The American Recovery & Reinvestment Act of 2009 Public Finance Impacts

Articles

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On February 17, 2009, President Obama signed into law The American Recovery and Reinvestment Act of 2009 (the “Recovery Act”). The Recovery Act makes several modifications to the federal tax code that directly impact municipal bonds and the public finance market by (i) expanding the impact of manufacturing facility bonds; (ii) permitting financial institutions to deduct interest expenses allocable to tax-exempt interest; (iii) eliminating the alternative minimum tax treatment of tax-exempt bonds; and (iv) implementing (a) tax-credit bonds for schools, (b) Build America Bonds, and (c) Recovery Zone Development Bonds. The provisions of the Recovery Act implemented for these programs generally are available until December 31, 2010. As such, those interested in utilizing these provisions need to act quickly.

Manufacturing Facility Bonds

Prior to the Recovery Act, tax-exempt bond proceeds could be used to finance construction of manufacturing facilities, however, only 25% of the proceeds could be used to finance costs allocable to facilities which are directly related and ancillary to the manufacturing facility itself. Under the Recovery Act, for bonds issued after February 17, 2009, and before January 1, 2011, costs allocable to items (i) deemed “functionally related and subordinate” to a manufacturing facility, and (ii) located at the same site as the core manufacturing facility, will be treated as part of the manufacturing facility, thus removing the 25% limitation on financing the costs of “ancillary facilities.” Of equal importance, the Recovery Act expands the definition of manufacturing facility bonds to include facilities that manufacture not only tangible property, but also intangible property, including patents, copyrights, formulae, processes, designs, know-how, formats, and similar intangible property.

Deductibility of Interest Expense on Tax-Exempt Obligations by Financial Institutions

Prior to the Recovery Act, financial institutions were generally not allowed to deduct interest on indebtedness incurred to purchase or carry tax-exempt obligations, unless the obligation was a “qualified tax-exempt obligation.” To qualify, the issuer had to be what is commonly known as a “small issuer,” meaning it issued no

more than $10,000,000 in tax-exempt bonds in a calendar year, and the obligation was not a private activity bond (excluding qualified 501(c)(3) bonds).

The Recovery Act raises this $10,000,000 ceiling to $30,000,000 for bonds issued after December 31, 2008, and before January 1, 2011. Moreover, a 501(c)(3) borrower will be treated as the "issuer" of qualified 501(c)(3) bonds, so the bonds will be deemed a "qualified tax-exempt obligation" issued by a "small issuer" as long as the 501(c)(3) borrower has not surpassed the$30,000,000 limit within the calendar year. Moreover, refunding bonds of both governmental and 501(c)(3) borrowers that refund obligations not originally issued as "qualified tax-exempt obligations" may now be treated as such.

Alternative Minimum Tax (AMT)

Prior to the Recovery Act, interest on tax-exempt private activity bonds (other than qualified 501(c)(3) bonds) was considered an item of tax preference for AMT purposes. For bonds issued after December 31, 2008, and before January 1, 2011, including tax-exempt obligations issued to refund tax-exempt obligations issued between 2004 and 2008, the Recovery Act provides that the interest on tax-exempt private activity bonds is: (i) not an item of tax preference, and (ii) not included in adjusted gross earnings in determining the alternative minimum taxable income of corporations.

Qualified School Construction Tax Credit Bonds

The Recovery Act establishes a new form of tax credit bond. It permits state or local governments to issue a "qualified school construction bond" for the purposes of construction, rehabilitation or repair of public school facilities and acquisition of land for a public school to be constructed with its proceeds. The national bond volume limitation is $11 billion for 2009 and 2010, with 60% to be allocated to states in proportion to each state's grant funding level under the Elementary and Secondary Education Act. The remaining 40% is to be allocated each year directly to the nation's largest local educational agencies, with a corresponding amount to be deducted from the state allocation.

Build America Bonds

The Recovery Act permits the issuance of a new type of tax credit bond called "Build America Bonds," which must be issued prior to January 1, 2011. Build America Bonds provide bondholders with a federal tax credit equal to 35% of taxable interest on bonds issued pursuant to the Build America Bond provisions. State and local governments that elect to issue Build America Bonds must issue them in lieu of tax-exempt obligations. Private activity bonds may not be issued as Build America Bonds. Yield on Build America Bonds is to be computed without regard to the 35% tax credit. In order to qualify as a Build America Bond, the bond must be issued with a de minimis amount of premium. In lieu of the tax credit, issuers of Build America Bonds may elect to receive a rebate from the IRS of 35% of the interest received on the bonds, provided all of the available project proceeds are used for capital expenditures, issuance costs and reasonably required reserve funds.

Recovery Zone Bonds

The Recovery Act permits the issuance of a new tax credit bond called Recovery Zone Bonds, which are deemed to be a type of Build America Bond, provided they are issued before January 1, 2011. Several types of Recovery Zone Bonds are authorized, including Recovery Zone Economic Development Bonds and Recovery Zone Facility Bonds. Recovery Zones are defined as (i) areas designated by state and local governments as (a) having significant poverty, unemployment, or home-foreclosure rates or (b) being economically distressed due to the closure or realignment of a military installation pursuant to the Defense Base Closure and Realignment Act of 1990, or (ii) any area for which a designation as an empowerment zone or renewal community is in effect.

Proceeds of Recovery Zone Economic Development Bonds are to be used for "qualified economic development purposes." These include promotion of development or other economic activity in a recovery zone, such as capital expenditures paid or incurred with respect to property located in the recovery zone, as well as public infrastructure, construction of public facilities and expenditures for job training and educational programs. Issuers of Recovery Zone Economic Development Bonds will receive a tax credit equal to 45% of the interest on the bonds. Recovery Zone Economic Development Bonds are subject to a national bond volume limitation of $10 billion, allocated to states in proportion to their respective 2008 job losses; however, each state will receive no less than 0.9 percent of the allocation, with sub-allocations to counties and large municipalities on the basis of job losses. Recovery Zone Economic Development Bonds are subject to the current rules that apply to tax-exempt governmental bonds.

Recovery Zone Facility Bonds may be issued as exempt facility private activity bonds for recovery zone facilities provided that 95% or more of the net proceeds of the bonds are used to finance recovery zone property. Recovery zone property is depreciable property (i) which is constructed, reconstructed, renovated, or acquired by a taxpayer by purchase after the date of designation of a recovery zone, (ii) the original use of which property in the recovery zone commenced with the taxpayer, and (iii) substantially all of the use of which is in the recovery zone and is in the active conduct of the taxpayer's qualified business.

A qualified business is any trade or business except (i) the rental of residential property, and (ii) any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises. Recovery Zone Facility Bonds are subject to the current rules that apply to private activity bonds; however, unlike other private activity bonds, Recovery Zone Facility Bonds are subject to the rule prohibiting the acquisition of existing property, and they are not subject to the volume cap limitations. Recovery Zone Facility Bonds are subject to a national bond volume limitation of $15 billion, to be allocated to the states in proportion to their respective 2008 job losses; however, all states will receive no less than 0.9 percent of the allocation, with sub-allocations to counties and large municipalities within a state made on the basis of job losses.

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