Dilworth Paxson LLP

UPDATE

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American Recovery and Reinvestment Act of 2009
New Opportunities in Public Finance

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As part of the response to the recent and ongoing financial and economic crises, the United States Congress passed the American Recovery and Reinvestment Act of 2009 (the "Act") which was signed into law by President Obama on February 17, 2009. The Act addresses tax relief for individuals and families, energy incentives, tax incentives for business, manufacturing provisions, economic recovery incentives, infrastructure financing tools, and other provisions. The following discussion of the provisions relating to municipal bonds is intended to assist our clients in maximizing the opportunities presented by the Act, including new bond programs, new financing structures and the expansion of existing bond provisions.

SUMMARY OF BOND PROVISIONS

Mortgage Revenue Bonds

For residences purchased after December 31, 2008, the Act removes the prohibition previously set forth in the Internal Revenue Code of 1986, as amended (the "Code") on claiming the first time homebuyer's credit if the residence is financed with tax-exempt mortgage revenue bonds.

Clean Renewable Energy Bonds and Qualified Energy Conservation Bonds

The Act increases the national new clean renewable energy bond limitation by $1.6 billion for financing certain renewable energy facilities (e.g. wind, biomass, geothermal, irrigation, solar, hydropower, etc.).

The Act also increases the limitation on the issuance of qualified energy conservation bonds from $800 million to $3.2 billion. These bonds may be used for projects that reduce greenhouse emissions, reduce energy consumption in publicly-owned buildings, produce electricity from renewable resources and similar projects. The Act also amends certain special rules for bonds financing green community programs, such as loan programs for energy conservation measures for existing housing.

These two categories of energy bonds generate tax credits to investors rather than tax-exempt interest. Stripping and marketing of tax credits is permitted.

* **Practical Considerations**: Governments will be under increasing pressure to reduce energy consumption and greenhouse emissions. These bonds should be considered for both public and private projects, including P3's. In addition, energy conservation programs for low income homeowners may be a helpful tool in a long-term strategy for energy assistance payments.

Industrial Development Bonds for Manufacturing Facilities

Currently Section 144 of the Code provides that up to 25 percent of the net proceeds of a private activity bond issue for a manufacturing facility may be used to provide facilities which are directly related to and ancillary to the manufacturing facility. The Act amends this provision for such bonds issued in 2009 and 2010 to permit greater than 25% of the net proceeds of the bond issue to be used to finance a facility which is functionally related and subordinate to a manufacturing facility (determined without regard to the new provisions for intangible property) if located on the same site as the manufacturing facility.

These amendments also provide for the temporary expansion of the availability of private activity manufacturing bonds issued in 2009 and 2010 to finance facilities manufacturing intangible property such as patents, know-how, copyrights, formula and similar categories.

* **Practical Considerations**: Industrial development authorities may wish to review their recent financings to determine which borrowers may benefit from these provisions, especially those who were not able to finance certain facilities due to the pre-2009 rules, as well as software, biotech and similar companies, which present a new market for tax-exempt financing.

Build America Bonds

Build America Bonds are a new category of bonds issued prior to January 1, 2011 to finance traditional governmental projects. Rather than tax-exempt interest, at the issuer's choice, these bonds provide either a tax credit to the owner, or an interest subsidy paid by the U.S. Treasury to the issuer. A taxpayer who holds a Build America Bond on one or more interest payment dates during any taxable year is allowed a tax credit (includible in the bondholder's income) with respect to such interest payment date of 35 percent of the amount of interest payable by the issuer with respect to such date. Any unused credit may be carried over to the succeeding taxable year and the credits are "strippable" so that they can be marketed. As an alternative to the tax credit, an issuer of a qualified Build America Bond may elect to be paid a rebate in lieu of and equal to the 35 percent tax credit allowed to an investor, thus reducing the issuer's interest cost on the bonds. The rebate payments are made on or prior to each interest payment date to the issuer of such bond (or to any person who makes such interest payments on behalf of the issuer, such as a letter of credit bank), or as a reimbursement for previously paid interest.

A qualified Build America Bond issue for which a rebate of interest is elected must allocate all of its proceeds (except for proceeds in a reasonably required reserve fund and issuance costs) to capital expenditures for governmental purposes. The issuer must make an irrevocable election to treat the bonds as Build America Bonds and must also elect which credit will be applicable. If such bonds are of the type that results in the credit being taken by the holder, the capital expenditure requirement does not apply. Thus, it is likely that these tax credit bonds may be used for refundings as well as working capital financings if such financings could have been done on a tax-exempt basis.

* **Practical Considerations**: Issuers need to discuss with their financial advisors or investment bankers current market conditions for taxable bonds (including tax credit bonds) and tax-exempt bonds to determine the relative benefits of each, including combining Build America Bonds with traditional tax-exempt bonds, and structuring maturities to take advantage of the best pricing. The availability of tax credits to investors may open up new financing sources to issuers. It is not yet clear whether issuers will be able to pledge the federal interest rebate to debt service payments.

Recovery Zone Bonds

The Act creates certain new types of bonds as economic recovery tools subject to volume allocations among the states. The Act provides for up to $10 billion of National Recovery Zone Economic Development Bonds (as tax credit bonds) and for up to $15 billion of National Recovery Zone Facility Bonds (as tax-exempt bonds). In general terms, the National Recovery Zone Economic Development Bonds are aimed at financing facilities that promote economic development, whereas the National Recovery Zone Facility Bonds are aimed at financing commercial, industrial and other property actively used in a business.

For purposes of these provisions, "recovery zones" are (1) areas designated by the issuer as having significant poverty, unemployment, rate of home foreclosures or general distress; (2) areas designated by the issuer as distressed by reason of the closure or realignment of a military installation pursuant to the Defense Base Closure and Realignment Act of 1990; and (3) any area for which a designation as an empowerment zone or renewal community is in effect.

National Recovery Zone Economic Development Bonds are a special category of Build America Bonds where 100 percent of the excess of available project proceeds (as defined in Section 54A of the Code) of such issue over the amounts in a reasonably required reserve (within the meaning of Section 150(a)(3) with respect to such bond issue) are to be used for one or more qualified economic development purposes. National Recovery Zone Economic Development Bonds are taxable bonds providing the issuer with an interest rebate paid by the U.S. Treasury equal to 45% of the interest on the bonds payable by the federal government.

Qualified economic development purposes are expenditures for purposes of promoting development or other economic activity in a recovery zone including capital expenditures paid or incurred with respect to property located in such zone, expenditures for public infrastructure and construction of public facilities and expenditures for job training and educational programs. Present law rules applicable to tax-exempt governmental bonds, including private use restrictions, arbitrage, etc. apply.

National Recovery Zone Facility Bonds are tax-exempt bonds which are a type of exempt facility private activity bond. These bonds must be so designated by the issuer, issued before January 1, 2011, and be part of an issue where 95 percent or more of the net proceeds of such issue are to be used for recovery zone property. Recovery zone property, which may be private property, is property substantially all the use of which is in the recovery zone and is in the active conduct of a qualified business in such zone. The term qualified business covers any trade or business subject to certain exclusions such as for residential rental property, golf courses, racetracks and other facilities currently not eligible for tax-exempt financing. A qualified business would cover various commercial and industrial purposes and may also cover some trade or business activities conducted by non-profit corporations in limited cases. Facilities must be financed after the designation of a recovery zone takes place and must not have been previously used by another entity in the recovery zone.

* **Practical Considerations**: These bonds provide expanded alternatives to finance mixed use developments in qualifying areas, including commercial businesses, entertainment venues, public infrastructure, etc. and can be used in combination with conventional tax-exempt bonds and tax increment bonds.

Tribal Economic Development Bonds

The Act provides for a national tribal economic development bond limitation of $2 billion to be allocated among the Indian tribal governments in such manner as the Secretary of the Treasury,

in consultation with the Secretary of the Interior, determines appropriate. Tribal economic development bonds mean any bond, subject to certain restrictions on permitted uses of proceeds, issued by an Indian tribal government the interest on which would be exempt from tax under Section 103 of the Code if issued by a State or local government and which is designated by the Indian tribal government as a tribal economic development bond. The Act liberalizes the types of projects that may be financed by tribal bonds by no longer requiring that they only finance "essential governmental functions". Economic development projects of a commercial nature can be financed as long as they are located on an Indian reservation. Gaming facilities may not be financed with these bonds.

Qualified School Construction Bonds

Qualified school construction bonds are a new type of tax credit bonds to be issued for the construction, rehabilitation or repair of a public school facility, including land acquisition on which the facility is to be constructed. The particular tax credit on an issue of these bonds will be set according to rates publicly disseminated by the Secretary of the Treasury. These rates will be set to replicate a hypothetical contemporaneous tax-exempt bond with the objective that the qualified school construction bond would not need to be issued at a discount or with an interest coupon. The bond must be designated by the issuer who must be a State or local government within the jurisdiction of which such school is located. These bonds are subject to national volume limitations of $11 billion annually for each of 2009 and 2010, subject to certain carryovers of unused volume. The allocation formula provides that 40 percent of the volume limitation is to be allocated by the federal government among local education agencies which are the relatively larger and poorer districts.

* **Practical Considerations**: Unlike QZABs, these bonds may be used to finance new school construction and land acquisition. Thus, they offer another tool for school districts to access the tax credit markets.

Qualified Zone Academy Bonds

The Act extends and expands the existing qualified zone academy bond program by providing volume limitation of $1.4 billion for each of 2009 and 2010. Qualified zone academy bonds ("QZABs") are tax credit bonds where the allowable tax credit rate is determined according to substantially contemporaneous rates specified periodically by the Treasury Department. These bonds may be issued only for school rehabilitation projects, equipment acquisition and certain other purposes (excluding new construction) in certain qualified school systems (which generally are distressed or otherwise needy or serving underprivileged students). 2008 tax law changes expanded the universe of eligible purchasers to include any investor and permitted the stripping and marketing of the tax credits.

* **Practical Considerations**: Changes in 2008 allow QZABs to be held by a broader range of investors, which should improve demand and cost-effectiveness.

High Speed Intercity Rail Facility Bonds

The Act liberalized the speed requirements for high speed intercity rail facility bonds issued after the date of enactment of the Act. High speed intercity rail bonds are a type of private activity exempt facility bond to finance facilities (excluding rolling stock) for the transportation of passengers between metropolitan statistical areas and thus are not designed for mass transit purposes. Such facilities must be made available to members of the general public as passengers. The prior requirement that high speed intercity rail facility vehicles had to be reasonably expected to "operate at speeds in excess of" 150 miles per hour between scheduled stops has been changed to "be capable of attaining a maximum speed in excess of" 150 miles per hour between such scheduled stops.

Pass-through of tax credits on bonds held by RICs

The Act specifies procedures for passing through to investors in a regulated investment company ("RIC") the tax credits attributable to many tax credit bonds, including, but not limited to, Build America Bonds and QZABs. While previously permitted, the Treasury had never issued regulations. The Act provides some specificity, requiring an election by the RIC to pass through the credits and requiring recognition of the proportionate credit amount as interest income to the investor taking the credit. As before, regulations will be needed to provide guidance on the procedures involved.

* **Practical Considerations**: This provision will likely improve the demand for most tax credit bonds as it will speed up the process of providing guidance on how RICs must handle the distribution of credits to shareholders.

Marketability Enhancements and Wage Requirements

Deductibility of Interest Expense for Tax-Exempt Obligations and Bank Qualified Bonds

The Act makes certain amendments to Section 265 of the Code (i.e. provisions limiting the interest deduction associated with purchasing or carrying tax-exempt bonds) to improve the marketability of tax-exempt bonds. These include adding a de minimis safe harbor exception for tax-exempt interest expense of financial institutions. Under this provision, tax-exempt obligations issued during 2009 or 2010 and held by a financial institution in an amount that does not exceed 2% of the adjusted basis of the institution's assets are not taken into account for the purpose of determining the portion of the institution's interest expense subject to the disallowance rule of Section 265(b). Related to this change is an amendment to Section 291(e) of the Internal Revenue Code that treats as a financial institution preference item that portion of any obligation not taken into account by reason of the new de minimis exception.

For purposes of this de minimis rule, a refunding bond (whether current or advance) is treated as issued when the refunded bond was issued. Thus, for a refunding to qualify, the refunded (original) bond must have been originally issued in 2009 or 2010.

For bank qualified issues (which allow financial institutions to avoid the disallowance of interest expense deduction for tax-exempt obligations), with respect to obligations issued during 2009 and 2010, the small issuer limitation is increased from $10,000,000 to $30,000,000, and for purposes of qualified 501(c)(3) bonds, treats the 501(c)(3) organization (i.e. the conduit borrower), rather than the conduit bond issuer, as the issuer of the bonds.

The Act also makes certain changes for a "qualified financing issue" issued during 2009 or 2010 to allow for the bank qualification benefits of Section 265 to be utilized by separate borrowers in a pooled financing by treating each portion of such issue as a separate issue which is issued by the qualified borrower to which such portion relates. Qualified borrowers include a State or political subdivision or a 501(c)(3) organization. These entities must still be mindful of the need to count issuances by subordinate entities. For example, a parent 501(c)(3) will need to count the bonds issued by its subordinate entities.

* **Practical Considerations**: Smaller governmental issuers and non-profits may have better access to more investors, including greater use of direct bank loans. Issuers of conduit 501(c)(3) bonds may wish to alert potential borrowers to the availability of bank qualified debt.

Alternative Minimum Tax Limitations on Tax-Exempt Bonds

The Act provides for a temporary repeal of the alternative minimum tax limitations on tax-exempt bonds issued in 2009 or 2010. This applies to treatment of interest on private activity bonds as an item of tax preference as well as the requirement for corporate holders of bonds to include the interest in their adjusted current earnings for purposes of AMT. Refunding bonds issued in 2009 or 2010 will also escape the alternative minimum tax if the bond being refunded was issued after December 31, 2003 and before January 1, 2009. From the statutory language applicable to refunding bonds, there does not appear to be a requirement that the original new money bond had to have been issued in 2004 through 2008. Thus, even if the original bond dates back pre-2004, it appears that a refunding done during 2004-2008 would qualify for the AMT exemption.

* **Practical Considerations**: Issuers might consider refunding (reissuing) callable bonds and loans issued during the qualifying period in order to eliminate AMT and possibly lower interest cost. This may be more practical in cases of direct variable rate bank loans.

Prevailing Wage Law applicability to projects financed by certain bonds

The Davis Bacon prevailing wage requirements generally applicable to certain contracts with the federal government will be applicable to projects financed by the following tax credit bonds: (i) new clean renewable energy bonds, (ii) qualified energy conservation bonds, (iii) qualified zone academy bonds, (iv) qualified school construction bonds, and (v) recovery zone economic development bonds.

* **Practical Considerations**: In some jurisdictions, issuers may find this to be a significant cost in evaluating financing options and may steer issuers to more conventional tax-exempt bonds.

Technical Corrections to the Act

It is anticipated that there will be a technical corrections act clarifying a number of these provisions. We will supplement this Update as appropriate.