of which is in the recovery zone in the active conduct of a business in a recovery zone. Such obligations must be used for capital projects to be used in business activity within the recovery zone. Such business activity excludes residential rental and certain prohibited businesses (e.g., suntan facilities, massage parlors, racetracks). Generally, all rules for exempt facility bonds under the Code apply, except that an allocation of the general state volume cap is not required and the prohibition against acquisition of existing property does not apply.

### **Application of Certain Labor Standards to Projects Financed with Proceeds of Certain Tax Favored Bonds**

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The Act provides that certain labor standards and wage rate requirements under Subchapter IV of Chapter 31 of Title 40 of the United States Code will apply to projects financed with the proceeds of bonds issued after the date of enactment of this provision that are (i) NCREBs, (ii) QECEBs, (iii) QZABs, (iv) QSCBs (as newly created under the Act) or (v) Recovery Zone Economic Development Bonds (as newly created under the Act).

### **RICS Allowed to Pass Through Tax Credit Bond Credits**

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The Act permits a regulated investment company (“RIC”) to pass through tax credits received from NCREBs, QECEBs, QZABs, CREBs, QSCBs, Qualified Forestry Conservation Bonds and Build America Bonds to shareholders. Such pass through requires the RIC to make an affirmative election to do so and to provide notice to shareholders.

## Other Provisions

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The Act creates a new category of tax-exempt obligations for tribal economic development, modifies the definition of high speed intercity rail facilities relating to high speed intercity rail facility bonds and increases the new markets tax credit.

If you would like to discuss any of the issues addressed in this Client Alert or would simply like to find out more about Chapman, please contact Kelly Kost at [kost@chapman.com](mailto:kost@chapman.com) or visit us at [www.chapman.com](http://www.chapman.com).

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