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Qualified Zone Academy Bonds Final Regulations

Background. In 1997, Congress enacted Section 1397E of the Internal Revenue Code, which provides banks, insurance companies and other corporations actively engaged in the business of lending money ("eligible taxpayer") with a tax credit if they own qualified zone academy bonds on the credit allowance date. In late September 2000, final regulations were issued with respect to qualified zone academy bonds (the "Final Regulations"). The following is a brief summary of qualified zone academy bonds, taking into account the provisions of the Final Regulations.

Qualified Zone Academy Bonds. Qualified zone academy bonds are taxable bonds of a state or local government that meet certain criteria. Under the Final Regulations, qualified zone academy bonds may be issued on behalf of a state or local government under rules similar to those for determining whether bonds that are issued on behalf of a state or political subdivision constitute obligations for purposes of Section 103 of the Internal Revenue Code. The requirements that must be satisfied for an issue to constitute qualified zone academy bonds include the following:

- (i) ninety-five percent or more of the proceeds of the issue must be used for qualified purposes at a qualified zone academy;
- (ii) the academy must be located within the jurisdiction of the issuer;
- (iii) the issuer must designate the bonds as qualified zone academy bonds;
- (iv) the issuer must certify that it has written assurances that the private business contribution requirement will be met with respect to the qualified zone academy and the issuer must certify that it has received written approval from an eligible local education authority for the issuance of the qualified zone academy bonds; and
- (v) the term of the qualified zone academy bonds cannot exceed the maximum term determined by the Secretary of the Treasury.

Qualified Zone Academy. The term "qualified zone academy" generally means a public school (or academic program within a school) that is established and operated under the supervision of an eligible local education agency to provide education or training below the post-secondary level if (i) the public school or program is designed in cooperation with the business community to enhance the academic curriculum, increase graduation and employment rates and better prepare students for the rigors of college and the increasingly complex workforce, (ii) students in the public school or program will be subject to the same academic standards and assessments as other students educated by the eligible local education agency, (iii) the comprehensive education plan of the public school or program is approved by the eligible local education agency and (iv) either the public school is located in an empowerment zone or enterprise community or there is a reasonable expectation (as

of the date of issuance of the qualified zone academy bonds) that at least thirty-five percent of the students attending the school or participating in the program will be eligible for free or reduced cost lunches under the school lunch program established under the Richard B. Russell National School Lunch Act.

The Credit. In general, owners of qualified zone academy bonds are provided an annual federal income tax credit, to offset their regular federal income tax liability, rather than receiving interest. The amount of the credit is equal to the product of the credit rate (determined by the Secretary of the Treasury) multiplied by the face amount of the qualified zone academy bonds held by an eligible taxpayer on the credit allowance date. The credit rate is to be determined monthly (or more often as deemed necessary by the Secretary of the Treasury) and is to be the rate the Secretary of the Treasury estimates will generally permit the issuance of qualified zone academy bonds without discount and without interest cost to the issuer. The Final Regulations provide that if a holder cannot use the credit to offset its federal income tax liability (including the situation in which the taxpayer is not an eligible taxpayer), the holder will be allowed a deduction for the taxable year that includes the credit allowance date (or next succeeding tax year) equal to the amount of the unused credit.

Private Contribution. The private business contribution requirement is satisfied if the eligible local education agency that established the qualified zone academy has written commitments that "private business contributions" will be provided to the qualified zone academy. The Internal Revenue Code requires that private entities commit to make qualified contributions having a present value, as of the date the qualified zone academy bonds are issued, of not less than 10 percent of the proceeds of the issue. Qualified contributions are any combination (of a type and quality acceptable to the eligible local education agency) of equipment, technical assistance in developing a curriculum or in training teachers in technology matters, service of employees as volunteer mentors, internships, field trips or any other property or services specified by the eligible local education agency. The Final Regulations provide that for these purposes a "private entity" includes any person (as defined in Section 7701(a)) other than the United States, a state or local government or any agency or instrumentality thereof or related party. Under this definition, a private entity includes 501(c)(3) organizations and individuals. The Final Regulations clarify that cash can constitute a private business contribution, provided that the cash is to be used for the items listed above. However, under the Final Regulations, the services of employees of an eligible local education agency do not qualify as a private business contribution. Finally, the preamble to the Final Regulations indicates that the issuer's certification that it has written assurances of the necessary private business contributions will be respected if the certifications are reasonably made.

Ninety-five Percent Test. As discussed above, the Internal Revenue Code requires that ninety-five percent or more of the proceeds of an issue of qualified zone academy bonds must be used for a qualified purpose. A qualified purpose is the rehabilitation or repair of a public school, providing equipment, developing course material or training teachers. The preamble to the Final Regulations indicates that the definition of what constitute qualified purposes should be broadly interpreted. The preamble also indicates that issuers may apply principles similar to those contained in Treas. Reg. Section 1.142-2 (relating to remedial actions for tax exempt obligations) to cure an unexpected failure to spend ninety-five percent of the proceeds of an issue of qualified zone academy bonds for qualified purposes.

Volume Limitation. The Internal Revenue Code restricts the amount of qualified zone academy bonds that can be issued in a particular calendar year. In January 2000, the IRS published Revenue Procedure 2000-10 allocating among the various states the \$400,000,000 annual limit applicable for the year 2000. The annual limit for the year 2001 is also \$400,000,000.

Effective Date. The Final Regulations apply to all qualified zone academy bonds sold on or after September 26, 2000. Elective retroactive application is permitted for qualified zone academy bonds sold before this date only with regard to the new rules on private business contributions and the expanded definition of a state or local government.