



Summary of New Direct-Payment Treatment for Certain Former Tax Credit Bonds

March 2010

1 Purpose. This memorandum describes the impact of a new federal law, the Hiring Incentives to Restore Employment Act, H.R. 2847 (the “Employment Act”), on the following four types of bonds that until now could only be issued as “tax credit” bonds:

- Qualified School Construction Bonds (QSCBs)
- Qualified Zone Academy Bonds (QZABs)
- New Clean Renewable Energy Bonds (NCREBs)
- Qualified Energy Conservation Bonds (QECBs)

The law was passed by the U.S. Congress on March 17 and signed into law by the President on March 18, 2010. In this memorandum we refer to these bonds collectively as the “New Direct-Payment Bonds.”

2 Direct Payments; No Tax Credits. Under Section 301 of the Employment Act, (a) holders of the New Direct-Payment Bonds will receive taxable interest but no tax credits, just like the holders of Build America Bonds (“BABs”) and Recovery Zone Economic Development Bonds (“RZEDBs”), and any other taxable bonds, and (b) bond issuers will receive direct interest-subsidy payments from the U.S. Treasury, just like issuers of BABs and RZEDBs. But for the New Direct-Payment Bonds, the federal subsidy is higher:

QSCBs and QZABs for each interest payment, the interest subsidy payment is the lesser of (1) 100% of the interest payable on the bond or (2) the interest that would have been payable if it were computed based on the **tax-credit rate** in effect on the date bonds were sold;

NCREBs and QECBs for each interest payment, the interest subsidy payment is the lesser of (1) 100% of the interest payable on the bond or (2) the interest that would have been payable if it were computed based on **70% of the tax-credit rate** in effect on the date bonds were sold.

3 QSCB/QZAB Example. On Friday, March 19, 2010, the ABC School District sold direct-payment QSCBs, bearing interest at **5.0%**. According to the U.S. Treasury-Direct website, the federal tax credit rate for tax credit bonds sold on that date was **5.73%**. On each interest payment date,

the U.S. Treasury will pay the District an amount equal to **100%** of the interest payable on that date (assuming no offsets - discussed below). But if the QSCBs bore interest at **6.0%**, then on each interest payment date the U.S. Treasury would pay the District an amount equal to interest payable on the bonds **computed at 5.73%** (an effective subsidy of about 87%). A direct-payment QZAB would be treated the same.

4 NCREB/QECB Example. On Friday, March 19, 2010, the City of Dreams sold direct-payment QECBs, bearing interest at **6.0%**, when the federal tax credit rate for tax credit bonds was **5.73%**. Seventy percent of that rate is **4.01%**. On each interest payment date, the U.S. Treasury will pay the City an amount equal to interest payable on the bonds **computed at 4.01%** (an effective subsidy of about 67%).

5 Arbitrage. For BABs and RZEDBs, the U.S. Treasury pays interest subsidy payments under Section 6431 of the Internal Revenue Code (the “Code”). Under that section, the “yield” on an issue of BABs or RZEDBs, for purposes of the arbitrage rules, is computed by subtracting out the interest subsidy payments from the bond payments, thereby reducing the yield. Because the U.S. Treasury will pay interest subsidy payments for New Direct-Payment Bonds under the same section, we have concluded that the yield on New Direct-Payment Bonds will be computed the same way: by subtracting the interest subsidy payments.

6 Procedure for Interest Subsidy Payments; Form 8038-CP; Compliance Checks. This law is so new that the IRS has not released any information about how the interest subsidy payments will be paid. But we believe the procedure will be very similar to the procedure in place now for BABs and RZEDBs, summarized below:

- For each interest subsidy payment, the issuer must file IRS Form 8038-CP (or a similar form) with the IRS requesting the payment.
- Form 8038-CP must be filed no earlier than 90 days nor later than 45 days before the interest payment date.
- For each interest subsidy payment request, the issuer must state whether an event occurred since the last Form 8038-CP was filed that could affect the status of the bonds as eligible for the interest subsidy payment.
- The issuer must confirm that the amount requested is the correct amount, adjusted for a previous underpayment or overpayment.
- The payment can be made by check or direct deposit.
- If the issuer hired an outside party to prepare Form 8038-CP, that party must complete the “Paid Preparer” section on the form.

We also think it is likely that the IRS will send a “Direct Pay Bonds Compliance Check Questionnaire” to each issuer of New Direct-Payment Bonds, just as it is doing for issuers of BABs. The Questionnaire asks whether the issuer has established written procedures relating to the issue price on the bonds, timely expenditure of bond proceeds, use of proceeds to pay costs of issuance and costs of the financed project, and proper determination of the interest payable on the bonds, and related questions.

Also, interest subsidy payments are treated as “overpayments” of federal income tax, which means that the IRS can offset all or a portion of an interest subsidy payment for any federal tax payable by the issuer, such as payroll taxes. We have seen at least one instance of a reduction in an interest subsidy payment due to an offset.

7 Effective Date; Sunset; Questions.

(a) **In Effect Now.** The New Direct-Payment Bond rules apply to bonds issued after the date of enactment of the Employment Act (March 18, 2010).

(b) **Sunset.** Before the Employment Act, Code sections 54AA(g) and 6431(a) authorized the Treasury to make interest subsidy payments (“credits”) to issuers of “qualified bonds” **issued before 2011.** A BAB is a “qualified bond” if (1) 100% of the available project proceeds (less proceeds in a reserve fund) are used for capital expenditures, and (2) the issuer elects to treat the bonds as “qualified bonds.” The Employment Act adds new subsection (f) to 6431, which provides that “specified tax credit bonds” (QSCBs, QZABs, NCREBs, and QECBs) are treated as “qualified bonds” eligible for the direct interest subsidy payments under section 6431, “without regard to the requirement that the qualified bond be issued before 2011.”

Upon first impression, it appears that issuers could issue New Direct-Payment Bonds in 2010, 2011, and beyond. But for each category of “specified tax credit bonds,” the issuer must “designate” the bonds as such, and the amount of bonds that may be designated is limited by the respective Code section:

QSCBs (Section 54F)	\$11 billion for each of calendar years 2009 and 2010; unused cap maybe carried forward
QZABs (Section 54E)	\$1.4 billion for each of calendar years 2009 and 2010; unused cap may be carried forward up to two years
NCREBs (Section 54C)	\$800 million total; year of issuance not restricted
QECBs (Section 54D)	\$3.2 billion total; year of issuance not restricted

Therefore, it appears that direct-payment NCREBs and QECBs may be issued in any year, subject to the overall volume cap for each category. Direct-payment QSCBs and QZABs may be issued in 2010 with current volume cap, or after 2010, but only under a carry-forward of 2009 or 2010 volume cap.

8 Summary of Requirements for QSCBs, QZABs, NCREBs, and QECBs.

(a) **General Rules Applicable to All Bond Types.**

(1) *Use of Available Project Proceeds.* The issuer must reasonably expect to (A) spend 100% of the Available Project Proceeds for qualified expenditures (depending on the type of bond) within three years after the issue date, and (B) enter into a binding contract with a third party to spend at least 10% of the Available Project Proceeds within six months after the issue date. “Available Project Proceeds” are the sale proceeds of the bonds, less up to 2% of the sale proceeds used to pay bond issuance costs, plus investment earnings. If any Available Project Proceeds remain unspent three years after the issue date, the issuer must use all of those proceeds to redeem Bonds within 90 days, unless the issuer obtains an extension from the IRS.

(2) *Limit on Term of Bonds.* The final maturity date of the bonds cannot be later than the maximum allowable term established by the U.S. Treasury on the bond sale date.

(3) *Sinking Funds.* Amounts set aside in a fund to pay the bonds, including a reserve fund or sinking fund, cannot be invested at a rate higher than the “permitted sinking fund yield” established by the U.S. Treasury on the bond sale date. In addition, the sinking fund cannot be funded at a rate more rapid than equal annual installments, and it cannot be funded at a rate faster than reasonably expected to result in an amount necessary to repay the Bonds.

(4) *Project Fund and Cost of Issuance Fund.* Bond Proceeds deposited in the project fund and cost of issuance fund and investment earnings on those proceeds may be invested without yield restriction during the three-year expenditure period. After that period, unspent proceeds are restricted to the yield on the bonds until the redemption date discussed above.

(b) **Qualified School Construction Bonds.** QSCBs must be issued by a state or local government with jurisdiction over the school. 100% of the Available Project Proceeds of a QSCB must be used for (1) the construction, rehabilitation, or repair of a public school facility, (2) the acquisition of land on which the school is to be constructed with a portion of the Bond proceeds, and (3) costs of acquiring equipment to be used in the portions of the school being constructed, renovated or repaired. A “public school facility” means any administrative office, classroom, library or media center, performing-arts center, physical education or athletic facility, food services facility, playground, parking lot, or other structure or facility relating to any of these facilities or purposes, at a public elementary or secondary school established by or operated under the supervision of a local educational agency.

(c) **Qualified Zone Academy Bonds.** QZABs must be issued by a state or local government with jurisdiction over the qualified zone academy. 100% of the Available Project Proceeds of a QZAB must be used for a “qualified purpose” (defined below) with respect to a qualified zone academy established by a local educational agency. A qualified zone academy (an “Academy”) is a public school or schools, or an academic program within a school or several schools, as follows:

(1) The school is a “public school,” and the issuer’s governing body is an “eligible local education agency” within the meaning of Section 1397E(d)(4)(B) of the Code and Section 9101 of the Elementary and Secondary Education Act of 1965.

(2) The Academy was designed in cooperation with business to enhance the academic curriculum, increase graduation and employment rates, and better prepare the students for the rigors of college and the increasingly complex workforce.

(3) The students in the Academy will be subject to the same academic standards and assessments as other students educated by the issuer.

(4) The financed project and the Academy have been approved by the issuer’s governing body.

(5) Either (A) there is a reasonable expectation as of the bond issue date that at least 35% of the students enrolled in the school qualified for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act, or (B) the Academy is located within the boundaries of an empowerment zone or an enterprise community.

The term “qualified purpose” means (1) rehabilitating or repairing the public school facility in which the Academy is established, (2) providing equipment for use at the Academy, (3) developing course materials for education to be provided at the Academy, and training teachers and other school personnel in the Academy. In addition, the Academy must have written commitments from private entities to contribute money or property with a present value of at least 10% of the proceeds of the QZABs.

(d) **New Clean Renewable Energy Bonds.** NCREBS may be issued by a “qualified issuer,” defined as a public power provider, a cooperative electric company, a governmental body, a clean renewable energy lender, or a not-for-profit electric utility that has received a loan or a loan guarantee under the Rural Electrification Act. 100% of the Available Project Proceeds of a NCREB must be used for capital expenditures incurred by governmental bodies, public power providers, or cooperative electric companies for one or more “qualified renewable energy facilities,” defined as a “qualified facility” (as determined under Code section 45(d) without regard to paragraphs (8) and (10) thereof and without regard to any placed in service date) owned by a public power provider, a governmental body, or a cooperative electric company. Examples of qualified facilities under Code section 45(d) are as follows:

- 45(d)(1) Wind facility
- 45(d)(2) Certain closed-loop biomass facilities
- 45(d)(3) Certain open-loop biomass facilities
- 45(d)(4) Geothermal or solar energy facility
- 45(d)(5) Small irrigation power facility
- 45(d)(6) Landfill gas facilities
- 45(d)(7) Trash facilities
- * * *
- 45(d)(9) Qualified hydropower facility
- * * *
- 45(d)(11) Marine and hydrokinetic renewable energy facilities

Each of these facility types has special requirements.

(e) **Qualified Energy Conservation Bonds.** QECCBs must be issued by a state or local government. 100% of the Available Project Proceeds of a QECCB must be used for “qualified conservation purposes,” including the following:

(1) Capital expenditures incurred for purposes of (i) reducing energy consumption in publicly-owned buildings by at least 20 percent, (ii) implementing green community programs (including the use of loans, grants, or other repayment mechanisms to implement such programs), (iii) rural development involving the production of electricity from renewable energy resources, or (iv) any qualified facility (as determined under section 45(d) without regard to paragraphs (8) and (10) thereof and without regard to any placed in service date).

(2) Expenditures with respect to research facilities, and research grants, to support research in (i) development of cellulosic ethanol or other nonfossil fuels, (ii) technologies for the capture and sequestration of carbon dioxide produced through the use of fossil fuels, (iii) increasing the efficiency of existing technologies for producing nonfossil fuels, (iv) automobile battery technologies and other technologies to reduce fossil fuel consumption in transportation, or (v) technologies to reduce energy use in buildings.

(3) Mass commuting facilities and related facilities that reduce the consumption of energy, including expenditures to reduce pollution from vehicles used for mass commuting.

(4) Demonstration projects designed to promote the commercialization of (i) green building technology, (ii) conversion of agricultural waste for use in the production of fuel or otherwise, (iii) advanced battery manufacturing technologies, (iv) technologies to reduce peak use of electricity, or (v) technologies for the capture and sequestration of carbon dioxide emitted from combusting fossil fuels in order to produce electricity.

(5) Public education campaigns to promote energy efficiency.

QECBs can be issued as governmental-purpose bonds or as private activity bonds. If issued as private activity bonds, the “qualified conservation purposes” includes only capital expenditures.

If you have any questions, please contact your bond attorney or one of the Gilmore & Bell tax attorneys listed below.

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