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Public Finance Tax Update

Treasury Releases 2010 Regulatory Plan

On December 7, 2009, the Department of the Treasury released its Regulatory Plan. The Regulatory Plan includes statements of the Treasury's regulatory priorities. The IRS, together with Treasury, promulgates regulations that interpret and implement the Internal Revenue Code and related tax statutes. The purpose of these regulations is to carry out the tax policy determined by Congress in a fair, impartial and reasonable manner, taking into account the intent of Congress, the realities of relevant transactions, the need for the government to administer the rules and monitor compliance, and the overall integrity of the Federal tax system. This article supplements the IRS 2009-2010 Priority Guidance Plan article published in the December 2009 Public Finance Tax Update. During fiscal year 2010, Treasury and the IRS will accord priority to the following regulatory projects affecting municipal finance:

- *Arbitrage Investment Restrictions on Tax-Exempt Bonds.* The arbitrage investment restrictions on tax-exempt obligations under Section 148 of the Internal Revenue Code generally limit issuers from investing bond proceeds in higher-yielding investments. Treasury and the IRS plan to issue proposed regulations to address selected current issues involving the arbitrage restrictions, including clarification of the issue price definition used in the computation of bond yield, clarification and simplification of the rules regarding modifications and terminations of qualified hedging transactions, guidance on the treatment of working capital financing and selected other issues.
- *Tax Credit Bonds.* Tax credit bonds are bonds for which the holder receives a federal tax credit in lieu of some or all of the interest on the bond. The American Recovery and Reinvestment Act of 2009 created a number of new types of tax credit bonds and modified the law as it concerned several existing types of tax credit bonds. The IRS and Treasury intend to provide guidance on numerous legal issues concerning tax credit bonds and to develop clear guidelines for the IRS Tax Exempt Bond enforcement program.

FY 2011 Budget Proposes Reform and Extension of Build America Bond Program

On February 1, 2010, President Obama transmitted the proposed fiscal year 2011 budget to Congress. The budget proposes certain modifications to the Build America Bond program, some of which are highlighted below:

- Permanent extension of the Build America Bond program at a 28% federal subsidy; the current authority to issue Build America Bonds that offer a 35% subsidy is set to expire on December 31, 2010
- Allowance of certain governmental current refundings and working capital financings with Build America Bonds
- Expansion of the program to allow financings for certain Section 501(c)(3) organizations with Build America Bonds

- *Build America Bonds.* Treasury and the IRS plan to issue proposed regulations to provide guidance on interpretative issues that have arisen in implementing the broad new Build America Bond program in Section 54AA of the Internal Revenue Code under the American Recovery and Reinvestment Act of 2009.
- *Private Activity Bonds.* Treasury and the IRS plan to issue final regulations on allocation and accounting rules for application of the private business restrictions on tax-exempt governmental bonds under Section 141 of the Internal Revenue Code. These regulations will include guidance on public-private partnerships and mixed-use arrangements in which projects are used in part by state and local governments and in part by private businesses. These regulations will finalize 2006 proposed regulations with modifications in consideration of the public comments.

Public Utilities – Local Furnishing Requirement

In Private Letter Ruling 200942002, the IRS determined that a public utility providing retail electric services met the definition of a facility for local furnishing of electricity although the utility sold excess electricity outside of its service area pursuant to a state mandate. However, the portion of the cost of the local utility system financed with tax-exempt bonds may not exceed the cost of the system allocable to the local furnishing of electric energy.

The utility provides retail electric delivery and supply services within two counties and is authorized to provide services solely to customers in its service area pursuant to the state public utility commission's authorization. The utility owns and operates (or controls, through long-term power purchase agreements) an integrated system of electric generation, transmission and distribution facilities that makes up most of the utility's facilities used to provide electric service in the service area.

The IRS has issued previous rulings regarding the utility and its system. In determining whether the system constitutes facilities for the local furnishing of electric energy, the IRS has required the utility to demonstrate that the system has not been designed differently, sized larger, built sooner or constructed in a more costly fashion than is reasonably required solely for the purpose of serving the service area, and that none of such facilities of the system would have been planned or constructed for any reason other than to provide electric service to the retail customers served by the utility within the service area (the "*character requirements*"). The IRS adopted the standard that the utility be a net importer of electric energy measured on an annual basis (the "*net importer test*"), to substantiate that the system meets the character requirements.

The utility's transmission facilities do not have transmission capability in excess of that needed to supply local retail customers and to meet reliability requirements imposed by Federal and state regulatory agencies. However, fundamental changes in the electric industry require the utility to wheel electricity from generating sources not controlled by, or used for the benefit of, the utility to consumers who are not local retail customers. The utility's transmission resources are held on a priority basis to serve local retail customers; use of the transmission facilities in wheeling transactions reflects use of the transmission capacity unnecessary to service local retail customers and is mandated pursuant to open access orders or protocols of the Federal Energy Regulatory Commission, the state public utility commission or the state independent system operator. The mandated wheeling could cause the utility's outbound electricity flows to exceed inbound flows needed for local retail customers.

In addition, the utility's generating units do not have generating capability exceeding that required by the state public utility commission and the state independent system operator to meet the needs of local retail customers. However, fundamental industry changes and mandatory protocols of the state

public utility commission and the state independent system operator may require the utility's generating units to run although the utility has sufficient energy to supply its service area. State-mandated levels of generation and a reliability reserve resulting from the state independent system operator's least-cost, best-fit policy may also result in the utility generating excess energy. Pursuant to orders or mandatory protocols of the state public utility commission and/or the state independent system operator, the utility is required to sell excess energy to wholesale customers that may be outside of the service area. The utility's generating units are held on a priority basis to serve local retail customers, so wholesale sales, which cause the utility to incur outbound flows of generated power, reflect the use of generating capacity that is not then needed to service local retail customers and is pursuant to least-cost, best-fit dispatch orders or mandatory protocols of the state public utility commission and/or the state independent system operator.

In its request for a private letter ruling, the utility requested that the net importer test be eliminated as a prerequisite to meeting the character requirement to qualify its system as a facility for the local furnishing of electric energy within the meaning of the Internal Revenue Code. In the alternative, the utility requested that the net importer test disregard (i) outbound flows caused by wheeling of electricity generated by resources not controlled by or for the benefit of the utility and (ii) outbound flows caused by wholesale sales of excess electricity from the utility's generating units if required pursuant to Federal or state regulations, rules, orders, decisions or mandatory protocols.

The IRS concluded that the annual net importer test should not be eliminated as a means of demonstrating whether the system is a facility for the local furnishing of electric energy under the Internal Revenue Code. Instead, the IRS determined that the net importer test be modified to disregard outbound flows caused by wheeling of electricity generated by resources not controlled by or for the benefit of the utility and outbound flows caused by wholesale sales of excess electricity from the utility's generating units if required pursuant to Federal or state regulations, rules, orders, decisions or mandatory protocols. However, wholesale sales of excess power may only be exempted from outbound flows only if for each calendar year the total amount of electric energy supplied by the utility to the local retail customers equals or exceeds the total amount of electric energy generated by the utility's generating units minus the excess resulting from, and reserves established pursuant to, Federal or state regulations, rules, orders, decisions or mandatory protocols. In making its determination, the IRS noted that while the Internal Revenue Code only excepts Federal Energy Regulatory Commission-mandated wheeling transactions in determining whether a facility meets the local furnishing requirement, state regulatory mandated sales of electricity outside the service area should also be excluded from the net importer test. The IRS reasoned that in both cases, the utility has no control over the transactions, both occur in the utility's business as a local furnisher and both result in outbound flows of electricity. The IRS also cited the Treasury Regulations that discuss the mandatory wheeling exceptions to deliberate actions, which exempts mandated wheeling due to both Federal and state regulatory authority from the deliberate action rules.

Lastly, the IRS noted that although the system meets the definition of facilities for local furnishing of electric energy, the utility must comply with the requirements of the Internal Revenue Code that the portion of the cost of the system financed with tax-exempt bonds may not exceed the portion of the cost of the system allocable to the local furnishing of electric energy.

Extension of Temporary Rules Allowing Issuers to Purchase and Hold Tax-Exempt Obligations

In December 2009, the IRS released Notice 2010-7 to extend from December 31, 2009, to December 31, 2010, the expiration dates of certain temporary rules allowing state and local governmental issuers to purchase and hold their own tax-exempt obligations under special reissuance standards

for tax-exempt obligations. The intent of the extensions of these temporary rules is to facilitate liquidity and stability in the tax-exempt bond market in recognition of some continuing credit enhancement and liquidity constraints. The Notice modified Notice 2008-88, which had amended and supplemented Notice 2008-41.

Under general Federal income tax principles, a debt instrument is treated as retired or extinguished when an issuer acquires its own debt because a merger of the interests of the issuer and the holder occurs. Under existing guidance, an obligation purchased by or on behalf of a governmental issuer pursuant to a qualified tender right is not retired until the end of the 90-day period from and after the date of such purchase. In response to liquidity constraints in the tax-exempt bond market, Notice 2008-41 extended the 90-day period to 180 days for any purchase by or on behalf of a governmental issuer pursuant to a qualified tender right as long as such purchase occurred before October 1, 2008.

In response to auction failures in the auction rate bond sector of the tax-exempt bond market, Notice 2008-41 provided other temporary rules. Notice 2008-41 allowed governmental issuers to purchase their own tax-exempt auction rate bonds on a temporary basis without resulting in a reissuance or retirement of the purchased tax-exempt obligations solely for purposes of Section 103 and Sections 141 to 150 of the Internal Revenue Code if the governmental issuer purchased the tax-exempt auction rate bonds before October 1, 2008, and held those obligations for not more than a 180-day period from the date of purchase. Notice 2008-41 allowed temporary waivers of interest rate caps on auction rate bonds to be disregarded in determining whether there was a significant modification of such bonds if the agreement to waive such a cap and the period during which such waiver was in effect both were within the period between November 1, 2007, and October 1, 2008.

In light of the then-continuing liquidity constraints in the tax-exempt bond market, Notice 2008-88 expanded the types of bonds eligible for relief under Notice 2008-41 and extended the time period for such relief provisions to apply. Notice 2008-88 provided that tax-exempt qualified tender bonds and tax-exempt commercial paper purchased by a governmental issuer would continue in effect without resulting in a reissuance or retirement of such bonds if, irrespective of when the governmental issuer purchased such bonds, the governmental issuer held the bonds until not later than December 31, 2009. Notice 2008-88 clarified that, in the case of the purchase of any particular obligation of tax-exempt commercial paper including a purchase at maturity, a refinancing of such purchased tax-exempt commercial paper during the permitted holding period would be treated as part of the same issue as that of the purchased tax-exempt commercial paper.

Notice 2008-88 extended the application of the special 180-day holding period for qualified tender bonds to those qualified tender bonds purchased pursuant to qualified tender rights until December 31, 2009. In addition, Notice 2008-88 extended the application of Notice 2008-41 to disregard certain waivers of interest rate caps on tax-exempt auction rate bonds until December 31, 2009.

Notice 2010-7 extends the application of the various rules set forth in Notice 2008-88 to December 31, 2010.

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