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Summary of Qualified Energy Conservation Bonds

The qualified energy conservation bond program (QECBs) is governed by Sections 54A and 54D of the Code[1,2]. QECBs are taxable obligations and are eligible to be issued as tax credit obligations (i.e., the investor receives a tax credit) or direct-pay subsidy obligations (i.e., the issuer receives an interest subsidy payment in lieu of the investor receiving the tax credit.)

QECBs

QECBs are intended to promote energy conservation and contemplate governmental, non-governmental (i.e., so-called "private activity") and tribal projects.[3] Qualified uses of QECBs are described as "qualified conservation purposes." Such uses include capital expenditures for projects related to reducing energy consumption in publicly-owned buildings by at least 20 percent, implementing green community programs, rural development involving renewable energy production, and qualified facilities as determined under Code Section 45(d) (other than refined coal or Indian coal facilities and without regard to placed-in service dates). See the chart at the end of this summary for a complete list of the qualified conservation purposes.

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[1] Internal Revenue Code of 1986, as amended (the "Code"). Code Section 54A was added in the "Heartland, Habitat, Harvest and Horticulture Act of 2008." See http://www.law.cornell.edu/uscode/html/uscode26/usc_sec_26_00000054---A000-.html.

[2] Section 54D was added to the Code by the "Energy Improvement and Extension Act of 2008" (the "2008 Energy Act") as part of the "Emergency Economic Stabilization Act of 2008." See at http://www.law.cornell.edu/uscode/html/uscode26/usc_sec_26_00000054---D000-.html.

[3] As reflected in the House report to predecessor legislation of the 2008 Energy Act containing identical relevant QECB provisions enacted in the 2008 Energy Act, "…[t]he Committee believes that it is important to encourage energy conservation. The Committee believes that State and local governments often are in the best position to assess community needs and recognizes there are a number of approaches to energy conservation that State and local governments may wish to encourage. For example, the Committee recognizes that State and local governments may wish to encourage the development of combined heat and power systems, facilities that use thermal energy produced from renewable resources, smart electrical grids, the use of solar panels, mass transit, bicycle paths, or residential property that reduces peak-use of energy. In addition to these approaches, the Committee believes that State and local governments will develop numerous other approaches to energy conservation. Furthermore, the Committee recognizes that there is great potential for energy conservation in urban areas and the Committee believes that local officials should have the flexibility to develop their own approaches to energy conservation. Therefore, the Committee believes that it is appropriate to empower State and local governments by providing them with access to subsidized financing to help promote energy-efficient policies tailored to the needs of local communities." H. R. Rep. No. 110-658, at 94 (2008). Moreover, in furtherance of such goals, the legislative history of the American Reinvestment and Recovery Act of 2009 ("ARRA") provides, as follows: "…[a]lso, the provision clarifies that capital expenditures to implement green community programs includes grants, loans and other repayment mechanisms to implement such programs. For example, this expansion will enable States to issue these tax credit bonds to finance retrofits of existing private buildings through loans and/or grants to individual homeowners or businesses, or through other repayment mechanisms. Other repayment mechanisms can include periodic fees assessed on a government bill or utility bill that approximates the energy savings of energy efficiency or conservation retrofits. Retrofits can include heating, cooling, lighting, water-saving, storm water-reducing, or other efficiency measures." H. R. Rep. No. 111-16, at 627 (2009).

Upon the enactment of the American Recovery and Reinvestment Act of 2009, $3.2 billion in allocation was made available for QECBs. That allocation has been ratably distributed among the states based on their populations pursuant to IRS Notice 2009-29 (found on the web at http://www.irs.gov/irb/2009-16_irb/ar10.html). Each large local governments (i.e., population of 100,000 or more) within a state received a proportionate amount of its state's allocation. Indian tribal governments are to be treated in the same manner as large local governments. Not more than 30 percent of the allocation to states or large local governments may be used for QECBs that are private activity bonds. Code Section 54D does not contain an expiration date for the use of the allocation, and it allows the large local governments to waive their allocations. Rules vary by state and locality on the use of the allocation and the applicable waiver processes.

In the case of any QECB that is for private activity purposes under Code Section 141, a qualified conservation purpose does not include any expenditure that is not a capital expenditure. Conversely, any bond that is issued to provide loans, grants or other repayment mechanisms for green community programs is not considered a private activity bond for purposes of the allocation formula.

Direct Subsidy Option for QECBs

The issuer may elect to receive a subsidy payment (the "Direct Payment"), or allow the investor to receive a tax credit against federal income taxes.

The Direct Payment is equal to the lesser of (1) the interest paid by the issuer on each interest payment date; or (2) 70 percent of the amount of interest that would have been payable had the issuer selected the tax credit option using applicable rate of the tax credit to determine the amount of interest. The rates are published each business day and found at https://www.treasurydirect.gov/GA-SL/SLGS/selectQTCDate.htm. The Direct Payment is established to be paid contemporaneously with each interest payment date on the obligation. For information on the payment mechanics, please see our alert or in IRS Notice 2010-35 found on the web at http://www.irs.gov/irb/2010-19_IRB/ar06.html.

The tax credit is measured quarterly on each March 15, June 15, September 15 and December 15. The credit may be claimed against both regular and AMT liability. The tax treatment of the credit is described in IRS Notice 2010-28 found on the web at http://www.irs.gov/irb/2010-15_IRB/ar08.html. IRS Notice 2009-15, dated Feb. 9, 2009, describes the manner for determining tax credit rates and may be found on the web at http://www.irs.gov/irb/2009-06_IRB/ar09.html.

The tax credits may be stripped in accordance with the rules that apply to the stripping of interest for tax-exempt bonds that are found in Code Section 1286. Please see our alert "IRS Announces Rules for Separating Tax Credits and Qualified Tax Credit Bonds" regarding the stripping rules that were issued in IRS Notice 2010-28 found on the web at http://www.irs.gov/irb/2010-15_IRB/ar08.html. Additionally, Code Section 54A provides that unused credits may be carried over to the ensuing tax year if the taxpayer is unable to use the credit as a result of the limitations in the statute.

The maturities of these bonds are subject to a maximum maturity that U.S. Treasury sets monthly based on the formula described in Code Section 54A(d)(5) and published the maximum maturity at https://www.treasurydirect.gov/GA-SL/SLGS/selectQTCDate.htm.

Expenditure of QECB Proceeds

All of the available project proceeds (APP)[4] must be spent on the qualified costs. APP on governmental QECB projects must be spent on the qualified conservation purposes that may include working capital, whereas APP on private activity QECBs must be spent on capital expenditures, i.e., costs chargeable to the account of the borrower (or would be so with a proper election).

APP is required to be used on the qualified purpose within three years of the date of issuance (with limited exceptions). This period operates as a temporary period for purposes of the arbitrage-rebate rules under Code Section 148. At issuance, the issuer must reasonably expect to comply with this test as well as reasonably expect to incur, within six months of issuance, expenditures amounting to 10 percent of the APP. If, at the end of three years, 100 percent of APP is not spent, the period may be extended by Treasury upon application to it. An application to extend the period must be submitted prior to the period's expiration. If the period is not extended, a portion of the bonds must be redeemed within 90 days. The portion to be redeemed shall be determined in accordance with the "non-qualified" bond rules in Code Section 142 and the regulations thereunder.

QECBs may be structured as non-amortizing, bullet obligations that allows the subsidy to be captured on the full principal amount over the life of the bond. That result is achieved using the reserve fund option. Generally, qualified tax credit bonds must satisfy the arbitrage-rebate rules found in Code Section 148. For the reserve fund to be so structured, there must be an expectation that the funds will be used to repay the issue; the reserve fund must not be funded at a rate more rapid than equal annual installments; the amount of deposits must not be expected to result in an amount greater than necessary to repay the issue; and the yield on the fund cannot exceed the rate used to determine the maximum maturity on the bonds, i.e. the permitted sinking fund yield that is published at https://www.treasurydirect.gov/GA-SL/SLGS/selectQTCDate.htm.

Other Restrictions

Code Section 54A provides that the issuer must certify that it is in compliance with state and local conflict of interest laws and additional Treasury rules that may exist or be promulgated. Lastly, the project being financed must comply with the Davis Bacon prevailing wage rules.

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[4] APP means the sales proceeds of an issue (i.e. the amount received from the purchaser) less issuance costs financed by the issue. Such issuance costs may not exceed two percent of the sales proceeds, plus the earnings on the difference between the sale proceeds and financed costs of issuance.

QECBs – Qualified Conservation Purposes

Capital Expenditures for:	Research	Other
➢ Reducing energy consumption in publicly-owned buildings by at least 20%	Expenditures for research facilities and research grants to support research in:	➢ Mass commuting facilities to reduce energy consumption
➢ Implementing green community programs, includes "the use of loans, grants, or other repayment mechanisms to implement such programs"	➢ Cellulosic ethanol & non-fossil fuel development ➢ Technologies for the capture & sequestration of carbon dioxide produced through the use of fossil fuels	➢ Demonstration projects including commerciali-zation of green building technology, agricultural biofuel conversion, advanced battery manu-facturing technologies, technologies to reduce peak use of electricity or technologies for the capture & sequestration of carbon dioxide emitted from combusting fossil fuels to produce electricity
➢ Rural development involving production of electricity from renewable energy resources	➢ Increasing in efficiency of existing technologies for producing non-fossil fuels	➢ Public education campaigns to promote energy efficiency
➢ New CREBs projects	➢ Automobile battery tech-nologies & other tech-nologies to reduce fossil fuel consumption in transportation	
	➢ Technologies to reduce energy use in buildings	