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House Ways and Means Committee reports tax title to economic recovery package

On January 22, 2009, the House Ways and Means Committee favorably reported H.R. 598, the American Recovery and Reinvestment Tax Act of 2009 (the "Bill"). The Bill contains the tax provisions of the larger economic recovery package that will be considered by Congress in the coming days. The Bill creates several new tax-exempt bond and tax-credit bond programs and expands and modifies existing tax-credit bond programs. The Bill also makes several changes to the tax treatment of certain tax-exempt bond investments. With limited exceptions, the provisions in the Bill related to tax-exempt bonds and tax-credit bonds apply only to bonds issued through 2010.

New tax-exempt bond and tax-credit bond programs

Taxable Governmental Bond option

The Bill creates a new type of tax-credit bond that pays investors both taxable interest and a federal tax credit equal to 35 percent of that taxable interest ("Taxable Governmental Bonds"). State and local governments may elect to issue Taxable Governmental Bonds in lieu of a tax-exempt governmental bond. Importantly, for bonds issued in 2009 and 2010 only, issuers may elect to receive a rebate from the IRS of 35 percent of the interest paid on the bonds in lieu of investors receiving the tax credit.

Taxable Governmental Bonds may be issued only for those purposes for which tax-exempt governmental bonds may be issued under present law. In addition, the tax rules that apply to tax-exempt governmental bonds (e.g., private use restrictions, arbitrage, etc.) also would apply to Taxable Governmental Bonds.

The Bill imposes neither a termination date nor a volume limitation on the Taxable Governmental Bond program.

New tax-exempt private activity bond: Recovery Zone Facility Bonds

The Bill authorizes the issuance of $15 billion of a new category of tax-exempt private activity bonds ("Recovery Zone Facility Bonds") for use in areas designated as Recovery Zones. The Bill generally defines Recovery Zones as areas designated by state and local governments as having significant poverty, unemployment, or home foreclosure rates.

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Generally, property eligible for depreciation that is actively used in a business may be financed with the proceeds of Recovery Zone Facility Bonds, provided the property is acquired after the date on which a Recovery Zone designation took effect.

The $15 billion volume limitation for Recovery Zone Facility Bonds would be allocated to the states in proportion to their respective 2008 job losses. Recovery Zone Facility Bonds must be issued prior to January 1, 2011.

New taxable bond: Recovery Zone Economic Development Bonds

The Bill authorizes the issuance of $10 billion of a new category of taxable bonds similar to Taxable Governmental Bonds (described above). Recovery Zone Economic Development Bonds would pay interest at a taxable rate established by the market and the Federal Government would provide issuers with a direct payment equal to 55 percent of the interest on the bonds (compared to 35 percent for Taxable Governmental Bonds).

Recovery Zone Economic Development Bonds may be issued for purposes that promote development or economic activity in a Recovery Zone. The bonds also are subject to the present-law rules that apply to tax-exempt governmental bonds (e.g., private use restrictions, arbitrage, etc.).

The $10 billion volume limitation for Recovery Zone Economic Development Bonds would be allocated to the states in proportion to their respective 2008 job losses. Recovery Zone Economic Development Bonds must be issued prior to January 1, 2011.

New tax-credit bond: Qualified School Construction Bonds

The Bill creates a new category of tax-credit bonds to finance the construction, rehabilitation, or repair of public school facilities, "Qualified School Construction Bonds." Similar to existing tax-credit bonds, the credit rate for Qualified School Construction Bonds is required to be set by the Secretary of the Treasury at a rate that permits issuance of such bonds without discount and interest cost to the qualified issuer.

The Bill authorizes $11 billion annually of Qualified School Construction Bonds for 2009 and 2010. Sixty percent of that authority is allocated to the states in proportion to the respective number of children between the age of five and 17 within each state. The remaining volume would be allocated to the largest local educational agencies in the nation (as determined by the Treasury, the Department of Commerce, and the Secretary of Education).

The Bill also provides an additional $200 million of annual Qualified School Construction Bond authority for 2009 and 2010 that is allocated to Indian tribal schools by the Secretary of the Interior.

New tax-exempt bond: Tribal Economic Development Bonds

Present law treats bonds issued by Indian tribal governments as tax-exempt only if substantially all of the proceeds of such bonds are used for "essential governmental functions" or certain manufacturing facilities.

The Bill authorizes the Treasury (in consultation with the Department of Interior) to allocate $2 billion of Tribal Economic Development Bonds. Tribal Economic Development Bonds generally may be issued for the same purposes as tax-exempt bonds issued by state and local governments. Thus, the essential governmental function requirement that applies to bonds issued by tribal governments under present law generally would not apply to Tribal Economic Development Bonds. The Bill also would permit tribal governments to issue tax-exempt private activity bonds. Tribal

Economic Development Bonds could not, however, be used for certain gaming facilities or facilities located outside the Indian reservation.

Modifications to existing tax-exempt bonds and tax-credit bonds

Increase to New Clean Renewable Energy Bonds limitation

New Clean Renewable Energy Bonds ("New CREBs") are a type of tax-credit bond that may be used to finance certain renewable energy facilities (generally, facilities that generally qualify for the production tax-credit under the Internal Revenue Code). The Bill increases the amount of New CREBs that may be issued from $800 million to $2.4 billion.

Increase to Energy Conservation Bonds limitation

Energy Conservation Bonds are a type of tax-credit bond that may be issued for broadly-defined qualified conservation purposes. The Bill increases the amount of Energy Conservation Bonds authority from $800 million to $3.2 billion. The Bill also clarifies that permitted uses of Energy Conservation Bonds include making loans and grants to individuals for green community programs. For example, states may issue these tax-credit bonds to finance loans to individual homeowners to retrofit existing housing with energy conservation property.

Extension of Qualified Zone Academy Bonds authority

Present law authorizes the annual issuance of $400 million of Qualified Zone Academy Bonds ("QZABs") in 2008 and 2009. QZABs are a type of tax-credit bond that may be used for certain school expenditures (but new construction is prohibited).

The Bill extends QZAB issuance authority through 2010 and increases the annual volume limitations for 2009 and 2010 to $1.4 billion.

Amendments to tax treatment of investors in tax-exempt bonds

Bank deductibility of interest related to tax-exempt investments

Generally, federal tax law disallows a deduction for interest on indebtedness incurred to purchase or carry tax-exempt obligations. For financial institutions, the disallowance is based on the percentage of a taxpayer's assets comprised of tax-exempt obligations (the "pro-rata rule").

In the case of obligations issued by a "small issuer" (generally, an issuer that expects not to issue more than $10 million in tax-exempt obligations within a calendar year), the general pro-rata rule does not apply and only 20 percent of the interest allocable to the tax-exempt obligations of a qualified small issuer ("bank qualified bonds") is disallowed.

The Bill would create a temporary two-percent safe harbor permitting financial institutions to purchase certain tax-exempt investments without a corresponding interest expense disallowance. Under the Bill, to the extent the average adjusted basis of tax-exempt obligations is two percent or less of the average adjusted basis of total assets, financial institutions would be permitted an 80 percent deduction for interest on indebtedness related to tax-exempt obligations. The two-percent safe harbor would apply only to bonds issued in 2009 and 2010 (but would only apply to refunding bonds to the extent the refunded bond was issued in 2009 or 2010).

The Bill increases the definition of "small issuer" for purposes of the bank qualified bond rules from $10 million to $30 million, but only with respect to bonds issued in 2009 and 2010. In addition, the Bill provides that for purposes of determining whether an issuer meets the small issuer exception, qualified 501(c)(3) bonds issued in 2009 or 2010 are treated as if they were issued by the 501(c)(3) organization for whose benefit they were issued (and not by the actual issuer of such bonds).

Application of AMT to private activity bonds

The alternative minimum tax ("AMT") imposed on individuals and corporations is computed by adjusting a taxpayer's taxable income to take into account certain preference items and adjustments. One of the preference items taken into account for purposes of the AMT is tax-exempt interest on most tax-exempt bonds issued for private activities.

In addition, in the case of a corporation, an adjustment based on current earnings is determined, in part, by taking into account 75 percent of certain items, including tax-exempt interest, that are excluded from taxable income but included in the corporation's earnings and profits (the "ACE Adjustment"). This ACE Adjustment applies to interest on tax-exempt governmental bonds, as well as interest on most private activity bonds.

Under the Bill, interest on private activity bonds issued in 2009 and 2010 is not a preference item for purposes of the AMT. This rule would not apply to a refunding bond unless the refunded bond also was issued in 2009 or 2010.

In addition, under the Bill, the ACE Adjustment would not apply to bonds issued in 2009 and 2010. This rule would not apply to a refunding bond unless the refunded bond also was issued in 2009 or 2010.

If you have any questions or require further information regarding these or other matters, please call your regular Nixon Peabody contact or feel free to contact one of the attorneys listed below:

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