CDFA Spotlight:
Update on Clean Renewable Energy Bonds

by Doug Lamb

Introduction & Background

The Clean Renewable Energy Bond ("CREB") program is a relatively new federal subsidy. The Energy Policy Act of 2005 ("EPACT")[1] provided the initial authorization for the CREB program. Such authorization was in the amount of $800 million with a sunset date of December 31, 2007. With the enactment of the Tax Relief and Health Care Act of 2006 (the "Extenders Act")[2], the authorization for the CREB program increased to $1.2 billion. Additionally, the Extenders Act lengthened the sunset date for the program through December 31, 2008. The IRS has issued various notices containing regulatory guidance on the CREB program; however, no regulations have been published at this time. As described in IRS Notices 2006-7[3] and 2007-26[4], however, temporary regulations are expected. The CREB program is codified in Section 54 of the Internal Revenue Code of 1986, as amended (the "Code").

One of the objectives for CREBs is to provide qualified non-taxing paying entities (e.g. state and local governments and certain cooperatives) a subsidy for the cost of developing certain renewable energy facilities that produce electricity. The renewable energy facilities that qualify for the CREB program are wind facilities, closed and open-loop biomass facilities, geothermal or solar energy facilities, small irrigation power facilities, landfill gas facilities, trash combustion facilities, refined coal production facilities and hydropower facilities, all as described in Section 45(d) of the Code without regard to any placed in service date.[5]

The CREB subsidy is a federal tax credit delivered to the holder of the CREB. The issuance of a CREB requires delivery of an instrument to the holder evidencing an obligation to repay the holder for its loan of the proceeds thereof. Subject to certain limitations, the CREB lender (or holder) may be any entity or natural person - generally, it is one that pays federal income taxes thus benefiting from the CREBs federal tax credit.[6]

To issue a CREB, the issuer must have received approval from the Internal Revenue Service ("IRS"). The form of that approval is commonly referred to as an award of allocation. By statute, there is only $1.2 billion of CREBs authorized to be issued. [7] That full amount has been awarded, subject to any

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[1] Public Law No. 109-58, 119 Stat. 594 (2005).

[2] Public Law No. 109-432, 120 Stat. 2922 (2006).

[3] 2006-10 I.R.B. 559. See http://www.irs.gov/irb/2006-10_IRB/ar07.html.

[4] 2007-14 I.R.B. 1 (modifying and superseding Notice 2005-98). See http://www.irs.gov/irb/2007-14_IRB/ar17.html. Notice 2007-26 states that temporary regulations will apply to CREBs sold on or after June 13, 2007 with respect to the interim guidance provided in Notice 2007-26. Moreover, the Notice states that taxpayers may rely on the interim guidance provided therein and in Notice 2006-7 prior to the effective date of the temporary regulations.

[5] See Code Section 54(d)(2)(A). CREBs specifically exclude Indian coal production facilities described in Section 45(d).

[6] See Code Section 54(1)(3) regarding bonds held by pass-thru entities.

[7] See Code Section 54(f).

awards that have been relinquished. Of that amount, a sizeable portion has been issued. Of those CREBs issued to date for governmental borrowers, most, if not all, of those have been issued in private placements with a purchaser that has generally been a bank, a similar financial institution or an accredited investor. The deadline for issuance of the $1.2 billion in authorized CREBs is December 31, 2008.[8]

Borrower, Project & Issuer Requirements

Under the CREB statute, the facility must be owned by a qualified borrower that is defined to include any governmental body or mutual or cooperative electric company.[9] A governmental body includes a political subdivision of a state and other entities. Notice 2006-7 states that the temporary regulations are expected to provide that the term political subdivision shall have the same meaning as in Treasury Regulations Section (hereinafter "Treas. Regs. Sec.") 1.103-1. It is also expected that a qualified borrower will include any instrumentality of a state or political subdivision as determined for purposes of Section 103 of the Code.[10]

Pursuant to Revenue Ruling 57-128, there are six relevant factors in determining whether an entity constitutes an instrumentality for purposes of Section 103 of the Code. The IRS has ruled that all six factors need not be present in every case. These factors are: (i) the extent that the entity is formed for a governmental purpose and performs a governmental function; (ii) the extent that the performance of the entity's function is on behalf of one or more states or political subdivisions; (iii) the extent of private interests involved, or whether the states or political subdivisions involved have the powers and interests of an owner; (iv) the extent that control or supervision of the entity is vested in a public authority or authorities; (v) express or implied statutory or other authority is necessary for the creation and/or use of the entity, and whether such authority exists; and (vi) the degree of the entity's financial autonomy and the source of its operating expenses.[11]

Under the CREB statute, 95% or more of the proceeds of the CREB must be used for capital expenditures incurred by the borrower for the project.[12] As a result, any costs of issuance or reserve fund deposits to be funded out of the CREB must not exceed 5%.[13] A qualifying capital expenditure is generally a cost that is chargeable to capital account.[14] Generally, if the cost is includable in the basis of the asset, it is a capital expenditure. The purpose of these requirements is to ensure that the CREB proceeds are used for project costs that are includable in the basis of the asset and to avoid use of the

[8] See Code Section 54(m).

[9] See Code Section 54(j)(3) and (4). A governmental body is any state, territory, possession of the United States, Washington, D.C., Indian tribal government, and any political subdivision thereof.

[10] See Notice 2006-7, Section 3.

[11] See Revenue Ruling 57-128, 1957-1 C.B. 311.

[12] See Code Section 54(d)(1)(B). The 95% requirement is not measured after netting out proceeds of the CREB used to fund a reasonably required reserve or replacement funds described in Treas. Regs. Sec. 1.148-2(f)(2).

[13] Notice 2007-26, Section 13(4) states that, "[f]or purposes of the requirement under [Code S]ection 54(d) to use 95 percent of the proceeds of an issue of CREBs for qualified costs to finance capital expenditures for qualified projects, proceeds used to finance a reserve or replacement fund (e.g., a debt service reserve fund to secure the CREBs) will be treated as nonqualified costs and will be eligible for financing with CREBs only from the five percent nonqualified portion of the proceeds…"

[14] See Treas. Regs. Sec. 1.150-1(b).

CREB proceeds for working capital type items. Importantly, costs of acquiring existing facilities generally will not be treated as qualified costs for purposes of the 95% test.[15]

Furthermore, the proceeds of a CREB are subject to reasonable expectations tests similar to those found in Treas. Regs. Sec. 1.1.48-2(b). In the case of CREBs, the issuer must reasonably expect as of the date of issuance of the CREB that: (i) 95% of the proceeds are to be spent prior to the fifth anniversary of such issuance; (ii) there will be a binding commitment with a third party to expend at least 10% of the proceeds of the CREB within six months of issuance; and (iii) the projects will be completed, and the proceeds will be spent, with due diligence.[16]

Regarding the facilities that qualify for financing, Notice 2006-7 provides that the expected temporary regulations should expand the concept of a qualified project to include any facility owned by the qualified borrower that is functionally related and subordinate to the qualifying facility. A functionally related and subordinate facility is one that is commensurate in size and function to the qualified facility and is determined in accordance with Treas. Regs. Sec. 1.103-8(a)(3).[17]

A CREB must be issued by an entity that is a qualified issuer. Such an issuer includes a governmental body, a cooperative electric company or a clean renewable energy bond lender.[18] As described above, Notice 2006-7 expects that the temporary regulations will expand the meaning of political subdivision. Specifically, those regulations are expected to provide that a qualified issuer includes on-behalf of issuers.[19]

A cooperative electric company means a mutual or cooperative electric company described in Code Section 501(c)(12) or Code Section 1381(a)(2)(C), or a not-for-profit electric utility which has received a loan or loan guarantee under the Rural Electrification Act. A clean renewable energy bond lender means a lender which is a cooperative which is owned by, or has outstanding loans to, 100 or more cooperative electric companies and is in existence on February 1, 2002, and shall include any affiliated entity which is controlled by such lender.[20]

Financial Aspects & Additional Legal Requirements

Ratable Principal Amortization; Setting the Credit Rate & the Maturity; the Credit

Section 54 of the Code controls many, in not all, aspects of the economics of a CREB transaction. One of the most significant aspects of CREBs is the ratable amortization requirement found

[15] See Notice 2007-26, Section 13(5).

[16] See Code Section 54(h)(1).

[17] See Notice 2006-7, Section 3(1).

[18] See Code Section 54(j)(4).

[19] Notice 2006-7, Section 3(3), provides that "[a] clean renewable energy bond may be issued on behalf of a State or political subdivision within the meaning of Section 1.103-1(b) under rules similar to those for determining whether a bond issued on behalf of a State or political subdivision, constitutes an obligation of that State or political subdivision for purposes of Section 103." Generally, the IRS has endorsed two types of on behalf of issuers: (i) entities created under a specific state statute to issue bonds for a governmental purpose approved by the IRS in Revenue Ruling 57-187, and (ii) entities created under a general not-for-profit corporation statute that have certain characteristics that establish a relationship with a political subdivision approved by the IRS in Revenue Ruling 63-20 and in Revenue Procedure 82-26.

[20] See Code Section 54(j).

in Section 54(l)(5).[21] In effect, this requirement requires level amortization of principal throughout the life of a CREB. For example, a $1,000,000 face amount CREB with a 10 year maturity would be required to have ten $100,000 annual principal installments, with the first installment required to be made in the calendar year in which the CREB is initially issued. This requirement has received much attention because it leads to difficult choices for borrowers and lenders as to timing of issuance and the ability to make the first payment when a project may not yet be complete.

Under the CREB statute, the tax credit rate and the maximum maturity of the CREB are determined by U.S. Treasury on a periodic basis.[22] Each of the tax credit rate and the maximum maturity is set on the sale date of the CREB. That date is the day there is final, binding commitment for the purchase and sale of the CREB.[23] On such day, one would consult the Bureau of Public Debt website to determine the credit rate that applies to each principal installment.[24] That website will also reveal the maximum maturity for a CREB sold on that day.[25] The published maturity is a maximum, and it is quite possible that an issuer and a purchaser might consider contracting for a maturity that is less than the maximum.

The amount of the CREB tax credit that may be received by a holder is determined quarterly based on a formula that takes into account the outstanding amount of the CREB for that date and the tax credit rate for that year. As a result, on each quarterly credit allowance date, the holder is entitled to a federal income tax credit that is one-quarter of the product of that credit rate and the outstanding principal amount of the CREB.[26] The credit allowance dates are the 15th day of each March, June, September and December, and the last day on which the CREB is outstanding.[27] The resulting amount of the CREB tax credit is included in the holder's gross income.[28]

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[21] Code Section 54(l)(5) states that "[a] bond shall not be treated as a clean renewable energy bond unless it is part of an issue which provides for an equal amount of principal to be paid by the qualified issuer during each calendar year that the issue is outstanding." As restated in Section 2 of Notice 2007-26, the issuer is required to pay and amortize an equal amount of the principal of an issue of CREBs during each calendar year that the issue is outstanding.

[22] See Code Section 54(b)(3). Section 9 of Notice 2007-26 states that "[f]or each issue of CREBs, a separate credit rate will apply to each of the level annual repayments of principal of the issue …"

[23] Id.

[24] See https://www.treasurydirect.gov/SZ/SPESRates?type=CREBS. Notice 2007-26 provides that "[t]he credit rates will be determined by the Treasury Department based on its estimate of the yield on outstanding AA rated corporate bonds of a similar maturity for the business day immediately prior to the date on which the issue is sold."

[25] Code Section 54(e)(2) states that the "…maximum term shall be the term which the Secretary estimates will 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 such bond. Such present value shall be determined without regard to the requirements of [IRS Form 8038] and using as a discount rate the average annual interest rate of tax-exempt obligations having a term of 10 years or more which are issued during the month. If the term as so determined is not a multiple of a whole year, such term shall be rounded to the next highest whole year." Section 8 of Notice 2007-26 further provides that "[t]he maximum term for a CREB is determined … using a discount rate equal to 110 percent of the long-term adjusted AFR, compounded semi-annually, for the month in which the bond is sold."

[26] See Code Section 54(b)(2).

[27] See Code Section 54(b)(4). Code Section 54(b)(5) states that for a CREB "… issued during the 3-month period ending on a credit allowance date, the amount of the credit determined … with respect to such credit allowance date shall be a ratable portion of the credit otherwise determined based

Reimbursement; Refinancing

A CREB may be used to reimburse the borrower for expenditures incurred on the project prior to issuance of the CREB so long as the borrower and issuer have each taken appropriate action.[29] Just as with tax-exempt bonds, there are timing and characterization rules that apply to the types of costs that may be reimbursed. For CREBs, the original expenditure must have occurred after August 8, 2005 - the date of enactment of EPACT. Additionally, for those original expenditures that are hard costs (e.g. costs of construction), they cannot have been incurred earlier than 18 months prior to the date reimbursed from the proceeds of the CREB. For those prior expenditures that are soft costs, not more than 20% of the CREB proceeds may be used to reimburse for such costs.[30]

A CREB may refinance existing debt for a qualified project so long as the original debt was incurred by a qualified borrower after August 8, 2005.[31]

Arbitrage; Change-In-Use

As with tax-exempt bonds, the issuer must satisfy the arbitrage requirements of Code Section 148 with respect to proceeds of the CREB, and if there is any change-in-use without remedial action, a redemption of all or a portion of the CREB may be required.

First off, the issuer must certify as to its reasonable expectations about the amount and the use of the gross proceeds of the issue as required by Treas. Regs. Sec. 1.148-2(b). Furthermore, Notice 2007-26 provides that subject to certain exceptions in the notice, the arbitrage investment restrictions under Code Section 148 and Treas. Regs. Sections 1.148-1 through 1.148-11, and the accompanying exceptions "…will apply to gross proceeds of CREBs to the same extent and in the same manner as they apply to gross proceeds of tax-exempt state or local governmental bonds the interest on which is excludable from gross income under section 103."[32] Of these exceptions, the ones seemingly having the broadest effect are likely to be, as follows: (i) if a CREB meets the reasonable expectations requirements as to the use of the proceeds, such proceeds may be invested without yield restriction for five years; and (ii) in determining the yield on a CREB, the CREB tax credit and the credit rate will be disregarded.[33] In

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on the portion of the 3-month period during which the bond is outstanding. A similar rule shall apply when the bond is redeemed or matures."

[28] Code Section 54 (g) states that "[g]ross income includes the amount of the credit allowed to the taxpayer under …[Section 54] … (determined without regard to [certain limitations on the amount of tax credits that may be claimed contained in] subsection (c)) and the amount so included shall be treated as interest income."

[29] Code Section 54(d)(2)(C) requires the (i) qualified borrower to have declared its intent to reimburse the original expenditure with the proceeds of a CREB before payment of the original expenditure, and (ii) qualified issuer to have adopted an official intent to reimburse the original expenditure with such proceeds not later than 60 days after payment of the original expenditure.

[30] Section 13 of Notice 2007-26 states that, in applying the reimbursement restrictions to CREBs, the general reimbursement rules and exceptions in § 1.150-2 will apply.

[31] See Code Section 54(d)(2)(B).

[32] See Section 12 of Notice 2007-26.

[33] The other exceptions to the arbitrage rules listed in Section 12 of Notice 2007-26 include, but are not limited to, (i) the exception to arbitrage yield restriction for investments of gross proceeds of tax-exempt bonds in specified non-AMT tax-exempt bond investments will be inapplicable to CREBs; and (ii) in determining whether a CREBs qualifies for the small issuer exception to the arbitrage rebate requirement, both CREBs and tax-exempt bonds (other than private activity bonds) that are reasonably expected to be issued or actually issued by the CREB issuer (and other applicable on-behalf-of entities

essence, this means that the proceeds of a CREB may not be invested at a yield higher than the effective interest rate on the CREB.

If 95 percent of the CREB proceeds are not expended by the close of the five year period beginning on the date of issuance and absent an extension, the issuer must redeem that portion of the CREB that is deemed to be nonqualified within 90 days after the end of such period. The nonqualified portion is determined in the same manner as under Code Section 142.[34] Furthermore, in determining whether the proceeds of the CREB have not been used for the qualified purposes, Section 11 of Notice 2007-26 provides that a deliberate action of the issuer or the borrower may disqualify a portion of the CREB.[35] A deliberate action may be cured, however, if a remedial action is taken which meets the requirements specified in the temporary regulations. The Notice states that it is expected that such temporary regulations will contain remedial actions allowing for redemption, defeasance or an alternative uses of disposition proceeds similar to the remedial actions contained in Treas. Regs. Secs. 1.141-12(d) and 1.141-12(e).

Approval to Issue CREBs

In addition to any state or local law requirements that may govern the issuance of a CREB, including applicable requirements for a cooperative, the issuer of a CREB must have received an allocation. At this time, there have been two rounds of allocation of CREBs for the allotted $1.2 billion in CREB authority. The second round of allocation included approximately $77 million of returned allocation from the first round.[36] Of the $1.2 billion in authority, not more than $750 million is for use by governmental bodies.[37] Notice 2007-26 provided the form of application and guidance for a request of allocation in the second round.

In IR-2008-16, dated February 8, 2008, the IRS reported that there were 342 second round applications from 33 states that pertained to 395 projects. Of those projects, the IRS reported that there were 156 proposed projects in California, 57 in Minnesota, 23 in New Jersey, 17 in Washington, 13 in Nebraska, 12 in Montana, 11 in Illinois and 10 in Wisconsin, and applications ranged in size from $15,000 to $38.5 million.

Recent Developments

On the legislative front, several bills have been introduced into Congress over the past year that would provide additional allocation and remove certain of the onerous restrictions on CREBs, e.g. providing for no principal amortization during the first calendar year the CREB is outstanding or allowing the tax-credit to be stripped. As of the date this article was submitted for publication, none of those bills has been presented to the President for signature.

The Clean Renewable Energy and Conservation Tax Act of 2007 (“CRECTA”) proposed a new category of clean renewable energy bonds (“New CREBs”) to finance qualified renewable energy facilities that (a) qualify under Code Section 45 (other than refined coal or Indian coal facilities and without regard to placed-in-service dates), and (b) are owned by public power providers (“PPPs”), governmental bodies

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and subordinate entities taken into account under that section) within a calendar year will be taken into account in measuring the applicable size limitation.

[34] See Code Section 54(h)(3).

[35] Notice 2007-26 provides that the term deliberate action “…will have the same meaning as used in [Treas. Regs.] Sec. 1.141-2(d)(3), except that ‘[S]ection 54’ will be substituted for ‘[S]ection 141’ in [Treas. Regs.] Sec. 1.141-2(d)(3)(i).”

[36] See IR-2008-16, dated February 8, 2008, available on the IRS website.

[37] See Code Section 54(f)(2).

or cooperative electric companies ("CECs"). A subsequent bill (the Renewable Energy and Energy Conservation Tax Act of 2008, ("REECTA")) excluded projects owned by governmental bodies from New CREBs.

The bond limitation for New CREBs under CRECTA and REECTA was $2 billion. Under CRECTA, not more than one-third of the total was to be allocated to each category of PPP, CEC and governmental body projects. Under REECTA, PPPs would not receive more than 60% of the allocation. Under CRECTA and REECTA, the tax credits for New CREBs could be stripped from the ownership of the bond, similar to the stripping of interest coupons for tax-exempt bonds.

Under CRECTA, there were additional provisions to create a new tax credit bond program for qualified energy conservation bonds ("QECBs"). The rules for QECBs would be similar to those for New CREBs. The QECB program would be intended for projects and programs that, among other things, (i) reduce energy consumption in public buildings by at least 20%, (ii) support rural development of renewable energy production, (iii) increase energy efficiency and reduce fossil fuel consumption in certain research facilities, and (iv) reduce energy consumption (and pollution) in commuting facilities. $3.0 billion in allocation was proposed for the QECB program under CRECTA, and that amount increased to $3.6 billion under REECTA.

Conclusion

This article is neither intended to be nor is it an exhaustive review of the applicable legal requirements for CREBs. Moreover, this article does not constitute advice (legal or otherwise) in relation to the issuance of a CREB, including the requirements of the Code and the regulations promulgated thereunder. Should you have any questions regarding the content of this article or CREBS in general, please contact Doug Lamb at 804.788.8513 or dlamb@hunton.com.