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House Stimulus Bill Expands Tax Credit Bonds; IRS Reformulates Pricing for Tax Credit Rate on Certain Bonds

On Friday, January 16, 2009, HR 598, entitled the "American Recovery and Reinvestment Tax Act of 2009" ("ARRTA"), was introduced by Rep. Charles B. Rangel (D-NY). On January 22, 2009, an amendment in the nature of a substitute that affects AARTA was presented. The materials below are reflective of such amendment.

New Clean Renewable Energy Bonds ("New CREBs"), Qualified Energy Conservation Bonds ("QECBs") and Qualified Zone Academy Bonds ("QZABs").

Sections 1611 and 1612 of ARRTA increase the current allocations for each of New CREBs and QECBs from $800 million to $2.4 billion and $3.2 billion, respectively. Each of the New CREBs and QECBs were created in the "Energy Improvement and Extension Act of 2008" that was included in the bailout legislation package enacted on October 3, 2008. Please see the contemporaneous update on the tax credit bond provisions included in the bailout legislation.

For QECBs, the eligible projects are expanded to include loans and grants for green community programs. The report from the Joint Committee on Taxation, dated January 22, 2009 (JCX-8-09), states the change " . . . will enable States to issue these tax credit bonds to finance loans and/or grants to individual homeowners to retrofit existing housing . . . [and] . . . [t]he use of bond proceeds for such loans and grants will not cause such bond to be treated as a private activity bond . . ."

For the QZAB program, Section 1512 of ARRTA proposes to increase the 2009 QZAB allocation from $400 million to $1.4 billion and extend the program into 2010 with allocation for that year in the amount of $1.4 billion. The October 2008 bailout package included legislation entitled "Tax Extenders and Alternative Minimum Relief Act of 2008" that reauthorized and extended the existing QZAB program. As a result, $400 million in allocation was added for each of calendar years 2008 and 2009.

Each of the New CREBs, QECBs and the modified QZAB programs are governed by Internal Revenue Code Section 54A, which was added in the "Heartland, Habitat, Harvest and Horticulture Act of 2008." Section 54A makes significant changes to the statutory framework that governs the existing CREBs (Section 54) and that previously governed QZABs (Section 1397E). Those changes include, among others, introduction of a reserve fund option that generally allows for equal annual installments that are not treated as

retiring a portion of the bond (subject to yield limitations), a three-year temporary period for expenditure of the bond proceeds, a 2% limitation on financing costs of issuance from the proceeds of the tax credit bond, stripping of the tax credits and carryover of the tax credits. Please see our contemporaneous update discussing these matters.

Tax Credit Bonds for Qualified School Construction

Section 1511 of ARRTA proposes to add a new category of tax credit bonds that would be codified in Section 54F and governed by the rules found in Section 54A. This category of tax credit bonds is entitled "Qualified School Construction Bonds" ("QSCB"). Under the proposed provisions, 100% of the available project proceeds (please see the above-referenced update for information on this concept) of such issue 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 such issue." The allocation for QSCB is $11 billion for each of calendar years 2009 and 2010. There is an additional $200 million in each of those years for Native American schools. Of the total allocation, 60 percent will be distributed among the states based upon secondary school populations within the state. The remaining 40% is to be distributed among "large local education agencies." Unused allocation may be carried over, and ARRTA does not place a limit on the years to which it may be carried over.

Credit Option for Taxable Governmental Bonds

Section 1521 of ARRTA proposes to add a new incentive for certain types of taxable governmental bonds. The incentive would be codified in Section 54AA of the Code and would be entitled "Taxable Bond Option for Governmental Bonds." So long as the bond is a governmental bond and not a private activity bond, the holder is entitled to a credit based upon a calculation that takes into account the amount of interest payable on the bond. The amount of the credit is 35% of the interest payable by the issuer on an interest payment date that is defined as "any date on which the holder of record of the taxable governmental bond is entitled to a payment of interest under such bond." The credit is subject to limits and carryover provisions similar to those for credits under Section 54A. The interest on the bond is includible in gross income.

Section 1521 also provides that an issuer may elect to receive a credit in lieu of the holder receiving a credit. To qualify, 100% of the available project proceeds must be spent on capital expenditures, and the issuer must elect this option. The Treasury would pay to the issuer the amount of the credit on or about each interest payment date. This provision would apply to bonds issued before January 1, 2011.

Section 1521 provides that any stateís laws must treat the interest on the qualifying taxable bond and the credit as being exempt from federal income tax.

Marketability Enhancements, New Category of Recovery Zone Bonds and Tribal Economic Development Bonds

There are other provisions of ARRTA that would benefit state and local bonds. For instance, in determining whether a bond is "bank qualified" for purposes of Section 265 of the Code, the $10 million limitation has been raised to $30 million for each of 2009 and 2010. Moreover, pooled bonds may be bank qualified without regard to a dollar limitation on the aggregate pool size so long as each pooled loan qualifies on its own under the $30 million cap.

There are additional changes that provide a "bank qualification" safe harbor to financial institutions holding tax-exempt debt, whereby tax-exempt bonds issued in 2009 and 2010 are not taken into account in determining whether the financial institution is entitled to the deduction under Section 265 so long as the amount of qualifying tax-exempt debt it holds does not exceed a 2% threshold of its average adjusted basis of assets. In other words, in calculating the existing 2% de minimis exception for banks and other institutions, these 2009 and 2010 bonds are ignored to the extent they comprise up to 2% of the average adjusted bases of the bankís assets.

In determining eligibility under Section 265 for qualified 501(c)(3) bonds, the bonds shall be treated as issued by the 501(c)(3) entity for whom the bonds were issued, and the requirements for qualification of the bond issue as part of a qualifying pool issue shall be applied as if the 501(c)(3) entity is the issuer.

Lastly, Section 1503 of ARRTA provides that private activity bonds issued in 2009 and 2010 would not be subject to AMT.

Section 1531 proposes the creation of a recovery zone bonds that would include economic development bonds and facility bonds, for which there is proposed $10 billion and $15 billion, respectively, in allocation. The allocation would be apportioned among the states according to employment losses. Within the states, the allocation is further subdivided

among counties and large local municipalities according to their employment losses. Each type of bond must be designated as such by the issuer and must be issued before January 1, 2011.

A recovery zone is either an area, designated by the issuer, with significant poverty, unemployment or rate of home foreclosures or an area for which an empowerment zone or renewal community is in effect. A recovery zone also includes any area of general distress (as defined in Section 1392(a)(2)).

A recovery zone economic development bond shall entitle the issuer to a credit similar to that available to an issuer of a qualified taxable governmental bond, as described above, except that the credit shall be 55% instead of 35%. The bond requires 100% of available project proceeds to be used for one or more qualified economic development purposes. Such purposes include expenditures for purposes of promoting development or other economic activity in a recovery zone, including capital expenditures paid or incurred with respect to property in the zone, expenditures for public infrastructure and construction of public facilities and expenditures for job training and educational programs.

A recovery zone facility bond shall be included within the meaning of an exempt facility bond under Section 142 of the Code. At least 95% of the "net proceeds" (as defined in Section 150 of the Code) of the bond must be used for recovery zone property. To be recovery zone property, it generally must be subject to Section 168 of the Code, have been acquired after the zone designation took effect, is first used in the zone by the taxpayer, is substantially all located in the zone and is used in the active conduct of a qualified business by the taxpayer in such zone. A qualified business is any trade or business except rental of residential property or a sin business (e.g. gambling, alcohol sales, country clubs, etc.). Furthermore, the limitations on acquisition of existing property found in Section 147(d) shall not apply.

A new category of tribal economic development bond was created, with an allocation of $2 billion. A bond qualifies if it would be exempt from taxation as a state or local bond under Section 103 so long as certain types of gaming are not occurring and the facility is not located outside an Indian reservation. Treasury is required to conduct a study and report on it to Congress within one year of the enactment of this provision.

Changes to Tax Credit Rates

In Notice 2009-15, released on and effective as of January 22, 2009, the Treasury will determine and announce tax credits daily for CREBs (Section 54), Midwestern tax credit bonds (Section 1400N(l)), and Qualified Forestry Conservation Bonds, New CREBs, CREBs and QZABs (Section 54A), based on "its estimate of the yields on outstanding bonds from market sectors selected by the Treasury Department in its discretion that have an investment grade rating of between A and BBB for bonds of a similar maturity for the business day immediately preceding the sale date of the tax credit bonds." See Notice 2009-15 that is linked hereto. The rates will be published on the website for the Bureau of Public Debt. For CREBs the link is https://www.treasurydirect.gov/SZ/SPESRates?type=CREBS, and for QZABs, the link is https://www.treasurydirect.gov/SZ/SPESQZABRate. This methodology is a departure from the prior methodology that based the rate on outstanding AA rated corporate bonds. This change is subject to further refinement and modifies Notice 2007-26, 2007-14 I.R.B.870 (April 2, 2007).

For questions about energy tax credit bonds, please contact Laura Jones or Doug Lamb.

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