

Report to Ohio School District Clients

Qualified Zone Academy Bonds

Ohio school districts have a significant opportunity to finance renovations to certain school facilities through the qualified zone academy bond (QZAB) program. More than \$100 million in 2009 and 2010 QZAB volume cap remains available for eligible Ohio school districts to issue “direct payment” tax credit bonds. As with direct payment qualified school construction bonds (QSCBs), an issuer of QZABs utilizing 2009 or 2010 QZAB volume cap may elect to receive subsidy payments directly from the federal government in lieu of the tax credit otherwise available to holders of QZABs. As explained below, the window of opportunity to issue direct payment QZABs is closing, with approximately \$50 million of 2009 volume cap expiring at the end of 2011 and a similar amount of 2010 volume cap expiring at the end of 2012.

Congress first authorized the QZAB federal income tax credit in 1997, and has continued to reauthorize the tax credit as a means to subsidize school building renovation costs. For years, strict arbitrage rules and the requirement that only financial institutions could hold QZABs sharply limited the program’s effectiveness. In 2008, Congress enacted significant technical changes to the QZAB tax credit provisions in the Internal Revenue Code of 1986, as amended (the Code) through the Emergency Economic Stabilization Act of 2008 (EESA). In 2009, Congress temporarily increased the national limit on QZAB financing through the American Recovery and Reinvestment Act of 2009 (ARRA). Then, in 2010, through the Hiring Incentives to Restore Employment Act of 2010 (HIRE), Congress modified the Code to permit issuers of “qualified tax credit bonds,” including certain QZABs, to elect to receive interest subsidy payments directly from the US Treasury (Direct Payments) in lieu of the federal income tax credit that would otherwise be available to bondholders. These changes were designed to enhance the availability and effectiveness of QZAB financing. However, as the QZAB program has been generally unused in Ohio in recent years, and as explained below, both the increased national limit on QZAB financing and the Direct Payment option begin to expire at the end of calendar year 2011.

From 1997 to 2008, Congress limited the total amount of QZABs nationally to \$400 million per calendar year. Each year the federal government allocates the authorized QZAB amount among the states based on relative poverty levels, and Ohio’s pre-ARRA allocations were approximately \$14 million per year. Under ARRA, the national QZAB limitation was increased to \$1.4 billion for each of 2009 and 2010, and Ohio’s allocations were \$51,280,000 for 2009 and \$50,855,000 for 2010. For 2011, the national limitation is back to the pre-ARRA amount of \$400 million, and the Ohio allocation is \$15,181,000.

Unused allocations for a particular year may be carried forward for two years. For example, the 2009 and 2010 allocations will expire at the end of 2011 and 2012, respectively. Ohio school districts must apply to the Ohio Department of Education, Office of School Finance (ODE-OSF), to receive an assignment of the State QZAB allocation.

Allocations of the QZAB limitation are made on a first-in, first-out basis. Thus, any QZAB allocations by ODE-OSF would come first from the 2009 allocation, then from the 2010 allocation, and so on. Under HIRE, issuers may only elect to receive Direct Payments with respect to QZABs issued under the 2009 and 2010 allocations. Thus, the opportunity for Ohio school districts to issue Direct Payment QZABs will diminish at the end of 2011 and cease at the end of 2012. Holders of QZABs issued under the 2011 allocation will be entitled to a federal income tax credit and should thus be willing to receive interest that is below market rates. However, as was demonstrated with Qualified School Construction Bonds, another type of qualified tax credit bond authorized by ARRA and benefitted by HIRE's Direct Payment provisions, the net interest cost of Direct Payment QZABs has generally been lower than that of QZABs whose holders receive the federal income tax credit. In other words, the 2009 and 2010 allocations of QZABs are more valuable to school districts than the 2011 allocation.

QZAB financing is available to public schools serving large concentrations of low-income families to pay for certain improvements to school facilities. In Ohio, the school district issuing QZABs may use the borrowed funds to renovate, repair or equip one or more qualifying school buildings (each an "academy").

There are a number of eligibility requirements that a school district must meet in order to qualify for QZAB financing. The school district must designate a public school or academic program within a public school as the "academy." The academy must be in an empowerment zone or an enterprise community, or the school district must reasonably expect that at least 35% of the students in the academy would qualify for free or reduced-price meals under the National School Lunch Program. The school district must also establish a relationship with one or more private entities that will make a contribution to the academy that has a present value (as of the date the QZAB financing closes) equal to at least 10% of the proceeds of the QZABs. This contribution may be cash or an in-kind contribution of property or services. The contribution must be received after the school district has indicated its intent to use the contribution to qualify for a QZAB allocation. The academy's programs must be "designed in cooperation with business to enhance the academic curriculum, increase graduation and employment rates and prepare students for college and the workforce," and the students must be subject to the same academic standards and assessments as other school district students. In addition, ARRA requires that a QZAB-financed project meet federal prevailing wage requirements.

In Ohio, QZABs may be structured as unvoted general obligation bonds (limited to 1/10 of 1% of assessed valuation), unvoted energy conservation bonds under Revised Code Section 133.06(G) (limited to 9/10 of 1% of AV) or lease-purchase obligations under Revised Code Section 3313.375 (not subject to

debt limits). Voted general obligation bonds and permanent improvement tax anticipation notes may also be issued as QZABs.

The amount of the QZAB federal income tax credit and the maximum term for QZABs are set by the US Treasury, with the maximum term adjusting monthly. In recent years, the maximum term for QZABs has ranged from 13 to 16 years.

Among the changes made to the QZAB tax credit and program through EESA were the following (applicable to QZABs issued after October 3, 2008):

- 100% of available proceeds of QZABs must be spent on qualified purposes within three years from the date of issue. Available proceeds are sale proceeds minus issuance expenses (capped at 2% of proceeds) plus investment proceeds. Under prior law, 95% of proceeds were required to be spent on qualified purposes within five years from the date of issue.
- The tax credit for QZABs may be claimed by any taxpayer, unless the issuer elects to receive a Direct Payment in lieu of the credit, where available. Under prior law the QZAB tax credit could only be claimed by certain financial institutions.
- QZABs are subject to relaxed arbitrage requirements that would permit single “bullet” maturities and the investment of sinking fund proceeds at a yield that, while restricted, could be substantially higher than the issuer’s interest rate (or net interest cost in the case of Direct Payment QZABs) on the QZABs. Under prior law, the yield on sinking fund proceeds was restricted to the issuer’s interest cost.
- Issuers of QZABs must certify as to satisfaction of all applicable state and local conflict-of-interest requirements and any similar requirements imposed by IRS regulation.

Squire, Sanders & Dempsey has served as bond counsel, special tax counsel and/or purchaser’s counsel on numerous QZAB financings for school districts in Ohio and other states and has assisted a number of Ohio school districts in the QZAB application process.

Contact:

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