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CLIENT ALERT

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The Stimulus Act of 2009: New Opportunities for Municipal Bonds and New Tax Credit Bonds

President Obama signed into law the American Recovery and Reinvestment Act of 2009 (the "Stimulus Act") on February 17, 2009. The following article, which appeared in the March 2009 version of the Bill of Particulars, vol. 35, ed. 3, pp. 59-62, provides a brief introduction to the provisions in the Stimulus Act that affect the issuance of municipal bonds and tax credit bonds:

The Stimulus Act contains numerous modifications to the federal tax laws affecting municipal bonds and tax credit bonds. These include marketability enhancements for the purchase of bonds by financial institutions, changes in the application of the alternative minimum tax to tax-exempt bonds, new categories of tax credit bonds and increases in allocations for existing tax credit bond programs. Most of the modifications apply only to bonds issued during the calendar years 2009 and 2010. We have summarized a few notable provisions below.

Marketability Enhancements

Changes to the Bank Qualification ("BQ") Provisions. The provisions of Section 265(b)(3) of the Internal Revenue Code of 1986, as amended ("IRC"), allow financial institutions to deduct 80% of the interest costs or other costs of carry for acquiring and holding the special category of tax-exempt bonds that have been designated "qualified tax-exempt obligations" (more commonly referred to as "bank qualified" or "BQ"). Prior to the Stimulus Act, BQ bonds had to be issued by a "qualified small issuer" that reasonably anticipated that it would not issue in a particular calendar year more than $10 million aggregate principal amount of tax-exempt obligations (other than certain private activity bonds which were excluded from the calculation). The Stimulus Act provided three significant amendments to the BQ rules for bonds issued in calendar years 2009 and 2010: (1) increased the $10 million threshold to $30 million for tax-exempt governmental and 501(c)(3) bonds, (2) in the case of a 501(c)(3) bond, allowed the 501(c)(3) conduit borrower to be treated as the issuer for "qualified small issuer" purposes (*i.e.*, each 501(c)(3) borrower has its own BQ limit), and (3) provided that any composite, pooled or other conduit financing issue may be designated as BQ if the proceeds are used to make loans to one or more ultimate borrowers, each of whom would separately qualify for the small issuer exception.

The following two examples illustrate the significance of these BQ changes: (1) A county may now undertake a $25 million BQ financing for schools, even though the county's economic development authority

earlier in the same calendar year issued $25 million BQ bonds for the local 501(c)(3) hospital. (2) A city's industrial development authority may combine into a single issue of $50 million BQ bonds that benefit two unrelated 501(c)(3) borrowers for $25 million each.

2% De Minimis Safe Harbor Exception

Prior to the Stimulus Act, IRC Section 265(b) provided that a financial institution was not allowed to deduct interest costs or other costs of carry for acquiring and holding tax-exempt bonds (unless such bonds had been designated as qualified tax-exempt obligations or "bank qualified," as described above). The Stimulus Act amended IRC Section 265(b) to provide that a financial institution may now deduct 80% of the interest costs or other costs of carry related to its purchase of tax-exempt bonds (of any type, including private activity bonds) issued in calendar years 2009 and 2010. The deduction may be claimed only to the extent that the amount of such tax-exempt obligations does not exceed 2% of the average adjusted bases of all assets of the financial institution (referred to as the "2% de minimis safe harbor exception"). This change is intended to give financial institutions an incentive to purchase not only BQ bonds but also tax-exempt bonds of all types (up to each financial institution's 2% limit). It is important to note, however, that current and advance refunding bonds are not eligible to be included in the 2% limit unless the bonds being refunded were themselves issued in calendar years 2009 and 2010.

Changes in the Alternative Minimum Tax (AMT)

Prior to the Stimulus Act, interest paid on most categories of tax-exempt private activity bonds (such as exempt facility bonds issued for airports, solid waste disposal facilities, qualified residential rental projects, etc.) was generally subject to the alternative minimum tax or "AMT." This treatment usually resulted in higher interest rates for such bonds. In addition, interest on all tax-exempt bonds, whether directly subject to AMT or not, was taken into account as current earnings for purposes of the alternative minimum taxable income of corporations. The Stimulus Act modified the AMT rules by allowing interest paid on all categories of new money, tax-exempt private activity bonds issued in calendar years 2009 and 2010 to be exempt from AMT. The Stimulus Act also provided that interest on all types of new money, tax-exempt bonds (including governmental bonds and all categories of private activity bonds) issued in calendar years 2009 and 2010 is not taken into account as current earnings for purposes of AMT for corporations. For purposes of the AMT modifications, a refunding bond is treated as issued on the date of the refunded bond; except that (a) interest on governmental and private activity bonds issued to refund bonds issued in calendar years 2004 through 2008 will still be exempt from AMT and not taken into account as current earnings for purposes of AMT for corporations, and (b) interest on governmental refunding bonds continues to be exempt from AMT regardless of when the refunded bonds were issued.

What to Expect

In Virginia, where most 501(c)(3) financings are undertaken through the local industrial/economic development authority, the change allowing 501(c)(3) conduit borrowers to be afforded their own BQ limit is significant. Now, localities will not have to choose between their own BQ-eligible financings and a 501(c)(3) borrower's desire to undertake a BQ financing. In certain circumstances, local issuers may be able to refund outstanding non-BQ bonds on a BQ basis and lower the interest costs. For governmental bonds, financings may be structured with multiple series to address whether the bonds are eligible for the 2% de minimis safe harbor or whether interest on the bonds is included in adjusted earnings for purposes of the corporate AMT. For private activity bonds, refunding bonds may be structured to receive the non-AMT and non-current earnings marketing benefits (if the refunded bonds were issued in calendar years 2004 through 2008). It is reasonable to expect that there will be competition to use a financial institution's 2% de minimis safe harbor exception.

New Tax Credit Bonds

Compared to tax-exempt bonds, tax credit bonds constitute a relatively new financing tool for local governments. A tax credit bond is issued on a taxable basis and the holder or investor typically receives a tax credit in lieu of tax-exempt interest. For certain tax credit bonds, the holder may strip the credit from the bonds and sell the credit. The credit is included in gross income and treated as interest. Typically, the credit is an annual credit measured quarterly based on a formula that accounts for the credit rate and the outstanding amount of the bonds.

The Stimulus Act included several provisions affecting existing tax credit bonds, including increased allocations for new clean renewable energy bonds, qualified zone academy bonds,

and qualified energy conservation bonds, as well as new categories of tax credit bonds as described below. Of particular note are the following:

Qualified School Construction Bonds ("QSCBs")

A state or locality may issue QSCBs to finance the construction, rehabilitation, or repair of a public school facility or for the acquisition of land on which such a facility will be constructed. The national allocation for QSCBs is $11 billion for each of calendar years 2009 and 2010. The U.S. Treasury will allocate to the states based upon the respective amount each state is eligible to receive under the Elementary and Secondary Education Act of 1965 for the fiscal year prior to the calendar year of allocation. The states will then reapportion such amounts within their respective states. The Stimulus Act reserves 40% of the total national allocation for certain large local education agencies.

Tax Credit Build America Bonds ("BABs") and Refundable Credit Option

For issuers that might otherwise be able to issue tax-exempt governmental bonds (*i.e.*, not private activity bonds) to finance capital projects and working capital projects, the Stimulus Act now allows such issuers to elect instead to issue taxable bonds and permit the bondholders to receive a tax credit equal to 35% of the interest payable on each interest payment date. In the alternative, the Stimulus Act also allows an issuer to elect to receive the benefit of the tax credit itself (the so-called "refundable credit option"), in which case, the U.S. Treasury would pay directly to the issuer (or conduit borrower, generally) on each interest payment date an amount equivalent to the amount of the 35% tax credit. To qualify for the refundable credit option, 100% of the available project proceeds (*i.e.*, sale proceeds less up to 2% costs of issuance), net of any amounts placed in a reasonably required reserve fund, must be spent on capital expenditures (*i.e.*, no working capital). BABs must be issued before January 1, 2011.

Other Pertinent Provisions

Recovery Zone Bonds

The Stimulus Act creates new categories of tax credit bonds called "recovery zone economic development bonds" and "recovery zone facility bonds" for certain economic development projects in issuer-designated "recovery zones."

Small Issue Bonds

The Stimulus Act expands the eligible purposes of "small issue" manufacturing bonds issued before January 1, 2011, to include the creation or production of "intangible property" (defined as "any patent, copyright, formula, process, design, pattern, know-how, format, or other similar item" described in IRC Section 197(d)(1)(C)(iii)).

Davis-Bacon

The Stimulus Act imposes the prevailing wage requirements of Davis-Bacon Act of 1931 on projects financed by proceeds of (a) new clean renewable energy bonds (but not CREBs under prior law), (b) qualified energy conservation bonds, (c) qualified zone academy bonds, (d) qualified school construction bonds and (e) recovery zone economic development bonds.

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