Saul Ewing LLP

PUBLIC FINANCE DEPARTMENT

FEBRUARY 2009

"What keeps you up at night?"

Saul Ewing Public Finance Department:

George T. Magnatta
Chair

Timothy A. Frey
Vice Chair

The American Recovery and Reinvestment Tax Act of 2009 / tax-exempt and tax-credit bond provisions

By George T. Magnatta, Joshua S. Pasker and Michael C. Barnes

On February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Tax Act of 2009 (the "Act"). The Act contains many provisions that impact tax-exempt and tax-credit bonds and public finance, including provisions relating to new tax-exempt and tax-credit bond programs, increases in the allocation amounts of some existing bond programs and other provisions aimed at making certain bonds more attractive to investors. Below is a summary of some of the most significant sections of the Act that impact tax-exempt and tax-credit bonds and public finance:

EXEMPTION FROM THE ALTERNATIVE MINIMUM TAX

Taxpayers who have so-called items of tax preference may be subject to an Alternative Minimum Tax ("AMT") under the Internal Revenue Code of 1986, as amended (the "Code"). Prior to the passage of the Act, interest on tax-exempt private activity bonds (except tax-exempt housing bonds and qualified 501(c)(3) bonds) was treated as an item of tax preference for purposes of the AMT. The Act exempts interest on the remaining categories of private activity bonds for purposes of the AMT in the case of bonds issued in 2009 and 2010. Refunding bonds issued before 2011 would also be exempt from the AMT if the refunded bonds were issued between December 31, 2003 and January 1, 2009. This exemption is intended to make private activity bonds more attractive to investors, with the goal of increasing demand for such bonds and lowering the interest cost to issuers.

For corporations, the Code mandates than an adjustment (the "ACE adjustment") is to be made to taxable income by including a certain percentage of items, such as interest on tax-exempt bonds, that are included in the corporation's earnings but excluded from taxable income. Under the Act, the ACE adjustment does not apply to bonds issued in 2009 and 2010, and refunding bonds issued in 2009 and 2010 if the refunded bonds were issued between December 31, 2003 and January 1, 2009.

DEDUCTIBILITY OF COST OF INVESTMENT IN TAX-EXEMPT BONDS BY BANKS

Banks generally are not permitted to deduct the cost of purchasing and carrying tax-exempt bonds unless the issuer of the bonds qualifies as a "small issuer," with an annual calendar year issuance by the issuer (and certain related issuers) not exceeding $10 million. For bonds that qualify under the small issuer exception, banks can deduct 80% of the cost of purchasing and carrying the bonds. The Act increases the small issuer exception from $10 million to $30 million for calendar years 2009 and 2010. In conduit financings for Section 501(c)(3) organizations, the increased limit will apply to the borrowers and certain affiliates, not the issuer, meaning the bonds will qualify under the exception provided that an individual borrower and certain affiliates do not have an annual calendar year tax-exempt bond issuance exceeding $30 million. Similarly, pooled financings can also qualify for the exception if each of the pool borrowers does not have an annual calendar year issuance exceeding $30 million.

As noted above, financial institutions generally are not allowed to deduct the interest cost of purchasing and carrying tax-exempt obligations from issuers that do not qualify under the small issuer exception. The Act creates a safe harbor, whereby a financial institution can deduct 80% of the cost of purchasing and carrying tax-exempt bonds issued in 2009 and 2010 as long as the institution's tax-exempt holdings do not exceed 2% of its assets. For purposes of the safe harbor, a refunding bond is treated as issued on the date of issuance of the refunded bond (or in the case of a series of refundings, the original bond).

CHANGES TO EXISTING TAX-EXEMPT AND TAX-CREDIT BOND PROGRAMS

The Act extends the authority for issuance of Qualified Zone Academy Bonds ("QZABs") through 2010, and increases the annual amount of such bonds from $400 million to $1.4 billion for 2009 and 2010. QZABs are tax-credit bonds that can be used by qualifying school districts for the renovation and repair of school buildings, investments in new technology and the training of teachers, but cannot be used for new construction. (See below for details concerning Qualified School Construction Bonds, which can be used to finance new construction).

The Act also increases the issuance amounts for two types of energy bonds. The amount of New Clean Renewable Energy Bonds ("New CREBs") that can be issued was increased from $800 million to $2.4 billion. As under prior law and continued by the Act, projects such as wind energy facilities, solar energy facilities and geothermal energy facilities can qualify for New CREB financing. Also increased is the total allocation of Energy Conservation Bonds, from $800 million to $3.2 billion. In addition to increasing the limit, the Act expanded the type of projects that qualify for Energy Conservation Bonds. Under the Act, in addition to being used for large scale energy efficiency projects, the proceeds of these bonds can be used to provide loans and grants to individuals to facilitate "green community programs."

EXPANSION OF THE DEFINITION OF "MANUFACTURING FACILITY"

Prior to passage of the Act, the Code did not permit the issuance of tax-exempt private activity bonds to finance manufacturing facilities that created intangible property, such as patents or copyrights. Under the Act, the definition of "manufacturing facility" has been expanded to include facilities used in the creation or production of intangible property (including facilities that are "functionally related and subordinate to a manufacturing facility"). The expanded definition only applies for bonds issued after the date of enactment of the Act and before January 1, 2011.

CHANGE TO HIGH-SPEED RAIL REQUIREMENTS

Prior to the passage of the Act, certain high speed rail facilities that operate in excess of 150 miles per hour were eligible for financing through the issuance of tax-exempt private activity bonds. Under the Act, high speed rail facilities will now only need to demonstrate that they are capable of attaining a maximum speed in excess of 150 miles per hour to be eligible. This provision is effective for obligations issued after the enactment of the Act.

NEW BOND PROGRAMS

Congress has created additional new bond programs to aid state and local governments. The first new program gives issuers the option of issuing taxable Build America Bonds instead of

tax-exempt obligations. Build America Bonds can be issued only for those purposes for which tax-exempt governmental bonds can currently be issued, and the tax rules, such as private-use restrictions, that currently apply to tax-exempt governmental bonds also will apply to these bonds. An issuer can choose one of two options when issuing Build America Bonds: (i) the issuer can elect to issue tax-credit Build America Bonds and the investor will receive taxable interest along with a federal tax-credit equal to 35% of the interest received; or (ii) for Build America Bonds issued prior to 2011, the issuer can choose to receive a direct payment from the federal government equal to 35% of the interest paid on the bonds, and the holder of the bonds would not receive a tax-credit. If the issuer elects option (ii) above, the proceeds of the bonds can only be used for issuance costs, capital expenditures, and reasonable reserve funds. In either case, Build America Bonds are not treated as federally guaranteed.

The Act also makes provisions for new tax-credit bonds called Recovery Zone Economic Development Bonds. Interest on these bonds will be taxable to the holder, and the issuer will receive a direct payment from the government equal to 45% of the interest paid. Recovery Zone Economic Development Bonds can only be issued before 2011, and only for use in designated Recovery Zones. Recovery Zones are defined as areas designated by the issuer as having significant poverty, unemployment or general distress (including distress caused by the closure of a military base). The $10 billion total amount of the bonds will be allocated to states based on their employment declines from 2008.

In addition to the Recovery Zone Economic Development Bonds, the Act also provides for Recovery Zone Facility Bonds. Recovery Zone Facility Bonds are a new category of tax-exempt private activity bonds where the proceeds of the bonds must be used for property that has an active business purpose and was acquired, constructed or renovated by the purchaser after the designation of the area as a Recovery Zone. The $15 billion amount of such bonds are only available through 2011, and will be allocated to states in a similar manner as the Recovery Zone Economic Development Bonds described above.

The Act creates a new category of tax-credit bonds to be used for the construction, repair, or rehabilitation of public school facilities, including the acquisition of land. These bonds, called Qualified School Construction Bonds, will provide a tax credit in the amount set by the Secretary of the Treasury so that the issuer will incur no interest cost. In each of calendar years 2009 and 2010, $11 billion of such bonds will be available.

The provisions of the Act discussed above make 2009 a very attractive time to consider a taxable or tax-exempt bond issue. Saul Ewing LLP is available to help issuers receive the maximum benefits provided by the Act. Please contact George T. Magnatta (215-972-7126, gmagnatta@saul.com) or any other member of the Saul Ewing LLP Public Finance Department for assistance and guidance.

This Alert was prepared by George T. Magnatta, Chair of the firm's Public Finance Department, and Joshua S. Pasker and Michael C. Barnes, Associates in the Public Finance Department. George can be reached at gmagnatta@saul.com or 215.972.7126. Joshua can be reached at jpasker@saul.com or 215.972.7783. Michael can be reached at mbarnes@saul.com or 215.972.7188. This publication has been prepared by the Public Finance Department for information purposes only.

The provision and receipt of the information in this publication (a) should not be considered legal advice, (b) does not create a lawyer-client relationship, and (c) should not be acted on without seeking professional counsel who have been informed of the specific facts. Under the rules of certain jurisdictions, this communication may constitute "Attorney Advertising."

© 2009 Saul Ewing LLP, a Delaware Limited Liability Partnership.
ALL RIGHTS RESERVED.

Baltimore, MD
500 East Pratt St.
Charles O. Monk, II
410.332.8668

Chesterbrook, PA
1200 Liberty Ridge Dr.
Michael S. Burg
610.251.5750

Harrisburg, PA
2 North Second St.
Eric L. Brossman
717.257.7570

Newark, NJ
One Riverfront Plaza
Stephen B. Genzer
973.286.6712

New York, NY
245 Park Ave.
John J. Jerome
212.672.1996

Philadelphia, PA
1500 Market St.
Frederick D. Strober
215.972.1985

Princeton, NJ
750 College Rd. E
Marc A. Citron
609.452.3105

Washington, DC
2600 Virginia Ave. NW
Howard G. Slavit
202.295.6604
Ira M. Shepard
202.342.3419

Wilmington, DE
222 Delaware Avenue
Wendie C. Stabler
302.421.6865