

Public Finance TAX UPDATE

A NEWSLETTER HIGHLIGHTING RECENT FEDERAL INCOME TAX DEVELOPMENTS AFFECTING THE PUBLIC FINANCE INDUSTRY

March, 2009

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The content of the IRS's 2009 Tax Exempt Bonds Work Plan is explained in this article.
- ❶ **The American Recovery and Reinvestment Act of 2009.**
This article explains the provisions of the Act affecting the issuance of tax-exempt obligations, tax credit obligations and hybrid tax credit obligations.

2009 IRS Tax Exempt Bonds Work Plan

The IRS released its Tax Exempt Bonds Work Plan, Planning Guidelines for the 2009 Fiscal Year. The IRS uses the work plan to provide guidance and direction to IRS employees working with tax-exempt obligations.

The work plan is divided into two sections. Section One of the work plan provides guidance for the customer education and outreach activities of the IRS. Section Two of the work plan provides guidance for IRS compliance activities, which are designed to monitor and increase compliance with the provisions of the tax law governing tax-exempt obligations.

As part of its customer education and outreach activities, the IRS will continue to support educational programs and to assist professionals who provide tax advice or monitor post-issuance use or arbitrage compliance. As part of this effort, the IRS will continue to participate in workshops, seminars and meetings sponsored by bond industry groups and to improve and expand voluntary compliance programs. The IRS will also monitor noncompliance trends for the purpose of designing proactive education and outreach products for members of the tax-exempt bond community.

As part of its compliance activities, the IRS will focus on identifying and correcting noncompliance by, among other activities, continuing to:

- (i) measure the compliance levels of market segments by conducting project initiatives

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The American Recovery and Reinvestment Act of 2009

In February, 2009, President Obama signed the American Recovery and Reinvestment Act of 2009 (the "Act") into law. 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. 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,

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and identifying emerging trends; (ii) apply the provisions of Section 6700 of the Internal Revenue Code (promoter penalties); (iii) coordinate with, and refer cases to, other IRS functions, including the Office of Professional Responsibility and the Criminal Investigations Division; (iv) process Tax Exempt Bond Voluntary Closing Agreement Program submissions; (v) process willful neglect determinations on late filed returns; and (vi) assist field personnel in the identification and development of complex and emerging technical issues.

The IRS will continue to place the greatest emphasis on continuing investigations into arbitrage motivated or abusive transactions. The IRS anticipates that examinations related to arbitrage motivated or abusive transactions will continue to increase in fiscal year 2009 and that the greatest increase will be related to the use of swaps and other derivative contracts to divert rebatable arbitrage.

For abusive and arbitrage-driven transactions, the IRS will focus primarily on cases involving long investment periods or large investment amounts, including pooled financing cases; cases involving forward floats, escrow puts and other devices that may burn yield in advance refunding issuances; cases involving the use of derivatives to burn yield, including swaps, strips and swaptions; and the overissuance of tax and revenue anticipation notes. The IRS views the issuance of obligations for the primary purpose of diverting rebatable arbitrage as its highest compliance risk and enforcement focus. IRS managers will assign such transactions priority status and ensure that all appropriate penalties and sanctions are applied.

The IRS intends to continue to examine qualified hedging transactions, looking to complete approximately 100 examinations as part of a focused examination project. The IRS also anticipates that it will issue a summary report of findings with regard to the arbitrage compliance examinations initiated in fiscal year 2008 to address compliance issues related to the nonpayment of required rebate payments.

The fiscal year 2009 program goals also include a renewed focus on improving post-issuance compliance with the private use and private payment restrictions. The first step in this program, initiated in fiscal year 2006, was a charitable financing examination project consisting of approximately 30 examinations and directed at measuring compliance in the area of charitable health care and housing financings. The next step of the initiative included the development and distribution of a post-issuance compliance questionnaire to 207 charities and the analysis of the responses and reporting of the findings. The third step of the initiative involved the development and distribution of a post-issuance compliance questionnaire to governmental units during fiscal year 2009. The IRS also plans to continue to examine a small sample of qualified student loan bond issuances opened in fiscal year 2008. Once completed, the IRS will analyze the results of the initiative and assess compliance trends in the student loan bond market segment.

The IRS plans to develop a compliance project that addresses apparent noncompliance with the issuance cost requirements. This compliance project will most likely incorporate "soft-contact" letters. In addition, the IRS anticipates initiating examinations of certain specialty tax-exempt bonds and tax-credit bonds (*e.g.*, bonds issued to finance qualified green building and sustainable design projects). In fiscal year 2009, the IRS will also initiate research projects, possibly including a research project related to charter school financings and initiation of a project analyzing tax-exempt

ADDITIONAL MEMORANDA AVAILABLE

More detailed memoranda on the following topics are available:

- Build America Bonds;
- Recovery Zone Bonds;
- Qualified School Construction Bonds;
- New Clean Renewable Energy Bonds;
- Qualified Energy Conservation Bonds;
- Qualified Zone Academy Bonds; and
- Interest Expense, Bank Qualification and AMT

Your contacts at Chapman and Cutler LLP can provide you with any one of these memoranda upon request.

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financed transactions involving community development districts.

The IRS's arbitrage team will review Form 8038-R, "Request for Recovery of Overpayments Under Arbitrage Rebate Provisions," and determine whether the request can be surveyed or will require further investigation. All requests requiring further development will be assigned to a revenue agent on the arbitrage team for processing.

The IRS will perform compliance checks on late filed 8038s and will make determinations regarding whether the failure to file timely is due to willful neglect by following the procedures in published guidance. The IRS will contact the issuer for an explanation if necessary and will classify for examination cases involving non-responsive issuers.

The IRS will also coordinate the allocation of tax credit bond volume cap to applicants and anticipates a significant increase in the resources that are needed to process increases in allocable tax credit bonds in fiscal year 2009.

IRS managers will determine when the collection of bondholder names becomes a priority for an ongoing examination and are to consult with

the manager responsible for operation of the IRS's bondholder unit, when appropriate. As soon as a proposed determination of taxability is made, the bondholder unit will initiate efforts to identify bondholder names and open bondholder examinations. The IRS's bondholder unit will also be responsible for acquiring statute extensions, issuing deficiency notices and making discrepancy adjustments.

Examination Categories

For fiscal year 2009, IRS resources will be allocated to the following specialty areas:

- (i) solid waste disposal facilities; (ii) yield burning; (iii) failure to roll over escrowed securities to zero interest rate state and local government securities; (iv) loan pools; (v) tax and revenue anticipation notes; (vi) tax promoter penalties (Section 6700); (vii) Section 501(c)(3) charities; (viii) hospitals; (ix) single-family housing; (x) multi-family housing; (xi) tax incremental financing; (xii) student loans; (xiii) qualified zone academies; and (xiv) other specialty bonds and tax credit bonds.

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Market Segment Risk Assessment

As part of its assessment of compliance risks by market segment, the IRS has developed cases through referrals from internal IRS offices, other federal agencies, information or media sources, information gathering and compliance initiatives and regular classification of returns. The IRS has estimated noncompliance risks for the following types of bond issues in the following categories.

1. Governmental Obligations

Although the IRS has generally concluded that governmental bonds have a low risk of noncompliance, the IRS considers certain governmental obligations to have a medium risk of noncompliance. These medium risk obligations include: (i) obligations financing public school construction (due to a special arbitrage rebate exception and to prior examination findings); (ii) tax and revenue anticipation notes and bond anticipation notes (due to oversizing for arbitrage purposes); and (iii) hospital/healthcare obligations (due to increased indications of noncompliance relating to financings impacted by hospital mergers and privatization). Finally, the IRS considers advance refunding issues to have a high risk of noncompliance (due to yield burning and the use of derivatives to earn and divert illegal arbitrage).

2. Private Activity Obligations

The IRS has concluded that, as a whole, the potential risk for noncompliance for private activity obligations is greater than that for governmental obligations due to the presence of private borrowers and more complicated rules and regulations.

The IRS has concluded that the following obligations have a low risk of noncompliance: (i) obligations issued to finance or refinance docks and wharves; (ii) obligations for enterprise zones; and (iii) obligations for the provision of local electric facilities, gas and energy, water furnishing facilities and other non-government output facilities, primarily due to the low volume of bond issues related to each category.

The IRS has concluded that the following obligations have a medium risk of noncompliance: (i) single family mortgage obligations; (ii) multi-family housing obligations; (iii) small issue obligations; (iv) airport financing obligations; (v) sewage obligations; and (vi) student loan obligations.

Finally, the IRS has concluded that the following obligations have a high risk for noncompliance: (i) solid waste obligations (due to misinterpretations of the regulations applicable to solid waste obligations); (ii) Section 501(c)(3) obligations (due to the size of the category and the low level of voluntary closing agreement program requests relating to post-issuance compliance and based on information gathered through outreach and compliance efforts); and (iii) hospital/healthcare obligations (due to noncompliance issues related to mergers and privatization).

The American Recovery and Reinvestment Act of 2009

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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). This provision does not apply to non-financial institutions.

Bank Qualification. 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 State 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 501(c)(3) organization to which such portion relates.

Alternative Minimum Tax. 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. 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 twenty-five 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 twenty-five percent cap on ancillary facilities.

Mortgage Revenue Bonds—First-Time Homebuyer Credit. 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.

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Increase in Volume Limitation for Tax Credit Bonds. The Act increases the volume limitations for three existing types of tax credit bonds:

- (i) the volume limitation for New Clean Renewable Energy Bonds (“NCREBs”) is increased from the pre-Act volume limitation of \$800,000,000 to \$2,400,000,000;
- (ii) the volume limitation for Qualified Energy Conservation Bonds (“QECBs”) is increased from the pre-Act volume limitation of \$800,000,000 to \$3,200,000,000; and
- (iii) the volume limitation for Qualified Zone Academy Bonds (“QZABs”) is increased from the pre-Act volume limitation for 2009 of \$400,000,000 to \$1,400,000,000 and the Act 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. 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 thirty 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 thirty percent restriction on volume limitation for private activity bonds.

New Tax Credit Bonds for School Construction.

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 the most recent fiscal year ending before such calendar year. Also, forty 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 five through seventeen from families living below the poverty level or (ii) one of not more than twenty-five 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. The Act creates a new section of the Internal Revenue 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 themselves 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 thirty-five 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 Internal Revenue Code section, be excludable from gross income under Section 103 of the Internal Revenue Code, (ii) such obligation is issued before January 1, 2011 and (iii) the issuer makes an irrevocable election to have the new tax credit section of the Internal Revenue Code 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 Internal Revenue Code). Both the bond holder credit and 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 thirty-five 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. The Act creates new sections of the Internal Revenue 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 amounts 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.

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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 Internal Revenue Code section, be excludable from gross income under Section 103 of the Internal Revenue Code and (ii) the issuer makes an irrevocable election to have the new Internal Revenue Code section pertaining to the tax credit 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 activity 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 forty-five 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 ninety-five 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 Internal Revenue 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. 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 obligations 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. 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. 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.

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