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Tax Credit Bond Provisions in the 2008 Bailout Package

On October 3, 2008, President Bush signed into law the “Energy Improvement and Extension Act of 2008” (the “Energy Act”), the “Tax Extenders and Alternative Minimum Tax Relief Act of 2008” (the “Extenders Act”) and the “Heartland Disaster Tax Relief Act of 2008” (the “Heartland Act”). These three acts contain numerous municipal bond provisions.

The Energy Act affects Clean Renewable Energy Bonds (“CREBs”), found in Section 54 of the Internal Revenue Code of 1986, as amended (the “Code”), and private activity bonds for qualified green building and sustainable design projects, found in Section 142(l) of the Code (“Green Building Bonds”) and creates new categories of tax credit bonds for New Clean Renewable Energy Bonds, Section 54C of the Code (“New CREBs”), and Qualified Energy Conservation Bonds, Section 54D of the Code (“QECBs”).

The Extenders Act reauthorizes the existing qualified zone academy bond (“QZABs”) program under Section 54E of the Code, extends economic development bonds for the District of Columbia and contains the Heartland Act. The Heartland Act provides numerous tax benefits for the designated disaster areas, including areas in Texas and Louisiana affected by Hurricane Ike and areas in the Midwest affected by the summer 2008 flooding. The scope of the materials below will not address the Heartland Act provisions, D.C. economic development bonds or Green Building Bonds.

CREBs, New CREBs, QECBs and QZABs — General

CREBs

The CREBs provisions in the Energy Act extend the sunset date for the issuance of all CREBs through December 31, 2009. Prior to the Energy Act, authorization for the issuance of CREBs expired on December 31, 2008. CREBs will continue to be governed under the provisions of Section 54 of the Code and the regulatory guidance found in Notices 2006-7 at 2006-10 I.R.B 559 (dated March 6, 2006), 2007-26 at 2007-14 I.R.B. 870 (dated April 2, 2007) and Notice 2009-15 (dated January 22, 2009) that modifies Notice 2007-26 (the “Tax Credit Rate Pricing Notice”). The Internal Revenue Service disclosed details regarding the second-round allocation recipients in IR 2008-16 (dated February 8, 2008) that we summarized in our alert dated February 2008 that is linked here. For information on the first-round of allocations, see IR 2006-081 (dated November 20, 2006). It is not known whether unused and returned allocation from the first two rounds will be reallocated to other issues, but it is worth

noting that the second-round allocations for CREBs included approximately $77 million of returned allocation from the first-round allocations. For more information about CREBs, see the linked article written by Doug Lamb on CREBs. With the release of the Tax Credit Rate Pricing Notice that is linked here, the manner for determining tax credit rates for CREBs and QZABs has been modified. This modification will also apply to Qualified Forestry Conservation Bonds, New CREBs and QECBs once allocations are made for those programs and pending further changes as mentioned in the Tax Credit Rate Pricing Notice.

New CREBs, QECBs and QZABs

Each of the New CREBs, QECBs and the modified QZAB programs are governed by Code Section 54A that was added in the "Heartland, Habitat, Harvest and Horticulture Act of 2008." Section 54A imposes significant changes to the statutory framework that governed the existing CREBs (Section 54) and previously governed QZABs (Section 1397E). Those changes include, among others, introduction of "available project proceeds" (i.e., allows for a 2% limitation on financing costs of issuance from the tax credit bond), a reserve fund option that generally allows for equal annual installments that are not treated as retiring a portion of the bond (subject to yield limitations), a three-year temporary period, a 2% limitation on financing costs of issuance from proceeds of the tax credit bond, credit stripping and carryover of the credits. These concepts are described below.

New Tax Credit Bond Framework

At this time, Section 54A governs Qualified Forestry Conservation Bonds (Section 54B) ("QFCBs"), New CREBs (Section 54C), QECBs (Section 54D) and the "new" QZABs (Section 54E). Matters solely in respect of CREBs, New CREBs, QECBs and QZABs are discussed below, and the scope of the remaining materials will not focus on QFCBs even though Section 54A governs QFCBs.

New Concepts

Under Section 54A, use of the bond proceeds is captured under the concept of available project proceeds ("APP"). APP means the sales proceeds of an issue (i.e. the amount received from the purchaser) less issuance costs financed by the issue so long as such costs do not exceed two percent of the sales proceeds, *plus* the earnings on the difference between the sale proceeds and financed costs of issuance.

Section 54A introduces a three-year expenditure period for 100% of the APP. This period operates as a temporary period for purposes of the arbitrage-rebate rules under Section 148 of the Code. By the third anniversary of the issue, 100% of the APP must be spent. At issuance, the issuer must reasonably expect to comply with this test as well as reasonably expect to incur, within six months of issuance, expenditures amounting to 10% of the APP. If, at the end of three years, 100% of APP is not spent, the period may be extended by Treasury upon application to it. An application to extend the period must be submitted prior to the period's expiration. If the period is not extended, a portion of the bonds must be redeemed within 90 days. The portion to be redeemed shall be determined in accordance with the "non-qualified" bond rules in Section 142 and the regulations thereunder.

Another significant development is the addition of the reserve fund option. Generally, tax credit bonds must satisfy the arbitrage-rebate rules found in Section 148 of the Code. For the reserve fund to be structured in compliance with Section 148, there must be an expectation that the funds will be used to repay the issue. Moreover, the reserve fund must not be funded more frequently than annually, and the deposits must be equal installments. The amount of deposits must not be expected to result in an amount greater than necessary to repay the issue. Lastly, the yield on the fund cannot exceed the rate used to determine the maximum maturity on the bonds.

There is no ratable amortization requirement in Section 54A as there was with CREBs. Accordingly, even with the use of a reserve fund, it is possible that the bond may be structured (subject to credit concerns) so the investor is entitled to the tax credit on the full face amount of the bond for its entire life.

There are several other departures from the statutes governing CREBs and old QZABs. First, Section 54A allows the credit to be stripped in accordance with the rules that apply to the stripping of interest for tax-exempt bonds that are found in Section 1286 of the Code. Additionally, Section 54A provides that unused credits may be carried over to the ensuing tax year if the taxpayer is unable to use the credit as a result of the limitations in the statute.

Finally, Section 54A provides that the Issuer must certify that it is in compliance with state and local conflict of interest laws and additional Treasury rules that may exist or be promulgated.

Concepts Retained from Section 54

The tax credit rate and final maturity of the tax credit obligations will be determined by U.S. Treasury on a periodic basis and posted on Treasury's website. The website address for CREBs is https://www.treasurydirect.gov/SZ/SPESRates?type=CREBS, and the website address for QZABs is https://www.treasurydirect.gov/SZ/SPESQZABRate. The amount of the tax credit is measured quarterly based upon the annual tax credit rate, and the annual tax credit amount is the product of the sum of those quarterly measurements multiplied by 70% (except that the reduction does not apply to QZABs). The annual tax credit rate is the product of the published tax credit rate and the outstanding face amount of the bond. For more information about the tax credit rates for CREBs plus the limitations on their use that are included in Section 54A(b), see Sections 54(b) and 54A(b) and Doug Lamb's above referenced article on CREBs. For QZABs, there will be one tax credit rate for the entire maturity of the bond. For QECBs and New CREBs, it is not known at this time whether there will be a tax credit rate for each year as is the case for CREBs or one credit rate as is the case with QZABs. For more information about the mechanics of setting the tax credit rate and establishing the maximum maturity of the bond, as set forth for CREBs, see Section 8 and 9 of Notice 2007-26 attached hereto, as modified by Notice 2009-15 attached hereto.

Finally, the tax credit is treated as interest, and is included in gross income. The bonds can be sold to a wide range of investors. For instance, unlike the prior QZAB provisions that limited purchasers to banks and financial institutions, there is no such limitation in Sections 54A, 54C, 54D or 54E.

New CREBs

New CREBs may be used to finance qualified renewable energy facilities that produce electricity. Such facilities must qualify under Section 45(d) of the Code but do not include refined coal or Indian coal facilities. Moreover, the placed-in-service date limitations in 45(d) do not apply. The facilities must be owned by public power providers ("PPPs"), governmental bodies, or cooperative electric companies ("CECs"). A PPP is a State utility with a service obligation, as such terms are defined in section 217 of the Federal Power Act. With respect to the ownership requirements for governmental bodies and CECs, please see the section in the above referenced article entitled "Borrower, Project & Issuer Requirements."

New CREBs differ from CREBs in a number of ways, including that CREBs could finance refined coal facilities whereas New CREBs cannot.

The bond limitation for the New CREBs is $800 million, of which no more than one-third may be allocated to projects of PPPs, governmental bodies or CECs. Allocations to projects of PPPs will be made on a pro-rata basis based upon the total applied for amounts and allocation available. The method of allocation for the governmental and CEC projects will be in a manner determined by Treasury. It is expected the Internal Revenue Service will issue a notice explaining the allocation process and criteria upon which allocation will be awarded and that the smallest-to-largest methodology used for allocations of CREBs will continue to apply to CECs and governmental bodies. For a description of that methodology, see Section 6 of Notice 2007-26.

Under the New CREBs program, 100% of the APP must be spent on capital expenditures incurred by PPPs, CECs or governmental bodies. APP are required to be used on capital expenditures for the project within three years of the date of issuance (with limited exceptions). The tax credit amount for New CREBs is reduced to an amount that is 70% of the product of the formula used for old CREBs. The New CREBs credit may be claimed against both regular and AMT tax liability.

QECBs

The Energy Act creates a new tax credit bond program for "qualified energy conservation bonds" ("QECBs"). The rules for QECBs are similar to those for New CREBs. For instance, the tax credit amount for QECBs is the same as for New CREBs. There is one notable difference. The uses of QECBs are much broader than those for New CREBs. Specifically, QECBs contemplate ownership beyond governmental bodies or CECs.

Qualified purposes for QECBs are described as "qualified conservation purposes." Such purposes include capital expenditures for projects related to reducing energy consumption in publicly-owned buildings by at least 20%, implementing green community programs, rural development involving renewable energy production, and qualified facilities as determined under Section 45(d) (other than refined coal or Indian coal facilities and without regard to placed-in service dates) (i.e., the same 45(d) projects that qualify under New CREBs).

Such qualified conservation purposes also include expenditures with respect to (A) research facilities, and research grants to support research in (i) development of cellulosic ethanol or other non-fossil 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 non-fossil fuels, (iv) automobile battery technologies and other technologies to reduce fossil fuel consumption in transportation, or (v) technologies to reduce energy use in buildings; (B) mass commuting facilities and related facilities that reduce the consumption of energy, including expenditures to reduce pollution from vehicles used for mass commuting; (C) 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; and (D) public education campaigns to promote energy efficiency. The qualified conservations described in this paragraph are not further defined in Sections 54A or 54D.

In the case of any QECB that is a private activity bond for purposes of Section 141 of the Code, a qualified conservation purpose does not include any expenditure which is not a capital expenditure. Accordingly, any of the above qualified conservation purposes seemingly may be financed by a private activity QECB so long as the APP are used for capital expenditures, i.e., costs chargeable to the account of the borrower (or would be so with a proper election).

The Energy Act provides $800 million in allocation for QECBs that are to be distributed among the States by population. Large local governments (i.e., population of 100,000 or more) receive a proportionate amount of its State's allocation. Indian tribal governments are to be treated in the same manner as large local governments. It is anticipated that the allocation process for QECBs will be administered by Treasury. Moreover, not more than 30% of the allocation to states or large local governments may be used for QECBs that are private activity bonds.

New QZABs

The October 2008 bailout package also included legislation entitled "Tax Extenders and Alternative Minimum Tax Relief Act of 2008" that reauthorized and extended the existing QZAB program under Section 54E. As a result, $400 million in allocation was added for each of calendar years 2008 and 2009. Any QZAB issued after October 3, 2008 is subject to the rules in Section 54A and 54E even if the allocation for it arose on or before October 3, 2008.

New QZABs retain many provisions contained in the prior statute, including the private contribution requirement, the definition of a qualified zone academy and the restrictions on the use of proceeds for repairs and rehabilitation, teacher training, course materials and development of course material. The allocation process for QZABs will continue to be administered by the States and unused allocation may be carried forward to the two calendar years following the year in which the excess allocation arose, including allocations made under the old rules.

For questions about Energy Tax Credit Bonds, please contact Doug Lamb or Laura Jones.

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