February 23, 2009

Because of the rapidly changing conditions in the financial markets, we have established this special series of Client Alerts to advise you of the newest economic and legal developments and their wide-ranging business implications.

Municipal Bond Provisions in the 2009 Stimulus Act

On February 17, 2009 the President signed into law the American Recovery and Reinvestment Act of 2009 (the "Stimulus Act"). The Stimulus Act includes the following provisions regarding municipal bonds:

1. **AMT and Adjusted Current Earnings Exclusion**: The Stimulus Act exempts interest on all new money tax-exempt bonds issued in 2009 and 2010 from treatment as an item of tax preference for purposes of the individual and corporate alternative minimum tax, and from inclusion in the adjusted current earning of corporations for purposes of the corporate alternative minimum tax. In addition, bonds issued in 2009 and 2010 to refund bonds which in turn were issued in 2004 through 2010 also qualify for this exclusion. The exclusion does not apply to bonds issued to refund pre-2004 bonds. The benefit applies for the term of the bonds and is applied automatic to all qualifying tax-exempt bonds and no election is necessary. This benefit is similar to the one afforded last year to housing bonds.

2. **Increase in Bank Qualified Limit to $30 Million**: Under Section 265 of the Internal Revenue Code of 1986, as amended (the "Code"), financial institutions were allowed to deduct 80% of their carrying costs for tax-exempt bonds held by such institutions if the bonds were issued by a qualified small issuer that issue no more than $10 million in tax-exempt governmental and 501(c)(3) bonds annually. Under the Stimulus Act, the $10 million annual limit has been increased to $30 million. Additionally, each 501(c)(3) conduit borrower is treated as a separate issuer for this purpose. Thus, for example, it is possible for a $100 million issue of which $25 million is being loaned to each of four separate qualified borrowers to qualify. However, the entire composite issue will fail to qualify if (i) more than $30 million is loaned to any single qualified borrower, (ii) any of the borrowers is not a governmental or 501(c)(3) institution, or (iii) any borrower on a stand-alone basis would fail to meet any of the requirements of Section 265 of the Code. This provision applies to bonds issued in 2009 and 2010.

3. **2% Safe Harbor for Banks**: The Stimulus Act provides another related benefit to banks holding tax-exempt bonds by allowing them to deduct 80% of the interest costs on tax-exempt bonds issued in 2009 and 2010 as long as the banks hold no more than 2% of their assets in such tax-exempt bonds. Previously banks could only deduct the interest attributable to bank qualified bonds described in Section 2 above. Additionally, bank qualified bonds do not count against the 2% limit. This exception applies to both governmental and private activity bonds but does not apply to bonds issued to refund pre-2009 bonds.

4. **Build America Bonds**: The Stimulus Act creates a new category of tax-credit type bonds called "Build America Bonds" in which an issuer irrevocably elects with respect to an issue of bonds that would otherwise have qualified as tax-exempt governmental purpose bonds to issue those bonds as taxable bonds. The provision is not applicable to private activity bonds, including 501(c)(3) bonds. By electing to forego tax-exempt status under this "taxable bond option," the bonds receive the benefit of either (i) a tax-credit offered to the purchasers of the taxable bonds equal to 35% of the interest payable on the bonds ("Tax Credit Bonds"), which will result in the purchasers accepting a lower yield on the bonds, or (ii) an election to receive an interest subsidy payable by the federal government to the issuer (or conduit borrower) equal to 35% of each interest payment on the taxable bonds ("Interest Subsidy Bonds"). This rate is increased to 40% for bonds of qualified small issuers.

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(a) **Tax Credit Bonds** - The tax credit is included in the federal gross income of the taxpayer but is allowed as a credit against both the regular and alternative minimum tax. The tax credit can be stripped off and sold separately. The unused credit can be carried forward. The Joint House and Senate Conference Committee anticipates that Tax Credit Bonds will carry coupons that are 74.1% of the coupons on comparable regular taxable bonds. The Tax Credit Bonds cannot be issued with more than a *de minimis* amount of premium.

(b) **Interest Subsidy Bonds** - The interest subsidy option is only available for bonds where all of the proceeds are used to finance capital expenditures and fund a reasonably required reserve fund and pay costs of issuance not exceeding 2% of the proceeds of the issue. The interest subsidy is to be paid by the federal government contemporaneously with the issuer's (or conduit borrower's) interest payments but can be paid in advance or as a reimbursement. The Interest Subsidy Bonds cannot be issued with more than a *de minimis* amount of premium.

(c) **Transitional State Tax Treatment** - The tax credit and taxable interest are treated on an interim basis as exempt from federal income tax for purposes of the State income tax laws until a State provides otherwise.

(d) **Subject to Arbitrage Rules** - The Tax Credit Bonds and Interest Subsidy Bonds are subject to the regular arbitrage rules applicable to tax-exempt bonds. For this purpose, the yield on the Tax Credit Bonds is determined without regard to the tax credit on the bonds, and the yield on the Interest Subsidy Bonds is reduced by the amount of the interest subsidy on the bonds. However, the tax credits and interest subsidy are not treated as a prohibited federal guaranty of the bonds.

These provisions apply to bonds issued after the date of enactment of the Stimulus Act and before January 1, 2011.

5. **School Construction Bonds**: The Stimulus Act creates a new category of tax credit bonds called "Qualified School Construction Bonds." There is a nationwide limit on the amount of bonds that can be issued of $11 billion per year for calendar years 2009 and 2010. The bonds are issued as non-interest bearing bonds, and the bondholders receive tax credits instead of interest on the bonds. The tax credit rate is set at a rate that will permit the bonds to be issued at par. Similar to the credit on the Build America Bonds, the tax credit is included in the federal gross income of the taxpayer but is allowed as a credit against both the regular and alternative minimum tax. The tax credit can be stripped off and sold separately. Unused credits can be carried forward.

(a) **Qualified Projects** - All of the proceeds of these bonds must be used for the construction, rehabilitation, or repair of public school facilities or for the acquisition of land upon which such schools are to be constructed, and no reserve fund can be financed. Costs of issuance are limited to 2% of the proceeds. The schools financed must be located within the jurisdiction of the issuer and the issuer must designated the bonds for this purpose. The bonds do not appear to be subject to the private use limitations. The construction proceeds of the bonds must be expended within three years of issuance. Any remaining unspent construction proceeds must be used within 90 days to redeem bonds.

(b) **Allocation of Credits** -

(i) 60% of the national bond financing limitation is allocated among the States according to children ages 5 through 17. It appears that the States have the discretion to allocate the capacity within the State.

(ii) 40% of the national bonding capacity is allocated to certain large school districts. These are districts that are (A) among the 100 local educational agencies with the largest numbers of children ages 5 through 17 from families living below the poverty level or (B) one of not more than 25 additional districts designated by the

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Secretary of Education to be in particular need of assistance. These districts can reallocate their unused capacity to the State.

(c) **Indian Schools** - An additional $200 million is allocated in 2009 and 2010 to Indian schools.

(d) **Subject to Arbitrage Rules** - The bonds are subject to the regular arbitrage rules applicable to tax-exempt bonds; however, construction proceeds spent within three years of issuance are not subject to yield restriction and are exempt from rebate.

6. **QZAB Extension**: - The ability to issue Qualified Zone Activity Bonds is extended to 2010, and the national limit for QZABs is increased to $1,400,000,000 for 2009 and 2010.

7. **Recovery Zone Bonds**: The Stimulus Act creates two new categories of bonds entitled "Recovery Zone Economic Development Bonds" and "Recovery Zone Facility Bonds" that are specifically aimed at encouraging economic development in distressed areas having high unemployment, foreclosures, poverty, closure or realignment of military bases, etc., in addition to existing empowerment zones and renewal communities ("Recovery Zones"). The issuer designates which areas are the Recovery Zones. The nationwide bonding capacity to issue these bonds as described below is allocated among the States based upon the decline in employment in the States from 2007 to 2008 in proportion to the national decline in employment. The States may then allocate their capacity among the counties and large municipalities within the State based upon such relative declines in employment compared to the State rate (the counties and municipalities are allowed to reallocate their capacity to the State for further distribution).

(a) **Recovery Zone Economic Development Bonds** -

(i) These are basically Interest Subsidy Bonds as described in Section 4 above and are subject to the same limitations, except that the issuer receives an advance tax credit equal to 45% of the interest payable on the bonds on the interest payment date. In addition, the bond proceeds must be expended on capital costs with respect to property located within a Recovery Zone, public infrastructure ands construction of public facilities within a Recovery Zone, and expenditures for job training and educational programs within the Recovery Zone. It appears that these proceeds cannot finance private business use.

(ii) There is a national total capacity limit of $10 billion (in total, not for each year), and the bonds must be issued before January 1, 2011.

(b) **Recovery Zone Facility Bonds** -

(i) These are a new category of exempt facility bonds 95% of the proceeds of which must be used to finance property located in a Recovery Zone that was constructed, reconstructed, renovated or acquired by purchase after the Recovery Zone was designated, original use of which commences with the taxpayer and substantially all of the use of such property is pursuant to the conduct of an active trade or business in the Recovery Zone. The rental of residential property is not a qualified use. In addition, the usual prohibited facilities (e.g., gambling facilities, country clubs, etc.) cannot be financed. These bonds can be used to finance facilities such as hotels, office buildings, shopping centers, etc. similar to those financeable under the Gulf Zone Opportunity Bond provisions.

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(ii) There is a national total capacity limit of $15 billion (in total, not for each year), and the bonds must be issued before January 1, 2011.

8. **Tribal Bonds**: Indian tribes receive a national allocation of $2 billion for bonds for economic development.

9. **Pass-Through of Tax Credits**: The Stimulus Act allows mutual funds that purchase tax credit bonds to pass through the credits to their shareholders.

If you have questions regarding the municipal bond provisions in the 2009 Stimulus Act , or about this client alert, please contact G. Thomas Lee, Paul H. Billow or Edward J. Rojas, the principal authors of this alert, or another member of our Public Finance Group.

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