



## IRS Issues Guidance and Interim Guidance on Recovery Zone Bonds

Among the new kinds of taxable bonds introduced by the American Recovery and Reinvestment Act of 2009 (the Recovery Act) are Recovery Zone Economic Development Bonds (RZ Economic Development Bonds) and Recovery Zone Facility Bonds (RZ Facility Bonds) (together, RZ Bonds). While the two types of RZ Bonds differ in significant ways, they reflect a common policy goal: stimulating job creation and economic recovery in areas with highest employment declines by enabling state and local governments to finance certain projects and programs at lower borrowing costs.

On June 12, 2009, the Internal Revenue Service (IRS) issued Notice 2009-50 to provide (1) guidance on the volume cap amounts allocated to states and certain political subdivisions for RZ Bonds and (2) interim guidance on other matters relevant to RZ Bonds. The following information is intended to serve as a general overview of Notice 2009-50 and does not constitute an exhaustive discussion or legal advice.

### **RZ Economic Development Bonds in Brief**

RZ Economic Development Bonds are a “subspecies” of the taxable tax credit Build America Bonds (BABs) authorized in the Recovery Act and described in detail in other Dorsey updates (available at [www.dorsey.com/public\\_finance/](http://www.dorsey.com/public_finance/) - click the “just published” tab). Like Direct Payment BABs, RZ Economic Development Bonds allow issuers to receive direct federal subsidy payments as of each interest payment date to offset a portion of their interest expense. Unlike Direct Payment BABs, RZ Economic Bonds are subsidized at an amount equal to 45% of the total coupon interest payable.

RZ Economic Development Bonds are obligations issued as part of an issue meeting the following requirements:

- the obligations are BABs (as defined in Section 54AA(d) of the Internal Revenue Code (the Code));
- the obligations are issued before January 1, 2011;
- the issuer designates the obligations as RZ Economic Development Bonds; and
- sale and investment proceeds are used only for one or more “qualified economic development purposes,” as described below, and, if the issuer so chooses, costs of issuance up to 2% of the sale proceeds plus a reasonably required reserve fund (as described in Section 148(d) of the Code).

Qualified Economic Development Purposes are any expenditures to promote development or other economic activity in a “recovery zone,” as defined on page 2 of this update. Such expenditures include:

- capital expenditures in connection with property located in the recovery zone;
- expenditures for public infrastructure and construction of public facilities; and
- expenditures for job training and educational programs.

The IRS states in Notice 2009-50 that the term “qualified economic development purposes” is sufficiently broad to encompass working capital expenditures to promote development or other economic activity within a recovery zone. RZ Economic Development Bonds may be used (1) to reimburse qualified expenditures under Section 1.150-2 of the Income Tax Regulations; and (2) to reimburse otherwise eligible expenditures that were paid or incurred after February 17, 2009 (the effective date of the Recovery Act) and originally financed with temporary short-term financing issued after that date. Otherwise, RZ facility Bonds may not generally be used to refinance prior expenditures through refunding issues.

### **RZ Facility Bonds in Brief**

RZ Facility Bonds are a new kind of private activity exempt facility bonds. The general rules applicable to qualified private activity bonds apply to Recovery Zone Facility Bonds, except the aggregate annual state private activity bond volume cap and the

restriction on using bond proceeds to acquire existing property. Subject to certain limitations, rules applicable to exempt facility bonds also apply to RZ Facility Bonds.

RZ Facility Bonds are obligations issued as part of an issue meeting the following requirements:

- the obligations are issued before January 1, 2011;
- the issuer designates the obligations as RZ Facility Bonds; and
- at least 95% of the net proceeds are used for “recovery zone property,” as described below. For the purpose of RZ Facility Bonds, net proceeds are sale proceeds less amounts for a reasonably required reserve or replacement fund (as described in Section 148(d) of the Code).

Recovery Zone Property is depreciable property that meets the following additional criteria:

- the property must have been constructed, reconstructed, renovated, or purchased by the borrower after the date the applicable recovery zone was designated;
- the original use of the property in the recovery zone must have commenced with the borrower; and
- substantially all of the use of the property must be in the recovery 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.

## **Recovery Zone Criteria and Designation Process**

A recovery zone is any area federally designated as an empowerment zone or renewal community, as well as any area designated by the issuer as (1) “having significant poverty, unemployment, rate of home foreclosures, or general distress” or (2) economically distressed because of the closure or realignment of a military installation pursuant to the Defense Base Closure and Realignment Act of 1990. Notice 2009-50 contains no further information on the above criteria. With respect to the designation process, Notice 2009-50 states only that any state or local government that receives a volume cap allocation for RZ Bonds “may make these designations of recovery zones in any reasonable manner as it shall determine in good faith in its discretion.”

## **RZ Bond Volume Cap Allocation**

Allocation to States: The Recovery Act sets caps on the face value of RZ Bonds to be issued nationwide. The cap for RZ Economic Development Bonds is \$10 billion; for RZ Facility Bonds, it is \$15 billion. In accordance with the Recovery Act, each of these caps has been allocated among the states proportionately to reflect each state’s 2008 employment decline relative to the aggregate 2008 employment declines of all of the states, with modifications to ensure that no state receives less than 0.9 percent of the allocation for either of the RZ Bonds. A list of the RZ Bond allocations to each state is set forth on pages 16-18 of Notice 2009-50, which is available at [www.irs.gov/pub/irs-drop/n-09-50.pdf](http://www.irs.gov/pub/irs-drop/n-09-50.pdf).

Mandatory Reallocations to Certain Political Subdivisions: The Recovery Act requires that each state’s RZ Bond volume cap allocations be reallocated among the state’s counties and large municipalities (i.e., municipalities with a population of more than 100,000) (together, the Political Subdivisions). The suballocations must proportionately reflect each Political Subdivision’s 2008 employment decline relative to the aggregate 2008 employment declines of all of the Political Subdivisions in the state. Where the jurisdictions of counties and large municipalities overlap, the overlapping area is to be treated as part of the large municipality.

In recognition of the administrative burden created by the mandatory reallocation of RZ Bond volume caps, the Treasury Department and IRS have determined the suballocations in accordance with the method required under the Recovery Act. The list of the RZ Bond suballocations within each state is available at [www.irs.gov/pub/irs-tege/rzbllocalreallocations.pdf](http://www.irs.gov/pub/irs-tege/rzbllocalreallocations.pdf).

Waiver of Volume Cap Suballocations: A Political Subdivision may waive any portion of its suballocation for RZ Bonds. The applicable state may reallocate the waived volume cap “in any reasonable manner as it shall determine in good faith in its discretion.”

## Information Reporting Procedures

The procedures for reporting an issuance of [RZ Economic Development Bonds](#) and obtaining payments from the U.S. Treasury for them are similar to those applicable to Direct Payment BABs. For more information on those procedures, please see our previous update, *IRS Issues Much-Anticipated Guidance on Build America Bonds*, available at [www.dorsey.com/public\\_finance/](http://www.dorsey.com/public_finance/) - click the "just published" tab.

Issuers of [RZ Facility Bonds](#) are directed to report the issuance to the IRS using Form 8038, *Information Return for Tax-Exempt Private Activity Bonds Issues*, "at the same time and in the same manner" required under Section 149(e) of the Code (pertaining to exempt facility bonds), subject to certain modifications detailed in Notice 2009-50.

## For more information about Recovery Zone Bonds and related guidance and interim guidance provided by the IRS, please contact any of the following Dorsey attorneys:

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