[4830-01-u]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 8755]

RIN 1545-AV74

Qualified Zone Academy Bonds

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to the federal income tax treatment of qualified zone academy bonds. The regulations in this document provide needed guidance to holders and issuers of qualified zone academy bonds. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section of this issue of the **Federal Register**.

DATES: These regulations are effective January 1, 1998.

FOR FURTHER INFORMATION CONTACT: Timothy L. Jones, (202) 622-3980 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Section 226(a) of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (1997), amended the Internal Revenue

Code (Code) by redesignating section 1397E as section 1397F and adding a new section 1397E. Section 1397E authorizes a new type of debt instrument known as a qualified zone academy bond.

Explanation of provisions

In general

A qualified zone academy bond is a taxable bond issued by a state or local government the proceeds of which are used to improve certain eligible public schools. In lieu of receiving periodic interest payments from the issuer, an eligible holder of a qualified zone academy bond is generally allowed annual federal income tax credits while the bond is outstanding. These credits compensate the holder for lending money to the issuer and function as payments of interest on the bond.

These temporary regulations provide rules for the federal income tax treatment of qualified zone academy bonds. These regulations generally treat the allowance of the credit as if it were a payment of interest on the bond. These regulations also provide rules to determine (1) the credit rate, (2) the discount rate used to present value private business contributions, and (3) the discount rate used to determine the maximum term of a qualified zone academy bond.

These regulations generally do not provide guidance on the statutory requirements that must be met for a bond to qualify as a qualified zone academy bond. Section 1397E(d) sets forth a number of detailed requirements that must be met for a bond to qualify as a qualified zone academy bond. In particular, section 1397E(d)(1)(C) requires the issuer to certify (1) that it has written assurances that private entities have agreed to contribute a certain level of goods or services to the qualified zone academy, and (2) that it has the written approval of the eligible local education agency for the bond issuance. The Treasury and the IRS intend that these certifications will be respected and may be relied on by taxpayers if the certifications are reasonably made.

In addition, section 1397E(d)(1)(A) requires that 95 percent or more of the proceeds of an issue of qualified zone academy bonds are to be used for a qualified purpose described in section 1397E(d)(5) with respect to a qualified zone academy as defined in section 1397E(d)(4). The Treasury and the IRS intend that the qualified purposes set forth in section 1397E(d)(5) are to be broadly interpreted. The Treasury and the IRS also intend that, if an issuer is unable to actually spend 95 percent or more of the proceeds of a qualified zone academy bond for a qualified purpose, the issuer may apply remedial actions similar to the remedial actions set forth in §1.142-2 to preserve the qualification of a bond. Further, the Treasury and the IRS intend that taxpayers may rely on an issuer's determination that a public school (or academic program within a public school) is a qualified zone academy for purposes of section 1397E(d)(4) if the determination has a reasonable basis. The Treasury and IRS request comments on whether additional guidance is needed with respect to the section 1397E(d) requirements.

Section 1397E(e) imposes a national limitation on the amount of qualified zone academy bonds that can be issued. For 1998 and 1999, the IRS will publish a revenue procedure allocating the national limitation among the States and the possessions.

The credit allowance

A qualified zone academy bond provides an annual federal income tax credit to certain holders. Under the regulations, the credit is deemed paid on the credit allowance date--the last day of each one-year accrual period on the bond. A taxpayer that receives a credit on a credit allowance date may use the credit to offset its income tax liability for the taxable year that includes the credit allowance date.

There are two limitations on the use of the credit. First, only eligible taxpayers holding the bond on the credit allowance date may claim the credit. Section 1397E(d)(6) defines an eligible taxpayer as a bank, an insurance company, or a corporation actively engaged in the business of lending money. Second, an eligible taxpayer may claim the credit only to the extent the taxpayer has a tax liability for the taxable year that includes the credit allowance date. See section 1397E(c). The credit is nonrefundable.

Treatment of the credit as interest

The regulations treat the credit on a qualified academy zone bond as if it were a payment of qualified stated interest. This treatment effectively conforms the treatment of the credit with the treatment of interest income on debt instruments. Thus, for example, a holder that uses an accrual method of accounting accrues the credit amount over the one-year accrual period that ends on the credit allowance date.

Adjustment when credit is limited or disallowed

In two situations the holder of a qualified zone academy bond on a credit allowance date will not be able to use some or all of the credit to offset its tax liability. First, if the holder on a credit allowance date is not an eligible taxpayer (a bank, insurance company, or corporation actively engaged in the business of lending money), no credit is allowed. Second, the amount of the credit may exceed the income tax liability of a holder that is an eligible taxpayer. In this second case, because the credit is nonrefundable, some or all of the credit will not be used.

In these situations, the regulations allow the holder to adjust its income by deducting the amount of the unused credit. This deduction is allowed for the taxable year that includes the credit allowance date. The Treasury and the IRS request comments on whether this adjustment works appropriately when an eligible taxpayer holds a qualified zone academy bond on the credit allowance date but has an income tax liability (determined without regard to the credit) that is less than the amount of the credit.

Credit rate

Section 1397E(b)(2) authorizes the Treasury to establish a single, uniform credit rate that will permit the issuance of qualified zone academy bonds without discount and without interest cost to the issuer. This section also requires the Treasury to adjust the credit allowance rate on a monthly basis to reflect changes in market interest rates.

It is not possible to determine a uniform credit rate that would permit all qualified zone academy bonds to be issued at par. Some borrowers are less creditworthy than others and, therefore, borrow at less favorable rates. In addition, because section 1397E(b)(2) requires the Secretary to set the credit rate in the month before the bond is issued, changes in market interest rates between the time the rate is set and the time a qualified zone academy bond is issued can result in a bond being issued at a price that is different than par.

The regulations provide a single monthly rate that will minimize the discount or premium on qualified zone academy bonds.

Specifically, the regulations provide that the credit rate is 110 percent of the long-term applicable Federal rate (AFR), compounded annually, for the month of issuance. Tying the credit rate to the AFR ensures that the rate will be adjusted on a monthly basis to reflect changes in market interest rates. In addition, the Treasury and the IRS believe the 10 percent spread over the long-term AFR is appropriate, in part, because qualified zone academy bonds bear more credit and liquidity risk than long-term Treasury bonds.

Maximum term

Section 1397E(d)(3) sets out a formula for determining the maximum term of a qualified zone academy bond. The formula requires the use of a discount rate equal to the average annual interest rate of tax-exempt obligations having a term of ten years or more. Because there is no readily available source for this discount rate, the regulations provide that the discount rate is 110 percent of the long-term adjusted AFR, compounded semi-annually. The long-term adjusted AFR is published on a monthly basis and is designed to reflect the current yield of a risk-free tax-exempt obligation having a term of 9 years or more.

Taxable obligation

It is possible that some qualified zone academy bonds may either (1) provide for payments of stated interest, or (2) be issued at a discount. The Treasury and the IRS have determined that qualified zone academy bonds are not obligations the interest on which is excluded from gross income under section 103(a). There are a number of reasons for treating a qualified zone academy bond as a taxable obligation. For example, the requirement in section 1397E(g) that a holder include the allowed amount of the credit in gross income evidences an intention to treat qualified zone academy bonds as taxable, not tax-exempt, obligations.

Coordination with estimated tax rules

The regulations do not address the estimated tax consequences of holding a qualified zone academy bond. The Treasury and the IRS request comments on whether there is a need to coordinate the regulations with the estimated tax rules and, if so, how they might be coordinated.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

Several persons from the Office of Chief Counsel and the Treasury Department participated in developing these regulations.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.1397E-1T also issued under 26 U.S.C. 1397E(b) and 1397E(d). * * *

Par. 2. Section 1.1397E-1T is added to read as follows:

<u>§1.1397E-1T Qualified zone academy bonds (temporary)</u>.

(a) <u>Overview</u>. In general, a qualified zone academy bond is a taxable bond issued by a state or local government the proceeds of which are used to improve certain eligible public schools. An eligible taxpayer that holds a qualified zone academy bond generally is allowed annual federal income tax credits in lieu of periodic interest payments. These credits compensate the eligible taxpayer for lending money to the issuer and function as payments of interest on the bond. Accordingly, this section generally treats the allowance of a credit as if it were a payment of interest on the bond. In addition, this section provides rules to determine the credit rate, the present value of qualified contributions from private entities, and the maximum term of a qualified zone academy bond.

(b) Credit rate. The credit rate for a qualified zone academy bond is equal to 110 percent of the long-term applicable Federal rate (AFR), compounded annually, for the month in which the bond is issued. The Internal Revenue Service publishes this figure each month in a revenue ruling that is published in the Internal Revenue Bulletin. See §601.601(d)(2)(ii)(b) of this Chapter.

(c) Private business contribution requirement. To determine the present value (as of the issue date) of qualified contributions from private entities under section 1397E(d)(2), the issuer must use a reasonable discount rate. The credit rate determined under paragraph (b) of this section is a reasonable discount rate.

(d) Maximum term. The maximum term for a qualified zone academy bond is determined under section 1397E(d)(3) by 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 issued. The Internal Revenue Service publishes this figure each month in a revenue ruling that is published in the Internal Revenue Bulletin. See §601.601(d)(2)(ii)(b) of this Chapter.

(e) <u>Tax credit</u>--(1) <u>Eligible taxpayer</u>. An eligible taxpayer (within the meaning of section 1397E(d)(6)) that holds a qualified zone academy bond on a credit allowance date is allowed a tax credit against the federal income tax imposed on the taxpayer for the taxable year that includes the credit allowance date. The amount of the credit is equal to the product of the credit rate and the outstanding principal amount of the bond on the credit allowance date. The credit is subject to a limitation based on the eligible taxpayer's income tax liability. See section 1397E(c).

(2) <u>Ineligible taxpayer</u>. A taxpayer that is not an eligible taxpayer is not allowed a credit.

(f) <u>Treatment of the allowance of the credit as a payment of interest</u>--(1) <u>General rule</u>. The holder of a qualified zone academy bond must treat the bond as if it pays qualified stated interest (within the meaning of §1.1273-1(c)) on each credit allowance date. The amount of the deemed payment of interest on each credit allowance date is equal to the product of the credit rate and the outstanding principal amount of the bond on that date. Thus, for example, if the holder uses an accrual method of accounting, the holder must accrue as interest income the amount of the credit over the one-year accrual period that ends on the credit allowance date.

(2) Adjustment if the holder cannot use the credit to offset a tax liability. If a holder holds a qualified zone academy bond on the credit allowance date but cannot use all or a portion of the credit to reduce its income tax liability (for example, because the holder is not an eligible taxpayer or because the limitation in section 1397E(c) applies), the holder is allowed a deduction for the taxable year that includes the credit allowance date. The amount of the deduction is equal to the amount of the unused credit deemed paid on the credit allowance date.

(g) Not a tax-exempt obligation. A qualified zone academy bond is not an obligation the interest on which is excluded from gross income under section 103(a).

(h) Cross-references. See section 171 and the regulations thereunder for rules relating to amortizable bond premium. See §1.61-7(c) for the seller’s treatment of a bond sold between interest payment dates (credit allowance dates) and §1.61-7(d) for the buyer’s treatment of a bond purchased between interest payment dates (credit allowance dates).

(i) [Reserved]

(j) Effective date. This section applies to a qualified zone academy bond issued on or after January 1, 1998.

/s/ Michael P. Dolan

Deputy Commissioner of Internal Revenue

Approved: /s/ Donald C. Lubick

Acting Assistant Secretary of the Treasury