

**ALERT**

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# ARRA Makes Temporary Changes to Rules Concerning Industrial Development Bonds

Technology companies or manufacturers of tangible or intangible property should be aware that the American Recovery and Reinvestment Act of 2009 (ARRA) makes significant temporary changes to rules concerning tax-exempt private activity bonds, affecting bonds that are issued in the remainder of 2009 and 2010.

Manufacturers and technology companies that want to take advantage of lower interest rates related to borrowing should be particularly aware that §1301 of the ARRA expands the application tax-exempt qualified small issue bonds, commonly known as “Industrial Development Bonds” or “Small Issue IDBs.” Previously, Small Issue IDBs were not available to facilities producing *intangible* property, preventing many technology companies from benefiting from their use. However, the ARRA now provides for the application of the bonds for use in financing manufacturing facilities used in the production of intangible property, including patents, copyrights, formulas, processes, designs, patterns, knowhow, formats and other similar items.

The ARRA also makes significant modifications to the treatment of Alternative Minimum Tax (AMT) for bond buyers, serving to make the Small Issue IDBs more marketable. Prior to the new law, most Small Issue IDBs were issued at relatively higher interest rates because they were AMT bonds on which the interest was required to be factored into the alternative minimum tax income as a preference item or current earnings adjustment for corporations. Under the new law, the interest on private activity bonds, such as Small Issue IDBs, is no longer considered a preference item or an element of the current earnings adjustment under the AMT, giving these bonds a lower interest rate. Bonds issued between 2004 and 2008 can be refunded under the new non-AMT rules at lower interest rates, making them more attractive to investors. If you have an outstanding IDB bond, you should consider refinancing that bond at a lower interest rate.

The new law under the ARRA strives to make tax-exempt bond financing more attractive and accessible to both issuers and investors. Manufacturers and technology companies should make

themselves familiar with the implications of the Small Issue IDB and AMT rules, and take advantage of financing opportunities in order to best strategize how to incorporate the tax-exempt bond structure of Small Issue IDBs into their borrowing portfolio. The Small Issue IDB and AMT modifications are only two of the many changes made under the ARRA, and all companies should review the ARRA to determine how the many other provisions affect their operations.

A detailed summary outlining these important changes is included below. For more information, please contact the following Barnes & Thornburg LLP attorneys: Stephen Dutton (317-231-7542), David Millard (317-231-7803), Marcus Chandler (317-231-7535), Richard Starkey (317-231-7510), Kirk Grable (317-231-7781), Neal Steinbart (317-231-7257), Anneliese Williams (317-231-6425) and Alan Feldbaum (574-237-1114).

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# AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009 SUMMARY OF APPLICATION TO INDUSTRIAL DEVELOPMENT BONDS

## The American Recovery and Reinvestment Act of 2009

The American Recovery and Reinvestment Act of 2009 (ARRA) includes important changes to the treatment of tax-exempt qualified small issue bonds, commonly known as “Industrial Development Bonds” or “Small Issue IDBs.” Under section 144(a) of the Internal Revenue Code (the Code), Small Issue IDBs are tax-exempt private activity bonds issued by state and local governments for financing the acquisition, construction, reconstruction, or improvement of land or property for manufacturing facilities or certain depreciable farm property. Section 144(a) of the Code lists a number of general requirements and limits which apply to Small Issue IDBs.

### **General requirements for Small Issue IDBs include:**

- Ninety-five percent (95%) of the proceeds of the bonds must be used for:
  - Acquisition,
  - Construction,
  - Reconstruction,
  - Improvement of land, or
  - Rehabilitation of building if 15 percent of proceeds used for rehabilitation
- Limit on the amount of Small Issue IDB principal for single issues: \$10,000,000
- Limit on capital expenditures at facility for six year period (going back three years and forward three years): \$20,000,000
- Limit on aggregate amount of Small Issue IDBs per borrower worldwide: \$40,000,000

None of these general requirements change under the ARRA.

### New Small Issue IDB Law

Section 1301 of the ARRA broadened the scope and application of Small Issue IDBs by making temporary changes to the manufacturing facility requirements of the bonds. The modifications are effective from Feb. 17, 2009 until Dec. 31, 2010 and provide two alternative methods for use of Small Issue IDBs for a manufacturing facility: the inclusion of (i) intangible property; or (ii) functionally related and subordinate property.”

**(i) Definition of “Manufacturing Facility” under ARRA.** First, the ARRA expands the definition of a manufacturing facility to include a facility used in the production of *intangible* property.

### **Manufacturing facilities include:**

- A facility used in the creation and production of intangible property, defined by reference to Section 197(d)(1)(iii) as any:
  - Patent,
  - Copyright,

- Formula,
- Process,
- Design,
- Pattern,
- Knowhow,
- Format,
- Other similar item

The Joint Explanatory Statement of the House and Senate Conference Agreement envisions that under the new law this will include such facilities as those creating computer software or intellectual property associated with bio-tech and pharmaceuticals. The inclusion of intellectual property expands the potential use of Small Issue IDBs to facilities creating such property as books or song lyrics, computer software and programming, graphic design, engineering processes, and many other. This modification greatly expands the application of Small Issue IDBs and benefits a number of facilities that previously could not use the Small Issue IDB funding mechanism.

**(ii) Definition of Functionally Related and Subordinate Facilities**

Alternatively, bond proceeds may also be considered to provide a manufacturing facility if they are used to provide a facility “functionally related and subordinate” to a manufacturing facility (as defined without regard to the new rule under the ARRA) that is located on the same site as the manufacturing facility. The provision for “functionally related and subordinate” facilities differs from the requirement of the prior law that facilities be “directly related and ancillary,” expanding the number of facilities that now qualify under Small Issue IDB rules. Although not specifically defined with regard to Small Issue IDBs, analogy to the regulations of other contexts suggests that it is a related facility, commensurate with the character and size of the main manufacturing facility.

Additionally, a final amendment to the Small Issue IDB rules under the ARRA is that the limit of the prior law that less than 25 percent of the proceeds be used to provide the related facility does not apply to Small Issue IDBs issued in the temporary 2009-2010 time period. For this temporary period, more than 25 percent of bond proceeds may be used to provide the broader functionally related and subordinate on-site structures while still maintaining qualification as a Small Issue IDB, so long as the general 95 percent use threshold is maintained.

**Functionally Related and Subordinate Facilities:**

- Must be on-site facilities
- Not specifically defined with regard to Small Issue IDBs
- Defined elsewhere, Treas. Reg. 1.103-8(a)(3):
  - “Any land, building, or other property functionally related and subordinate to such facility. Property is not functionally related and subordinate to a facility if it is not of a character and size commensurate with the character and size of such facility”
- Included facilities in other contexts, Treas. Reg. 1.103-8
  - Parking areas,
  - Facilities for heating and cooling or trash disposal equipment,
  - Units for maintenance personnel,
  - Storage facilities, and
  - Office facilities

- Use of proceeds for functionally related and subordinate facilities no longer limited to 25 percent

The non-application of the previous 25 percent use limit to Small Issue IDBs issued in the remainder of 2009 and 2010 has additional implications for the potential to currently refund bonds. Like under prior law, Small Issue IDBs may only be currently refunded; however, tax benefits are now available to many issuers upon refunding that were not available under the prior law. In the case of an private activity bond issue for which over 25 percent of the proceeds would be used to provide for related and ancillary facilities, the prior law required the issue be split into two parts, a tax-exempt Small Issue IDB covering an issue for which proceeds would be used as allowable under the law and a taxable bond covering the related or ancillary facilities not satisfying the Small Issue IDB requirements. The temporary elimination of the 25 percent limit allows bonds that were issued for such projects to be refunded in one combined refunding issue as a Small Issue IDB, covering both the previously tax-exempt and the previously taxable bond issues. Refunding a taxable bond with a tax-exempt Small Issue IDB can help to increase the marketability of such bonds.

One caveat does exist for refundings under the Small Issue IDB rubric: an issuer must still comply with reimbursement regulations of Treas. Reg. 1.150-2. If the issuer makes an expenditure for the project in advance of issuing the original bonds (whether taxable or tax-exempt), it must execute a reimbursement resolution, indicating the intent to reimburse such expenditures with proceeds of the bond. The issuer must execute the resolution within 60 days of making the initial expenditure, and it must reimburse for the expenditure not more than 18 months after the later of that date the facility is placed in service or the date the expenditure was made, and in no case, can the reimbursement occur more than three years after the expenditure.

### **Other ARRA Provisions Affecting Small Issue IDBs**

Additional provisions of the ARRA also affect the practical effect of Small Issue IDBs. Section 1503 of the ARRA temporarily provides that the interest on private activity bonds, such as Small Issue IDBs, shall not be considered a preference item under the alternative minimum tax (the “AMT”). As a non-preference item, the interest on such bonds is not required to be added into the AMT equation to arrive at AMT income. The interest on Small Issue IDBs also shall not factor into the “current earnings adjustment” of a corporation under the AMT. These two changes also apply to refunding bonds issued within the 2009-2010 period that refund bonds originally issued in 2004-2008. It is thus possible to refund, as a non-AMT bond, a Small Issue IDB issued between 2004 and 2008 which previously fell under AMT preference and current earnings adjustment treatment. These additional tax amendments serve to make private activity bonds, such as the Small Issue IDBs, more attractive to investors and therefore more marketable.

#### **Alternative Minimum Tax Modifications:**

- Interest on private activity bonds, including Small Issue IDBs, is not a preference item under AMT
- Interest on private activity bonds, including Small Issue IDBs, is not a factor in “current earnings adjustment” for corporations
- Bonds originally issued between 2004 and 2008 may be refunded and dated as of the date of the refunding issue, so the new AMT rules apply

## **Conclusion**

This summary outlines important changes to the tax treatment of qualified small issue bonds under the ARRA. Not all of the particular requirements and nuances of the prior, nor of the new law, regarding Small Issue IDBs are discussed in this summary, but it does emphasize the temporary measures aimed at increasing marketability and expanding the availability of Small Issue IDBs to many facilities previously unable to take advantage of the tax-exemption associated with the bonds. Further, the modifications to the alternative minimum tax make Small Issue IDBs an attractive financing mechanism. Manufacturers and state and local government issuers should make themselves familiar with these, and the many other changes to tax-exempt financing mechanisms contained in the ARRA, in order to best strategize as to how the new rules can benefit their communities.