

Treasury Guidance on Qualified School Construction Bonds and Qualified Zone Academy Bonds– Notices 2009-35 and 2009-30

On Friday, April 3, 2009, the Internal Revenue Service ("IRS") released guidance relating to Qualified School Construction Bonds ("QSCBs") and Qualified Zone Academy Bonds ("QZABs"). QSCBs are new financing options created by the American Recovery and Reinvestment Act of 2009 ("ARRA"). QZABs existed prior to the enactment of ARRA, but ARRA provided additional authority to issue QZABs. Notice 2009-35 provides interim guidance and also sets forth the allocations of the special volume cap for QSCBs. Notice 2009-30 provides interim guidance and also sets forth the allocations of the special volume cap for QZABs. This Update provides a brief review of the general requirements of QSCBs¹, and summarizes this new guidance for state and local governments who may be interested in issuing QSCBs or QZABs.

Overview

ARRA created a new form of tax-credit bond to promote the construction and improvement of public schools. Specifically, ARRA provides for \$11 billion of authority for each of 2009 and 2010 to states and school districts to issue QSCBs. Federal Davis-Bacon prevailing wage rules apply to projects financed with QSCBs.

Previously, the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 provided for \$400 million of authority for 2008 and 2009 to school districts to issue QZABs. ARRA provided additional authority to issue QZABs. ARRA increased the limitation on QZABs for 2009 to \$1.4 billion and

¹ For a more detailed description of QSCBs, QZABs and other financing options created by the ARRA, please see Orrick's February 24, 2009 client alert, "The American Recovery and Reinvestment Act of 2009: What It Means to You and Your Financing Options," available at <http://www.orrick.com/fileupload/1657.pdf>. Also on April 3, 2009, the IRS issued Notice 2009-26, relating to Build America Bonds. For a summary of this Notice and other general guidance on tax-exempt financings, please see the publications page of Orrick's website, available at <http://www.orrick.com/publications>.

provided for \$1.4 billion of authority for 2010 to school districts to issue QZABs.

QSCB-Specific Guidance

Use of Proceeds. Generally, proceeds of QSCBs must be spent on constructing, rehabilitating or repairing a public school facility or for acquiring land on which such a facility is to be constructed with part of the proceeds of such issue of QSCBs. Notice 2009-35 provides that proceeds of QSCBs may also be spent on costs of acquisition of equipment to be used in portions of public school facilities constructed, rehabilitated or repaired with the proceeds of the QSCBs. Notice 2009-35 does not provide any guidance regarding the use of proceeds of QSCBs to reimburse expenditures paid prior to the issuance of QSCBs.

Eligible Issuers/Location of School. Notice 2009-35 provides that entities eligible to issue QSCBs include states, political subdivisions, large local educational agencies that are state or local governmental entities and entities empowered to issue bonds on behalf of any of the aforementioned entities. Furthermore, Notice 2009-35 provides that an issuer may issue QSCBs as a conduit financing issue based on a volume cap allocation received by the issuer itself or by a conduit borrower or other ultimate beneficiary of the issue of QSCBs. In all events, the costs of school facilities financed with the proceeds of an issue of QSCBs must relate to school facilities located within both the jurisdiction of the actual issuer of QSCBs and the jurisdiction of the entity that allocates volume cap to that issue of QSCBs. Accordingly, a school district that has received volume cap for QSCBs may either issue QSCBs itself or it may be a beneficiary of QSCBs issued by another eligible issuer described above provided that the school facilities to be financed with the proceeds of the issue of QSCBs are located within the jurisdiction of both the actual issuer of the QSCBs and the jurisdiction of the school district that allocated volume cap to the issue of QSCBs.

Information Reporting. A timely Form 8038 (as opposed to 8038-G) must be completed and filed for the issue of QSCBs with a notation on Line 20c that the bonds are "QSCBs".

Allocation of 2009 Volume Cap. Notice 2009-35 provides the official allocation of the \$11 billion of 2009 national bond volume cap for QSCBs. The entire Notice

and allocation are published at <http://www.irs.gov/pub/irs-drop/n-09-35.pdf>.

QZAB-Specific Guidance: Allocation of 2008 and 2009 Volume Cap

Notice 2009-30 provides the official allocation of the \$400 million of 2008 national volume cap for QZABs and \$1.4 billion of 2009 national bond volume cap for QZABs. The entire Notice and 2008 and 2009 volume cap allocation are published at <http://www.irs.gov/pub/irs-drop/n-09-30.pdf>.

Guidance Applicable to Both QSCBs and QZABs

Credit Rate and Maximum Maturity. Unlike bonds that bear interest that is exempt from income tax, QSCBs and QZABs pay the holder a federal tax credit in lieu of interest. The amount of the tax credit is determined by multiplying the bond's "credit rate" by the face amount of the holder's bond. The credit rate is generally established to allow the bond to be sold without discount and without interest cost to the issuer. QSCBs and QZABs are generally structured as "bullet" maturity bonds, with the Treasury Department establishing the maximum maturity, which is typically between 14 and 15 years. Both the credit rate and the maximum maturity date is determined by the Treasury Secretary on the date the bonds are sold. Notice 2009-35 and Notice 2009-30 provide that the applicable maximum maturity date and credit rate will be published daily by the Bureau of Public Debt on its Internet site for State and Local Government Series securities at <https://www.treasurydirect.gov>.

Sinking Fund Yield Limitation

A fund that is expected to be used to repay an issue of QSCBs or QZABs will not be treated as violating the arbitrage restrictions of Section 148 of the Internal Revenue Code of 1986 if: (i) the fund is funded at a rate not more rapid than equal annual installments, (ii) the fund is funded in a manner reasonably expected to result in an amount not greater than an amount necessary to repay the issue of QSCBs or QZABs, as applicable, and (iii) the yield on such fund is not greater than the "permitted sinking fund yield". The permitted sinking fund yield is determined by using a rate equal to 110 percent of the long-term adjusted federal rate, compounded semiannually, for the month in which the issue of QSCBs or QZABs was sold. Notice 2009-35 and Notice 2009-30 provide that the permitted sinking fund yield for each month will be published on its Internet site for State and Local Government Series securities at <https://www.treasurydirect.gov>.

This summary is designed to inform the reader, in a general manner, of the substance of these IRS Notices, and is not intended to be comprehensive. Anyone with questions should contact publicfinance@orrick.com, or one of the members of our Public Finance Tax Group listed below:

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