



## Public Finance to the Rescue: Economic Recovery Act Introduces New Kinds of Bonds, Expands Existing Authority, and Increases Incentives for Investing

On February 17, 2009, President Obama signed the widely anticipated economic stimulus legislation formally known as the American Recovery and Reinvestment Act of 2009 (the Act). Among many other strategies designed to reinvigorate the economy, the Act encourages more activity in the public finance sector by introducing new kinds of bonds, expanding authority for existing bond categories, and providing greater incentives for financial institutions and others to invest in municipal obligations. The following information is intended to serve as a general overview of certain provisions relevant to public finance and does not constitute an exhaustive discussion or legal advice.

# NEW KINDS OF BONDS

## New Taxable Tax Credit Bonds

The following new taxable tax credit bonds may only be issued in 2009 and 2010. Despite their taxable status, they must meet many of the requirements of tax-exempt bonds, and private activity bonds are not eligible. The Build America Bonds and Recovery Zone Economic Development Bonds share an innovative feature that allows issuers to receive a direct payment from the U.S. Treasury (the direct payment option) as of each interest payment date in lieu of providing bondholder tax credits (the bondholder tax credit option).

The direct payment option reflects a significant change in the federal government's approach to subsidizing municipal obligations. The following example involving Build America Bonds illustrates the effect of this approach on issuers and bondholders. If the issuer elects the direct payment option, the issuer will receive, as of each interest payment date, a payment equal to 35% of the interest payable on that date. Therefore, on bonds with an 8% yield for the bondholder, the issuer will pay an effective interest rate of 5.2%. In contrast, if the issuer elects the bondholder tax credit option for bonds payable at 6%, the bondholder will accrue a tax credit equal to 2.1% (35% of 6%), for a total yield of 8.1% for the bondholder. Both the interest paid to bondholders and the amount of any credit they receive are included in taxable income. Congress anticipates that bondholders will accept an interest rate approximately 74.1% of an otherwise equivalent taxable rate.



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### Build America Bonds

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- Direct Payment Option: Yes
- Bondholder Tax Credit Option: Yes
- Amount of Tax Credit or Direct Payment: 35% of interest payable
- Subject to National Volume Cap: No
- Authorized Uses of Proceeds: Any purpose for which tax-exempt governmental (i.e., not private activity) bonds may be issued, except that proceeds of bonds issued in connection with the direct payment option may only be used for capital expenditures, a reasonably required reserve fund, and costs of issuance (of up to 2% of the proceeds).

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### Recovery Zone Economic Development Bonds

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- Direct Payment Option: Yes
- Bondholder Tax Credit Option: Not Applicable
- Amount of Direct Payment: 45% of interest payable
- Subject to National Volume Cap: Yes (\$10 billion for 2009 and 2010 combined)
- Authorized Uses of Proceeds: Proceeds must be used for the following purposes in federally designated empowerment zones or renewal communities, or issuer-designated "recovery zones" (as defined below):
  - (1) capital expenditures with respect to property located in the zone;

(2) expenditures for public infrastructure and the construction of public facilities in the zone; (3) expenditures for job training and educational programs; (4) reasonably required reserve funds; and (5) costs of issuance (of up to 2% of the proceeds). Recovery zones are areas suffering from significant general distress or from significant home foreclosure, unemployment, or poverty rates, as well as areas that are economically distressed because of the closure or realignment of a military base pursuant to the Defense Base Closure and Realignment Act of 1990.

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### Qualified School Construction Bonds

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- Direct Payment Option: No
- Bondholder Tax Credit: Yes
- Amount of Tax Credit: Determined by the U.S. Treasury using process applicable to Qualified Zone Activity Bonds
- Subject to National Volume Cap: Yes (\$11 billion for each of 2009 and 2010)
- Authorized Uses of Proceeds: Proceeds must be used to build, rehabilitate, or repair public schools or to acquire land on which to build them. Whether charter schools qualify as “public schools” depends on the characteristics of the schools under state law, but applying federal tax law principles.
- Also Notable: A separate volume cap of \$200 million for each of 2009 and 2010 is allocated to the construction, rehabilitation, and repair of schools funded by the Bureau of Indian Affairs.

## New Tax-Exempt Bonds

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### Recovery Zone Facility Bonds

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(A New Kind of Private Activity Exempt Facility Bonds)

- Subject to National Volume Cap: Yes (\$15 billion for 2009 and 2010 combined)
- Authorized Uses of Proceeds: At least 95% of the net proceeds (as defined in the Code) must be used for “recovery zone property,” defined as property that is depreciable and meets the following additional criteria: (1) the property must have been constructed, reconstructed, renovated, or purchased by the borrower after the date the applicable recovery zone was designated; (2) the original use of the property in the recovery zone must have commenced with the borrower; and (3) substantially all of the use of the property must be in the zone and in connection with the borrower’s active conduct of a qualified business. A “qualified business” is any trade or business except the rental to others of residential rental property (as defined in the Code) and certain other uses including golf courses, country clubs, gambling facilities, and off-sale liquor stores, among others.
- Also Notable: All of the general rules applicable to the issuance of qualified private activity bonds also apply to Recovery Zone Facility Bonds, except the aggregate annual state private activity bond volume cap and the restriction on acquisition of existing property. These bonds may only be issued in 2009 and 2010.



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## Tribal Economic Development Bonds

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- Subject to National Volume Cap: Yes (\$2 billion)
- Authorized Uses of Proceeds: The proceeds of Tribal Economic Development Bonds may be used like the proceeds of any tax-exempt bond (including a private activity bond) issued by a state or local government. The “essential governmental function” test has been eliminated for such bonds. These bonds may not be used to finance certain gaming facilities or facilities located off the issuer’s reservation.
- Also Notable: Not more than one year from the date of enactment of the Act, the Secretary of the Treasury is required to report to Congress following a study of the effects of the new rules, including an analysis of whether Congress should retain them.

## EXPANDED AUTHORITY FOR EXISTING BOND CATEGORIES

### Additional \$1 Billion of Qualified Zone Academy Bonds

State and local governments may issue Qualified Zone Academy Bonds (QZABs) to finance “qualified zone academies.” A qualified zone academy is a public school or academic program below the college level that offers a specialized curriculum in partnership with businesses and is either (1) located in an empowerment zone or enterprise community under the Code or (2) reasonably expected to serve student populations of which at least 35% qualify for free or reduced-cost lunches. QZABs may be used to renovate buildings, purchase equipment, develop course material, and train teachers and personnel. The U.S. Treasury Department sets the amount of the tax credit for QZABs at a rate estimated to allow their issuance without interest or discount. The Act raises the annual national QZAB cap from \$400 million to \$1.4 billion in 2009 and provides new authorization for \$1.4 billion in 2010.

### Additional \$1.6 Billion of New Clean Renewable Energy Bonds

Under current law, qualified issuers may issue New Clean Renewable Energy Bonds (New CREBs) to finance facilities that generate electricity from a range of renewable sources including wind, biomass, and hydropower, among others. The Act raises the nationwide cap on New CREBs from \$800 million to \$2.4 billion, to be divided equally among three purposes: qualifying state and local government projects, qualifying projects of public power providers, and qualifying projects of electric cooperatives.

### Additional \$2.4 Billion of Qualified Energy Conservation Bonds

The Act adds \$2.4 billion to the \$800 million previously authorized for Qualified Energy Conservation Bonds (QECBs) for a total cap of \$3.2 billion. QECB proceeds may be used to finance certain capital expenditures related to reducing energy consumption, and certain expenditures related to the development of cellulosic



ethanol and other fuels and technologies, mass commuting facilities, and other projects. The Act clarifies that QECP proceeds may be used to make certain loans or grants or provide other “repayment mechanisms” to implement certain green community program initiatives such as retrofitting private buildings to increase energy conservation.

### **Additional Uses for Qualified Small Issue Bond Proceeds**

Proceeds of qualified small issue bonds may only be used to finance “manufacturing facilities,” with up to 25% of the proceeds allocable to certain ancillary facilities, as defined in the Code. The Act (1) expands the definition of manufacturing facilities for bonds issued in 2009 and 2010 to include those used to produce or create intangible property (including patents, copyrights, processes, etc.); and (2) allows proceeds of bonds issued in 2009 and 2010 to be used, without regard to the 25% limitation, for property that is functionally related and subordinate to a manufacturing facility located on the same site as the facility.

### **Expanded Authority for High-Speed Intercity Rail Facilities**

The Act expands existing financing authority to issue tax-exempt bonds for high-speed intercity rail facilities by broadening the definition of such facilities to remove the requirement that high-speed vehicles be expected to operate at speeds above 150 miles per hour. Under the Act, such vehicles need only be capable of attaining such speeds.

## **GREATER INCENTIVES TO INVEST**

### **Provisions Benefiting Financial Institution Bondholders**

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#### **Additional Interest Expense Deductions for Financial Institutions**

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Financial institutions generally are not permitted to deduct the portion of their interest expense that is allocable pro rata to the portion of their total assets that consists of tax-exempt bonds. The Act permits financial institutions to deduct 80% of their interest expense that is so allocated to the investment of up to 2% of their assets in tax-exempt bonds issued for new projects in 2009 and 2010, provided there is no indebtedness directly attributable to such bonds.

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#### **Limit for “Bank-Qualified” Bonds Increased from \$10 million to \$30 million**

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Before the passage of the Act, an issuer could not designate bonds as “qualified tax-exempt obligations” (obligations exempt from the automatic 100% interest deduction disallowance rule for financial institution bondholders and known as “bank qualified” bonds) unless the issuer reasonably expected to issue no more than \$10 million of governmental and qualified 501(c)(3) bonds during the calendar year. For bonds issued in 2009 and 2010, the Act increases that limit from \$10 million to \$30 million, applies the limitation to ultimate qualified borrowers of pooled financings (permitting larger pool issues), and applies the limitation separately to each 501(c)(3) conduit borrower. As a result, qualified 501(c)(3) bonds issued over this two-year period do not count toward the governmental issuer’s \$30 million limit.



## Provision Exempting Certain Interest Earnings from AMT and Corporate Adjustment

Interest on tax-exempt private activity bonds (but not governmental or 501(c)(3) bonds) is generally subject to the alternative minimum tax (AMT), and interest on any tax-exempt bonds is generally included in the corporate AMT adjustment based on current earnings. Under the Act, interest attributable to private activity bonds issued in 2009 and 2010 is not subject to AMT, and interest attributable to tax-exempt bonds is not included in the corporate AMT adjustment based on current earnings. For the foregoing purposes, a refunding bond is treated as issued on the date of issuance of the refunded bond (or original bond, if more than one refunding has occurred).

The Act also provides that with respect to bonds issued in 2009 and 2010 to refund bonds issued between January 1, 2004, and December 31, 2008, interest is not subject to AMT and is not included in the corporate AMT adjustment based on current earnings.

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