National Association *of* Bond Lawyers

TAX-CREDIT BONDS

To address interest in the current tax-credit bond programs, this document discusses a number of interacting statutory restrictions applicable to Qualified Zone Academy Bonds (QZABs) and/or Clean Renewable Energy Bonds (CREBs).[1] The issues discussed also could be addressed if Congress decides to enact new tax-credit bond programs. These items may be classified into two general categories:

- Provisions affecting the amount of subsidy to be provided; and
- Other provisions affecting the appeal of tax-credit bonds to issuers and investors.

Specific policy changes to the rules governing tax-credit bonds are not proposed, but areas are identified where technical rules could interfere with the ability of issuers and other involved parties to benefit fully from tax-credit bonds, and thus diminish the subsidy Congress intends to provide. Various options for delivering whatever subsidy Congress intends to provide are also discussed.

Regardless of the scope of tax-credit bond programs that Congress authorizes or the level of subsidy it ultimately decides is appropriate for these programs, application of several general tax policy principles would seem appropriate:

- Provide uniform rules for all tax-credit bond programs to the extent that policies underlying the programs allow;
- Provide applicable rules that are administratively as simple as possible (for ease of compliance and enforcement); and
- Authorize bond issuance for periods of sufficient length to facilitate the development of markets for these instruments (to the extent practicable with federal revenue constraints).

As a final introductory note, numerous tax-credit bond programs have been proposed in bills introduced in Congress. Virtually all such bills have had differences from the statutory provisions for QZABs and CREBs. One goal of this discussion is to prevent differences from being incorporated in the Internal Revenue Code of 1986, as amended ("Code"), for similar programs, wherever possible.

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[1] Congress also provided limited tax-credit bond financing for the three states affected by Hurricane Katrina (Internal Revenue Code (defined herein) Section 1400N(l)). Many issues similar to those discussed in this document arose with respect to the Hurricane Katrina tax-credit bonds. However, because of the limited scope of that program, this document focuses only on QZABs and CREBs.

I. Issues Related to Level of Subsidy to be Provided

Present law has conflicting language as to whether the existing tax-credit bond programs are intended to provide an "interest-free loan *only*" (economically similar to the reduced-interest loans provided by tax-exempt bonds) or whether the programs are intended to provide an "interest-free loan *plus*" a principal subsidy.

From the original enactment of QZABs in 1997 through 2006, no statutory arbitrage restrictions were imposed on them. This absence of an arbitrage rebate or similar requirement led to many QZABs being issued and sold for their maximum permitted maturity (*i.e.*, as a bullet maturity with no amortization rather than as "serial" or "term" bonds). Generally, in each QZABs financing, the issuer funded a sinking fund (on an installment basis) to finance principal repayment, with the investment earnings on the sinking fund being used in part for that purpose.[2] Thus, QZABs originally enjoyed an interest-free loan *plus* a principal subsidy. The principal subsidy was provided by the ability to earn and retain investment earnings in the sinking fund.

The CREBs program, on the other hand, has been subject since its 2005 enactment to the Code's tax-exempt bond arbitrage restrictions as well as to statutory initial spending requirements and a ratable principal amortization requirement.[3] This combination of requirements means that the CREBs program has provided an interest-free loan *only* to issuers.

In 2006, to align QZABs more closely with CREBs, the tax-exempt bond arbitrage restrictions (but not the ratable principal amortization requirement) were extended to QZABs. The tax-exempt bond arbitrage restrictions preclude subsidizing principal repayments with sinking fund earnings as had historically occurred with QZABs, thereby limiting the program to an interest-free loan *only* program. However, differences between the programs remain. The ratable principal amortization requirement applicable to CREBs eliminates any ability to defer principal repayments (even when such repayments are made entirely with issuer revenues). In addition, CREBs issuers financing construction projects commonly are forced to repay principal prior to the bond-financed facility generating revenue. This requirement can create financial hardship for issuers and additional risk for purchasers of the bonds, resulting in significant discounting of the purchase price for tax-credit bonds by the investment community and potentially frustrating the Congressional policy of an interest-free loan.

If Congress decides to review whether the policy underlying tax-credit bonds is intended to provide interest-free loans *only* or interest-free loans *plus* principal subsidies, that review could include three general issue areas that affect the amount of tax-credit bond subsidy:

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[2] This practice was consistent with the maturity-limit provision in Code Section 1397E(d)(3) which states that the term of QZABs should result in the "present value of the obligation to repay the principal on the bond being equal to 50 percent of the face amount of the bond." Comparable language is found in Code Section 54(e)(2), which created the CREBs program.

[3] A ratable principal amortization requirement, in substance, requires issuance of serial-maturity bonds.

- Arbitrage restrictions generally;
- Credit rate provisions; and
- Bond maturity limits.

Current Code provisions in each area are not uniform for both QZABs and CREBs, and in certain cases, the rules appear to work at cross-purposes. Each of these issue areas is discussed more fully below.

A. Arbitrage Restrictions

Both QZABs and CREBs are now subject to multiple statutory arbitrage-related restrictions:

- Tax-exempt bond arbitrage restrictions including rebate, yield restriction, and sinking fund restrictions; and
- Initial spending requirements.

The substantive effect of these restrictions is to reduce the amount of subsidy provided to issuers of the bonds. In the tax-exempt bond area, Congressional policy has been to provide a reduced-interest loan, without further subsidy, and to ensure that bonds are issued only in amounts needed for an eligible project and that bond proceeds are spent in a timely fashion. In its 2005 (CREBs) and 2006 (QZABs) legislation affecting tax-credit bonds, Congress incorporated this tax-exempt bond policy into the tax-credit bond programs through somewhat duplicative provisions that created a more narrowly subsidized program for the newly enacted CREBs than had existed for QZABs and changed basic tenets of the pre-existing QZABs program[4] (adding new restrictions without repealing or modifying statutory language that had previously allowed a more deeply subsidized QZABs program).[5]

Specifically, in Sections 1397E(g) and 54(i), the Code and related regulatory tax-exempt bond arbitrage restrictions described above are extended to tax-credit bonds. In addition, the Code provides statutory initial spending requirements for both QZABs and CREBs in Sections 1397E(f)(1) and (2) and 54(h)(1) and (2). These initial spending requirements are comparable to rules contained in tax-exempt bond arbitrage regulations establishing initial temporary periods when bond proceeds may be invested without yield restriction. The requirements are also similar to a statutory alternative to arbitrage rebate

[4] H.R. 6111, the *Tax Relief and Health Care Act of 2006.*

[5] Following the effective date of the new arbitrage restrictions, the QZABs market shrank. Bond counsel in different regions of the country have noted a markedly decreased interest in the issuance of QZABs with the new restrictions. While the long-term effect of the restrictions remains unclear, this market disruption illustrates the potential effects of (a) changes in the level of subsidy provided and (b) the imposition of other complex new restrictions.

for tax-exempt construction bonds contained in Section 148(f)(4)(C). Further, in Sections 1397E(f)(3) and 54(h)(3) (redemption to the extent proceeds are not spent within five years) and Section 54(l)(5) (ratable principal amortization for CREBs only), the Code includes two significant limitations on the maturity-limit provisions applicable to tax-credit bonds under Sections 1397E(d)(3) and 54(e)(2).

Legislative simplification of these provisions to reflect more accurately the level of subsidy intended to be provided for tax-credit bond programs could be considered. For example, if Congress intends to apply all tax-exempt bond arbitrage restrictions to tax-credit bonds (*i.e.*, authorize interest-free loan *only* programs), the statutory initial spending requirements could be repealed, as the tax-exempt bond Code and regulatory arbitrage provisions applicable to tax-credit bonds adequately encourage issuers to spend proceeds diligently and not issue too soon.

On the other hand, if Congressional policy is or will be to allow a limited principal subsidy, that could be accomplished by repealing the general incorporation of the tax-exempt bond arbitrage restrictions and providing in lieu thereof (a) a modified initial spending requirement for all tax-credit bonds and (b) rules governing the funding of sinking funds. Initial spending requirements would address Congressional concerns about earlier-than-necessary issuance of federally-subsidized bonds. Sinking funds could be limited as to overall amount and timing of deposits into the funds to allow earnings on the funds to be used to provide only the principal subsidy Congress approves.

In either case, the current ratable principal amortization requirement applicable to CREBs could be repealed with reliance being placed instead on the Code's arbitrage restrictions (assuming an interest-free loan *only* policy) or on combined initial spending requirements/sinking-fund sizing and timing restrictions (assuming an interest-free loan *plus* a principal subsidy policy).

B. Credit Rate and Determination

Current Code provisions governing QZABs and CREBs require the Treasury Department to set credit rates at levels designed to allow issuance of bonds at par, *i.e.*, without premium or discount. Issuance at par would provide the interest-free loans envisioned by these bond programs. The statutory frequency of and procedures for setting credit rates are different (monthly for QZABs in Code Section 1397E(b)(2) and daily for CREBs in Code Section 54(b)(3)). In Notice 99-35,[6] the Treasury Department provided for the application of daily credit rates for QZABs to address issuer concerns resulting from having only a monthly rate. In practice, however, even daily rate-setting frequently fails to provide credit rates that allow bonds to be issued at par. A uniform statutory rate-setting mechanism for all tax-credit bonds based on a rate that takes into account a broader range of underlying credit criteria could further the goal of simplification. Further, without some mechanism allowing different credit rates for borrowers with different credit standing, the goal of par issuance will not be met in many cases. Limited flexibility for the Treasury Department (or other volume-limit allocating

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[6] IRB 1999-28, July 12, 1999, page 26.

authority) to increase credit rates for issuers with weaker credit standing could further this policy objective.[7]

C. Bond Maturity

The Code provisions governing both QZABs and CREBs provide a "maximum term" for the bonds equal to the period that the Treasury Department determines will result in a federal contribution equal to 50 percent of the face amount of the bond (Code Sections 1397E(d)(3) and 54(e)(2)). The ratable principal amortization restriction applicable to CREBs (Code Section 54(l)(5)), discussed above under the subheading "Arbitrage Restrictions," effectively precludes maximizing even this allowable interest-free loan subsidy provided by the CREBs program.

Specifically, the CREBs ratable principal amortization restriction interferes with standard techniques for structuring longer-term debt in two significant ways. By requiring issuers to make annual principal repayments beginning with Year 1, the restriction denies issuers the ability to structure repayments either as bullet maturity bonds or in more typical serial or term bond maturities. Loss of these common principal repayment structures can impose financial hardship on issuers because the issuers are denied the benefits of delayed annual debt service payments that accompany traditional long-term debt.[8]

The financing of high-cost, longer-lived assets also may be hindered by the relatively short maximum maturities produced by the tax-credit bond maturity limits of current law.[9] For example, real estate financings with taxable or tax-exempt bonds frequently have terms of 30 years or more. For private-activity tax-exempt bonds, Code Section 147(b) generally limits maturity of such bonds to 120 percent of the average economic life of property being financed. Importing such a rule into the tax-credit bond provisions may provide a subsidy that is too "rich" under certain circumstances. For example, longer bond maturities combined with full tax-credit rates could produce subsides in excess of the current 50 percent maximum. Congress could find that such an additional subsidy is appropriate for some projects. On the other hand, if Congress rejects subsidies greater than 50 percent, it could provide issuers the option of issuing longer maturity bonds at reduced credit rates to allow more time for principal repayments.[10]

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[7] An example of increased flexibility for Treasury could be the authority to publish a table, including a range of rates related to credit standing as well as term of bond.

[8] Many tax-exempt bond structures for construction projects provide for a capitalized interest period (interest paid with bond proceeds) and deferred principal payments (principal payments beginning no earlier than the year in which the asset is placed in service). As described above, the ratable principal amortization restriction fails to include any initial grace period for principal repayments during construction.

[9] On the other hand, permissible QZABs financing purposes include working capital-type expenditures, equipment, and rehabilitation, all of which have relatively short economic lives. The current uniform maximum maturity for issues may be relatively generous for financing those purposes.

[10] In this regard, the Joint Committee on Taxation ("JCT") staff has expressed an interest in exploring how rules allowing variable credit rates for different projects generally would work. Specifically, the Treasury

II. Other Provisions Affecting Appeal of Tax-Credit Bonds to Issuers and Investors

A. Volume Limits and Sunset Dates

Issuance of both QZABs and CREBs is subject to relatively low volume limits nationally. As enacted, both programs are temporary, and require frequent reauthorization. Revenue constraints drive these limits, and such constraints are likely to continue if the current programs are extended or additional tax-credit bond programs are enacted. However, the combination of these relatively small national volume limits and early sunset dates act to decrease market understanding and interest in the bonds. Market participants incur substantial "start-up" costs to learn the relevant laws, to develop financing structures that both comply with the law and deliver the desired subsidy (*i.e.*, provide cost savings in comparison to a taxable borrowing), and to educate issuers and investors. Many issuers, investment advisers, and attorneys cannot justify spending the time needed to develop markets unless they believe they can recoup their sunk costs through continued access to the tax-credit bond program. This problem is more acute if the administrative rules governing issuance of tax-credit bonds are not uniform and administratively as simple as possible.

If volume limits are unavoidable because of revenue constraints, marketability of tax-credit bonds could be enhanced if Congress exempted from the tax-credit bond volume limits those tax-credit bonds utilized for projects that otherwise could be financed with tax-exempt bonds not subject to Code Section 146 volume limits. A more limited enhancement by Congress could allow tax-credit bonds for such projects to be issued with fractional reduced volume limit allocations equal to the excess of the federal subsidy provided by tax-credit bonds over that provided by tax-exempt bonds.

Further, early sunset dates affect market penetration. As described above, before committing substantial resources to developing the market for tax-credit bonds, market participants need market assurance that both the current tax-credit bond programs and any expansions will "be around." Taking into account start-up time for new (or significantly modified) tax-credit bond programs, greater market penetration could be achieved by reduced (at least in early years) volume limits as a trade-off for delayed sunset dates.[11]

B. Restrictions on Bond Ownership and Issuers

The tax credits on QZABs may only be claimed by eligible holders, limited to banks and other financial institutions. On the other hand, CREBs may be owned, and the credits claimed, by any taxpayer. The market's understanding of tax-credit bonds has increased such that allowing all taxpayers to own tax-credit bonds and to receive the tax

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Department in allocating bond authority could establish a credit rate designed to provide either an interest-free loan (as today) or a reduced-interest loan to the borrower.

[11] Carryforward rules for unused volume limit amounts similarly could somewhat offset the negative impact of early sunset dates.

credits (subject, of course, to tax-liability limits) could significantly expand the potential market for these programs.[12]

If Congress expands permitted owners of tax-credit bonds to all taxpayers, a provision like that formerly contained in Code Section 54(l)(5) could enhance the program's attractiveness. That provision (repealed in 2005) treated credits as estimated tax payments for purposes of the underpayment penalties of Code Sections 6654 and 6655.

The interest and principal components of corporate and tax-exempt bonds frequently are separated in the market place, thereby increasing market demand for the instruments. Similar tax-credit stripping has been proposed (and rejected) numerous times for tax-credit bonds due to the historical Congressional policy concerns about buying/selling tax benefits and compliance concerns about tracking stripped tax-credits. However, to the extent that Congress's objective is maximum market penetration, credit stripping could expand the potential investor pool and thereby increase utilization (*i.e.*, non-taxpaying entities, like pension funds, might be willing to hold the principal portion, but would not otherwise be investors).

Finally, the rules governing who may issue QZABs and CREBs are not uniform. QZABs, like tax-exempt bonds, must be issued by or on behalf of a State or local government. CREBs, on the other hand, may be issued by any "qualified issuer," defined in Code Section 54(j)(5) to include certain cooperative lenders and cooperative electric companies.

C. Funding of Reserve Funds

Both the QZABs and CREBs programs require expenditure of at least 95 percent of the "proceeds" (*i.e.*, gross proceeds) of a bond issue for the project being financed. Tax-exempt private activity bonds, on the other hand, require that at least 95 percent of the "net proceeds" of an issue be spent for the project being financed. The Code defines net proceeds as gross proceeds minus amounts deposited in a "reasonably required reserve fund." Reserve funds are common features of private activity and governmental tax-exempt bond issues that are not backed by the full faith and credit of the governmental issuer. The amount in the reserve fund provides additional security to investors, thereby increasing marketability of the bonds.[13] Marketability of tax-credit bonds could be enhanced if reserve funds could be financed with the proceeds of tax-credit bonds under rules comparable to those governing tax-exempt bonds.

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[12] If Congress extends tax-credit bond ownership to all taxpayers for QZABs and provides similar ownership rules for any future tax-credit bond programs, these rules applicable to CREBs could be considered, *e.g.*, allowing credits to flow through to investors in/owners of pass-through entities, such as S corporations, partnerships and regulated investment companies.
[13] Arbitrage restrictions, if any, imposed on reserve fund earnings could be determined based on the amount of subsidy intended by Congress. *See* above discussion on Arbitrage Restrictions regarding interest-free loan *only* versus interest-free loan *plus* a principal subsidy.

D. Issues Related to Reimbursement and Refinancing of Certain Other Debt

Code Section 54(d)(2)(B) and (C) allows limited use of CREBs for refinancing and reimbursement of expenditures initially financed with other debt. These rules limit refinancings to refinancing of debt originally incurred after enactment of the CREBs program. Although no comparable statutory provisions are provided for QZABs, Treas. Reg. §1397E-1(h) allows reimbursements consistent with Treas. Reg. §1.150-2. Unlike the reimbursement rules in Treas. Reg. § 1.150-2, the specific CREBs statutory requirements regarding reimbursement are more restrictive. For example, no 60-day grace period exists for expenditures incurred prior to the adoption of an official intent, no 20 percent exception for "preliminary expenditures" is provided, and all reimbursements must occur within 18 months of the expenditure as opposed to the later of: (i) 18 months from the expenditure or (ii) 18 months from the placed in service date of the project. This difference in reimbursement rules between CREBs and QZABs has led to confusion in the market place. Like the CREBs statutory provisions, these regulatory rules allow projects with respect to which advance "official action" is taken to be financed on an interim basis with short-term taxable or tax-exempt debt. That short-term debt then is replaced with longer-term tax-exempt ("permanent take-out") debt for the project. The longer-term debt is treated as original project debt rather than as a refinancing. Congress could clarify that all tax-credit bonds can similarly be used as permanent take-out debt by providing that reimbursement rules applicable to tax-exempt bonds also apply to tax-credit bonds.

E. Rules Regarding Accrual and Carryforward of Credits

The Code provides that tax-credits on CREBs belong to holders of the bonds on a “credit allowance date” defined to coincide with quarterly income tax estimated payment due dates. Tax credits on QZABs belong to holders at the end of each year the bonds are outstanding. Technical issues have arisen as to whether the tax credits “accrue” ratably through a year, or “spring” into existence only on credit allowance dates. Marketability of these bonds, and bonds for any new purposes Congress may approve, could be enhanced if the credits accrued ratably throughout each year the bonds are outstanding. If Congress has compliance concerns with daily accrual of tax credits, it could consider requiring annual information reporting for credits.

Tax-credits on QZABs and CREBs may offset both regular and alternative minimum tax liability; however, neither program provides refundable credits. Marketability of tax-credit bonds could also be enhanced if rules allowing carryforward and carryback of excess credits were adopted similar to other tax credits authorized in the Code.