American Recovery and Reinvestment Act of 2009

This memorandum contains a brief summary of the significant tax provisions of the "American Recovery and Reinvestment Act of 2009" that was passed by Congress on February 13, 2009 (the "Stimulus Act") and signed into law by the President on February 17, 2009.[1] The tax provisions included in the economic recovery package provide approximately $282 billion in tax relief for individuals, businesses, and State and local governments.

BENEFITS FOR STATE AND LOCAL GOVERNMENTS

- **Taxable Bond Option for Governmental Bonds ("Build America Bonds"):** The Stimulus Act provides State and local governments with the option of issuing tax credit bonds in 2009 and 2010 as an alternative to issuing traditional tax-exempt governmental bonds. Interest received from investing in Build America Bonds is taxable to the investors. The State or local government can either (1) provide investors with a federal tax credit equal to 35% of the interest paid or (2) elect to receive a direct payment from the Federal government equal to the amount of the Federal tax credit that would have otherwise been received by the investors.

- **Taxable Recovery Zone Economic Development Bonds:** The Stimulus Act creates a new category of taxable governmental bonds for investment in recovery zones. Like Build America Bonds, recovery zone economic development bonds may not be private activity bonds. A recovery zone includes (1) any area designated by the issuer as having significant poverty, unemployment, home foreclosures, or general distress, (2) any area 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. The Stimulus Act authorizes $10 billion in recovery zone economic development bonds. The authorized amount will be allocated among the States in proportion to each State's job losses in 2008 as a percentage of all States' job losses in 2008. A State's allocation is then reallocated among counties and municipalities with a population of more than 100,000 in the same manner. However, under a special rule, each state will receive a minimum allocation of $90 million, regardless of the amount of jobs lost. Recovery zone economic development bonds may be issued in 2009 and 2010 for purposes of promoting development or other economic activity within a recovery zone, which includes capital

[1] This memorandum is based on the text of the bill as reported out of the Conference Committee and submitted to the U.S. House of Representatives and the U.S. Senate for approval February 13, 2009.

expenditures for property located within the zone and expenditures for public infrastructure, public facilities, job training and educational programs. Interest received from investing in a recovery zone economic development bond is taxable to investors. However, the issuing State or local government receives from the Federal government a subsidy equal to 45% of the taxable interest paid (compared to 35% under the Build America Bonds).

- **Tax-Exempt Recovery Zone Facility Bonds:** The Stimulus Act also creates another category of exempt-facility, private activity bonds for investment in recovery zones. As stated above, a recovery zone includes (1) any area designated by the issuer as having significant poverty, unemployment, home foreclosures, or general distress, (2) any area 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. The Stimulus Act authorizes $15 billion in recovery zone facility bonds to be issued in 2009 and 2010. The authorized amount will be allocated among the States, counties and municipalities with a population of more than 100,000 in the same manner as the Recovery Zone Economic Development Bonds described above, and each state will receive a minimum allocation of $135 million. Recovery Zone Facility Bond proceeds can generally be used to finance any depreciable property for use in any trade or business other than residential rental housing in the recovery zone.

- **Expansion of Bank Qualification Limits:** In general, banks, savings and loan associations and other financial institutions are not allowed to deduct the portion of their interest expense that is allocable to investments in tax-exempt municipal obligations. Current law provides an exception to this rule if the financial institution invests in "bank qualified bonds." If the financial institution buys a bank qualified bond, it is allowed to deduct 80% of the cost of buying and carrying the bond. Currently, only "qualified small issuers" can issue bank qualified bonds. To be a qualified small issuer, the issuer must either be a state or local government or issue bonds on behalf of a state or local government. The issuer also must reasonably expect to issue not more than $10 million of tax-exempt obligations (other than certain private activity bonds) within a year. The Stimulus Act increases the $10 million limit to $30 million for tax-exempt obligations issued in 2009 and 2010 to finance new projects and to refund prior obligations. In addition, the small issuer exception and the $30 million limit apply separately to each 501(c)(3) organization, the ultimate borrower for whose benefit such obligations were issued, as long as the organization otherwise qualifies for the exception.

- **De Minimis Safe Harbor for Tax-Exempt Interest Expense for Financial Institutions:** As stated above, financial institutions are not allowed to deduct the portion of their interest expense that is allocable to investments in tax-exempt municipal obligations. The Stimulus Act provides that tax-exempt obligations issued during 2009 and 2010 will not be taken into account to the extent that the institution's total investment in tax-exempt obligations does not exceed 2% of its total assets. As a result, a bank may deduct 80% of the cost of carrying non-bank qualified tax-exempt bonds issued in 2009 and 2010, to the extent that its holdings of non-bank qualified bonds do not exceed 2% of its assets. The new de minimis safe harbor generally applies only to tax-exempt obligations issued to finance new projects.

- **AMT and Tax-Exempt Interest:** Both individuals and corporations are subject to the alternative minimum tax ("AMT"). In computing AMT, interest on all tax-exempt bonds generally is treated as an adjustment to a corporation's current earnings, and interest on tax-exempt private activity bonds is generally treated as an item of tax preference for all taxpayers. Current law contains an exception for tax-exempt housing bonds: interest on these bonds is not treated as a tax preference item or as an adjustment to a corporation's earnings and profits. The Stimulus Act temporarily extends this treatment to all tax-exempt bonds. The new AMT provisions apply to bonds issued in 2009 and 2010

to finance new projects on or after enactment of the Stimulus Act, to future refinancings of those bonds, and to tax-exempt bonds issued in 2009 and 2010 to refund bonds issued in 2004 through 2008.

- **Small-Issue Industrial Development Bonds (IDBs):** IDBs are tax-exempt obligations issued by State and local governments to finance private business manufacturing facilities. Current law restricts the use of bond proceeds to facilities used in the manufacturing or production of tangible personal property. In addition under current law, a manufacturing facility includes core facilities and any directly related and ancillary facilities. Directly related and ancillary facilities must be located on the same site as the core facilities, and not more than 25% of the net proceeds of the issue can be used to provide such facilities. The Stimulus Act expands the use of IDBs issued in 2009 and 2010 to include any facility used in the manufacturing, creation, or production of tangible or *intangible* property. Intangible property includes any patent, copyright, formula, process, design, pattern, knowhow, format, or other similar item. Also, the 25% restriction on directly related and ancillary facilities does not apply to IDBs issued in 2009 and 2010, and tax-exempt obligations may be issued to finance any facilities that are "functionally related and subordinate" to the facility. Functionally related and subordinate facilities must be located on the same site as the facility.

- **Qualified Zone Academy Bonds (QZABs):** QZABs are a form of tax credit bonds which offer the holder a Federal income tax credit in an amount approximately equal to the interest that would otherwise be paid on a taxable bond. While QZABs cannot be used to finance new school construction, they can be used to finance renovations, equipment purchases, developing course material, and training teachers and personnel at a qualified zone academy. The Stimulus Act allows an additional $1.4 billion of QZABs to be allocated among State and local governments in each of the years 2009 and 2010.

- **Qualified School Construction Bonds:** The Stimulus Act creates a new category of tax credit bonds for the construction, rehabilitation, or repair of public school facilities or for the acquisition of land on which a public school facility will be constructed. Approximately $11 billion of these bonds can be issued in each of the years 2009 and 2010. In each year, the $11 billion will be allocated among the States in proportion to the amount each State is eligible to receive under Section 1124 of the Elementary and Secondary Education Act of 1965.

- **Clean Renewable Energy Bonds (CREBs):** CREBS are another form of tax credit bonds which offer the holder a Federal tax credit instead of interest. CREBs are designated for clean renewable energy projects and can be issued to finance wind facilities, closed-loop bio-mass facilities, open-loop bio-mass facilities, geothermal or solar energy facilities, small irrigation power facilities, landfill gas facilities, trash combustion facilities, refined coal production facilities and certain hydropower facilities. The Stimulus Act authorizes an additional $1.6 billion of CREBs which will be divided into thirds among (1) State, local and tribal governments, (2) public power providers and (3) electric cooperatives.

- **Qualified Energy Conservation Bonds:** Qualified energy conservation bonds are also tax credit bonds. The Stimulus Act authorizes an additional $2.4 billion of qualified energy conservation bonds to finance State, municipal and tribal government programs and initiatives designed to reduce greenhouse gas emissions. Allocations are made to the States based on their respective populations.

- **Tribal Economic Development Bonds:** Currently, tribal governments can only issue tax-exempt bonds for projects that provide an "essential government function," which limits the ability of a tribal government to use tax-exempt bonds for economic development. The Stimulus Act allows tribal

governments to issue $2 billion in tax-exempt bonds for projects without this restriction to stimulate economic development. However, no portion of the tribal economic development bonds can be used for certain gaming facilities or facilities located outside the Indian reservation.

- **Prevailing Wage Rules:** The Stimulus Act mandates that the Davis-Bacon prevailing wage requirements be applied to projects financed with the proceeds of (1) new qualified CREBs, (2) qualified energy conservation bonds, (3) QZABs, (4) qualified school construction bonds and (5) recovery zone economic development bonds issued after enactment of the Stimulus Act.

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