

PUBLIC FINANCE BULLETIN

Qualified Zone Academy Bonds

In July, 2007, the Treasury issued temporary and proposed regulations (the “2007 Regulations”) that provide guidance regarding qualified zone academy bonds (“QZABs”). The 2007 Regulations withdraw proposed regulations previously issued in 2004 (the “2004 Regulations”) and provide guidance on, among other things, the use of proceeds, arbitrage restrictions, remedial actions and information reporting requirements for QZABs.

The Tax Relief and Health Care Act of 2006 (the “2006 Act”) amended Section 1397E of the Internal Revenue Code and, in general, added new arbitrage investment restrictions, information reporting requirements and a five-year spending requirement.

Use of Proceeds

In general, the 2007 Regulations provide that, for purposes of the use and expenditure of proceeds for qualified purposes, “proceeds” means sale proceeds, plus investment proceeds thereon. Accordingly, the requirement to use at least 95 percent

of the proceeds of an issue for a qualified purpose is applied by taking into account both the sale proceeds of the issue and any investment proceeds thereon. Similarly, the requirement to spend at least 95 percent of the proceeds from the sale of an issue on qualified purposes within a five-year period (and the associated requirements) applies to both sale proceeds and investment proceeds of an issue.

For purposes of the private business contribution requirement, the term proceeds means sale proceeds, without regard to any investment proceeds received or expected to be received.

Compliance with 95-Percent Test

The 2007 Regulations provide that an issuer must both reasonably expect to spend, and actually spend, at least 95 percent of the proceeds of an issue of QZABs within the five-year period beginning on the issue date (or be subject to the additional requirement to redeem obligations from unspent proceeds at the end of that five year period).

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Qualified Purposes

The 2007 Regulations provide guidance on the applicable standard for determining whether proceeds of QZABs are used for a qualified purpose of “rehabilitating” a public school facility, based on a known existing standard used for purposes of the rehabilitation tax credit under Section 47. In general, the rehabilitation standard requires a substantial rehabilitation involving a building that already has been placed in service and a rehabilitation process that preserves specified portions of the existing walls of the building. Eligible rehabilitation expenditures include some expenditures for reconstruction, subject to the restrictions on retention of certain percentages of the existing walls. Under the rehabilitation standard, eligible rehabilitation expenditures do not include expenditures to enlarge existing buildings or expenditures to acquire existing buildings.

Remedial Actions

In general, the 2007 Regulations specify two remedial actions that may be taken in certain circumstances if less than 95 percent of the proceeds of an issue are actually used for a qualified purpose. The two remedial actions are (i) redemption or defeasance of nonqualified obligations and (ii) alternative use of the disposition proceeds.

The 2007 Regulations provide that the issuer must rebate to the United States any investment earnings in the defeasance escrow used to defease nonqualified obligations that are in excess of the yield on the issue of QZABs. For this purpose, the credit rate for the QZAB issue is not included in the yield on the issue.

Arbitrage Investment Restrictions

The 2007 Regulations provide that the arbitrage investment restrictions under Section 148 of the Internal Revenue Code and the exceptions to those restrictions generally apply to gross proceeds of QZABs to the same extent and in the same manner as they apply to gross proceeds of tax-exempt local governmental obligations. For this purpose, to the extent that any particular arbitrage restriction depends on whether obligations are private activity obligations under Section 141, the determination of whether QZABs are private activity bonds will be based on the general definition of private activity bonds under Section 141.

The 2007 Regulations provide that:

(i) a five-year temporary period exception to the arbitrage yield restriction requirement applies to proceeds of QZABs if an issuer reasonably expects to spend 95

percent of the proceeds of an issue for qualified purposes within the five-year period beginning on the issue date;

(ii) in determining the yield on an issue of QZABs for arbitrage purposes, the QZAB credit is disregarded;

(iii) the yield restriction rules are inapplicable to amounts placed in defeasance escrow as a remedial action;

(iv) the exception to arbitrage yield restriction for certain investments in non-AMT tax-exempt obligations is inapplicable to QZABs;

(v) in determining whether an issue of QZABs qualifies for the small issuer exception to the arbitrage rebate requirement, both QZABs and tax-exempt obligations (other than private activity obligations) that are reasonably expected to be issued or actually issued by the QZAB issuer (and other covered on-behalf-of entities and subordinate entities) within a calendar year are taken into account in measuring the applicable size limitation; and

(vi) in applying the small issuer exception to the rebate of earnings from investments of amounts in a defeasance escrow, the issuer is not treated as a small issuer and amounts earned from such investments must be rebated to the United States.

Information Reporting Requirement

Issuers of QZABs must submit information reporting returns to the IRS similar to the information reporting returns required to be submitted to the IRS under Section 149(e) for tax-exempt State or local obligations at the same time and manner as those reports are required to be submitted to the IRS on such forms as shall be prescribed by the Commissioner of the IRS for such purpose.

Effective Date

The 2007 Regulations generally apply to obligations sold on or after September 14, 2007. In general, the provisions of the 2007 Regulations regarding the five-year spending period, the arbitrage investment restrictions, and the information reporting requirement added by the 2006 Act apply to obligations issued pursuant to allocations of the national qualified zone academy bond volume cap authority arising in calendar years after 2005 and sold on or after September 14, 2007. Issuers and taxpayers may generally apply the 2007 Regulations in whole, but not in part, to obligations sold before September 14, 2007.