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HIRE Act Permits Refundable Credit for Certain Tax Credit Bonds

On March 17, 2010, Congress passed the Hiring Incentives to Restore Employment Act of 2010 (the "HIRE Act"), which President Obama signed into law on March 18, 2010. Title III of that act amends Section 6431 of the Internal Revenue Code of 1986, as amended (the "Code"), to permit issuers of certain types of tax credit bonds to elect treatment similar to direct pay Build America Bonds ("BABs"), therefore entitling the issuer to receive a direct payment from the U.S. Treasury of some or all of the interest paid with respect to the bonds. The provisions of the HIRE Act apply to the following types of tax credit bonds: qualified school construction bonds described in Section 54F of the Code ("QSCBs"), qualified zone academy bonds described in Section 54E ("QZABs"), new clean renewable energy bonds described in section 54C ("new CREBs") and qualified energy conservation bonds described in section 54D ("QECBs").

Build America Bonds

Section 1531 of the American Reinvestment and Recovery Act of 2009 ("ARRA") added a new incentive for certain types of taxable governmental bonds, in which the issuer of the bond may elect to receive a credit equal to **35 percent** of the interest paid with respect to the bond under new Code Section 6431. These are the so-called "refundable credit option" or "direct pay" BABs. If the election is made, Treasury will pay to the issuer on each interest payment date an amount equivalent to the amount of the credit. A BAB is not treated as federally guaranteed for purposes of Code Section 149(b) by reason of the tax credit or the refundable credit. For a direct credit BAB, the amount of the credit is taken into account for purposes of calculating arbitrage yield.

Certain Tax Credit Bonds May Be Treated Like Direct Pay BABs

The HIRE Act provides that the issuer of a QSCB or a QZAB may elect to treat the bond as a "qualified bond" under Section 6431 of the Code, with the result that the issuer of the bond is entitled to receive a refundable credit on each interest payment date. The amount of that refundable credit is equal to **100 percent** of the lesser of (a) the amount of interest payable under the bond or (b) the amount of interest that would have been payable under such bond if such interest were determined at the applicable credit rate determined under Section 54A of the Code. The "applicable credit rate" is the tax credit rate applicable to the bonds on the date on which a binding written agreement to purchase the bonds is signed by the issuer and the purchaser or underwriter of such bonds, and is found at www.treasurydirect.gov/govt/rates/rates.htm under "Tax Credit rates." The interest paid on such bond is taxable to the holder.

Similarly, the HIRE Act provides that the issuer of new CREBs and QECBs may also elect to treat such bonds as a "qualified bond" under Section 6431 of the Code, entitled to a refundable credit. The amount of the credit for these types of bonds is equal to **70 percent** of the lesser of (a) the amount of interest payable under the bond or (b) the amount of interest that would have been payable under such bond if such interest were determined at the applicable credit rate determined under Section 54A of the Code.

The issuer must make an irrevocable election to treat the bond as a "qualified bond" eligible for the refundable credit, and no credit will be allowed to the holder of such bond under Section 54A of the Code. The December 31, 2010, deadline that otherwise currently applies to the issuance of BABs generally does not apply to the issuance of tax credit bonds that are treated as if they were "direct pay" BABs.

QSCBs

Qualified school construction bonds are a new category of tax credit bonds added to the Code by the ARRA. One hundred percent of the "available project proceeds" of such issues is to be used for the "construction, rehabilitation, or repair of a public school facility or for the acquisition of land on which such a facility is to be constructed with part of the proceeds of such issue." Congress allocated $11 billion in QSCBs for each of calendar years 2009 and 2010 — a total of $22 billion in allocation. Treasury then allocated to the states and to large local education agencies based upon the amounts a state is eligible to receive under the Elementary and Secondary Education Act of 1965 for the fiscal year prior to the calendar year of allocation. The states are then required to reapportion such amounts within their respective states. Unused allocation may be carried over, and ARRA does not place a limit on the number of years to which it may be carried over. Treasury allocated the 2009 QSCB allocation to the states and large local education agencies under Notice 2009-35; it allocated the 2010 QSCB allocation in Notice 2010-17 issued on March 17, 2010.

QZABs

Qualified zone academy bonds are tax credit bonds for public school purposes. The proceeds of QZABs must be used for renovation of existing schools (rather than construction), and the school must qualify as a "qualified zone academy." The qualifications for a qualified zone academy include the requirement that at least **35 percent** of the students in the academy qualify for free or reduced-price lunch; that the school has a program in place that has the goal of enhancing the academic curriculum, increasing graduation and employment rates or better preparing students for college and the workforce; and that the school obtains an agreement from a private entity to contribute cash, property or services with a value of at least **10 percent** of the net present value of the amount of money borrowed. In ARRA, Congress allocated $1.4 billion in QZAB allocation for each of calendar years 2009 and 2010, and Treasury then allocated to the states. QZAB allocation may be carried over for up to two years following the unused year. Treasury allocated the 2009 QZAB allocation to the states in Notice 2009-30; it allocated the 2010 QZAB allocation in Notice 2010- 22.

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 Section 45(d) do not apply. The facilities must be owned by public power providers ("PPPs"), governmental bodies or cooperative electric companies ("CECs"). Under the new CREBs program, **100 percent** of the available project proceeds ("APP") must be spent on capital expenditures incurred by PPPs, CECs or governmental bodies. One hundred percent of the APP is required to be used on capital expenditures for the project within three years of the date of issuance (with limited exceptions). ARRA increased the allocation for new CREBs from $800 million to $2.4 billion. Those allocations are made directly by Treasury based on application. All CREB allocations have been made except that $190,795,445 in new CREB allocations are still available for CECs. The 2009 new CREB allocation solicitation is found in Notice 2009-33.

QECBs

Qualified energy conservation bond proceeds may be used for “qualified conservation purposes,” defined to include capital expenditures for projects related to reducing energy consumption in publicly owned buildings by at least **20 percent**, implementing green community programs and utilizing renewable energy production for rural development and in 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 Section 45(d) projects that qualify under the new CREB rules).

Such qualified conservation purposes also include expenditures with respect to (A) research facilities and research grants to support research in (i) the 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; (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. ARRA also added language that clarified that the implementation of green community programs includes “the use of loans, grants, or other repayment mechanisms to implement such programs.” Moreover, QECBs issued for capital expenditures to implement green community programs will not be treated as private activity bonds solely because proceeds are to be used for such loans or grants to implement green community programs.

In the case of any QECB that is a private activity bond for purposes of Section 141 of the Code, a qualified conservation purpose only includes capital expenditures. Thus any of the above qualified conservation purposes may be financed by a private activity QECB so long as **100 percent** of the APP is used for capital expenditures, i.e., costs chargeable to the account of the borrower (or would be so with a proper election). Only **30 percent** of a state’s allocation can be used for QECBs that are private activity bonds.

ARRA increased the allocation for QECBs to $3.2 billion. Treasury allocated the QECB allocation to the states in Notice 2009-29 based on population, and the states are directed to reallocate the QECB allocation to the large local governments in the state on the same basis. A large local government is any county or municipality with a population of greater than 100,000. The remaining QECB allocation is to be reallocated by each state in its discretion.

Notice 2010-28: Stripping Transactions for Qualified Tax Credit Bonds

Nearly all of the tax credit bonds now permitted under the Code provide for quarterly tax credits to the holders thereof, and, in certain situations, such credits can be stripped — that is the credits can be separated from the underlying bonds and sold in the secondary market on their own. The tax credit bonds that permit stripping include the following:

- QZABs under Section 54E
- New CREBs under Section 54C
- QSCBs under Section 54F
- Credit BABs under Section 54AA (not direct pay or refundable BABs discussed above)

- QECBs under Section 54D
- Qualified Forestry Conservation Bonds (“QFCBs”) under Section 54B

No credit BABs and very few, if any, QECBs or QFCBs have been issued as of this time. QZABs, QSCBs and new CREBS have been issued. Given the provisions of the HIRE Act permitting QSCBs and similar tax credit bonds issued in the future to use a BABs-like structure but with even more favorable provisions for direct payments to the issuers, there may not be significantly more volume of such credit bonds issued. However, for the billions in principal amount already issued and any to be done in the future, the IRS has provided guidance for the stripping of the credits in Notice 2010-28. The salient points of the Notice are set forth below.

Stated Interest

The amount of quarterly tax credits is treated as a payment of stated interest on the bonds (or the credit coupons if stripped) to the holders thereof. A holder’s regular method of accounting determines when the recognition of this income occurs. The interest amount may be adjusted for amortization of bond premium; by purchase or sale between credit dates, including a deemed sale through stripping; and by accrual of original issue discount.

No Limit on Carryovers

There is no time limit on the carryover of the credit by the holder of the bond or the credit coupon, if stripped, on the credit date, except that a credit must be used in the first year after the credit date in which there would otherwise be tax liability.

Corporate Adjustments, RICs, REITs

A holder taxed as a corporation will reduce earnings and profits to the extent it would have reduced its tax liability with the receipt of cash instead of tax credits. A regulated investment company or real estate investment trust will account for distributions of tax credits by reducing its earnings and profits to the extent they would have been reduced by a cash distribution.

Sale of Bond Holdings

A pro rata division of the ownership of all rights in a bond is NOT a stripping transaction.

Designation Required

Each issuer of a credit bond issue must specifically designate the bonds as “strippable” and report that to the IRS.

Credit Coupons

Coupons representing a “stripped” credit must be registered as to ownership and each must have an assigned CUSIP number.

No Variable Credits

Credits may not be stripped in a manner creating variable shares of the credits.

Brokers Required

Stripped credit coupons must be held in an account with a broker as defined in Section 6045 of the Code.

Rules of Section 1286

The rules of subsections (a) (concerning the inclusion of income as if the bonds and credit coupons were issued with original issue discount), (b) (handling the treatment of basis at the time of stripping) and (e) (containing definitions of terms) of Section 1286 of the Code will apply to stripping transactions.

Aggregation

If a purchaser acquires **on the same day** more than one component of a bond after stripping (e.g., the stripped bond and one or more credit coupons or two or more credit coupons), then all such components are treated as one debt instrument in the aggregate and the payments thereon are not treated as stated interest (but there still is income attributable to the credits). If a purchaser acquires **on the same day** all of the then-outstanding components of a bond after stripping (that is, the stripped bond and all the credit coupons for future dates), then the aggregate instrument is treated as if it were an unstripped bond and there would be stated interest associated with the credits.

Reporting

Notice 2010-28 has an extensive discussion of the requirements, most of which are still to be fleshed out, for reporting the existence of credit bonds, including new Form 8038s to be completed by the issuers, Form 8912 reporting by credit holders, reports under the Form 1097 regime by intermediaries and others, and additional reports focusing on discount. The requirements as to designations of strippable issues, CUSIPs and maintenance of stripped credits in brokerage accounts all relate to such reporting requirements. Finally, the Service requests comments on any aspect of the reporting concepts described.

Hunton & Williams continues to consider the most viable method to maximize the tax benefits in credit stripping transactions. Please contact us to discuss or speak about particular situations.