



## QUALIFIED SCHOOL CONSTRUCTION BONDS (QSCBs)

### Questions and Answers

#### ***What are Qualified School Construction Bonds?***

Qualified School Construction Bonds (QSCBs or Tax Credit Bonds) were created by the federal American Recovery and Reinvestment Act (ARRA) of 2009. A part of the government's economic stimulus initiatives, the QSCB program provides tax credit financing to public schools for school construction and other eligible projects. QSCB proceeds can be used for the construction, rehabilitation, repair, and equipping of a public school facility or for the acquisition of land on which a facility is to be built using bond proceeds.

QSCBs are issued by or on behalf of a local public education agency, usually in the form of a general obligation bond or a lease financing using certificates of participation or lease revenue bonds. QSCBs are not tax-exempt and generally pay little interest, since the investor receives an annual federal income tax credit intended to substitute for the coupon interest. This tax credit is "secured" by the federal government pursuant to its obligation to apply it.

#### ***Are QSCBs taxable?***

Yes. The tax credit creates phantom income to the investor subject to federal income tax in the year the credit is available. When QSCBs are structured to include semi-annual interest ("supplemental interest") in addition to the tax credit, this income also has been federally taxable. The supplemental interest is secured by the issuer pursuant to its obligation to provide funds to the trustee for debt service payments.

Whether or not the bonds are exempt from state income tax is less clear depending on the state and the opinion of bond counsel. Each issue's Official Statement will disclose the tax status and should be consulted.

#### ***How is the tax credit rate determined?***

The tax credit rate is published daily by the U.S. Treasury. The rate is based on the department's estimate of the yields on outstanding bonds with an investment grade rating between A and BBB for bonds of similar maturity on the business day immediately preceding the sale date of the QSCBs.

#### ***Are QSCBs structured with serial maturities?***

Generally not. Most QSCBs issued to date have been structured with a single "bullet" maturity in 14 to 17 years. The maximum maturity range is specified by the U.S. Treasury. Typically QSCBs also have a sinking fund structure which allows the issuer to make annual payments that will earn interest over the duration of the bonds so that they can be paid off by the issuer in full at maturity. The issuer's sinking fund deposits can be invested in a variety of permitted investments, and are not subject to conventional IRS arbitrage limitations. For certain lease transactions, an invested sinking fund may replace the traditional reserve fund requirement.

The tax credit rate, final maturity date, and permitted sinking fund yield limit for a QSCB issue are published on the following website, as applicable on the day a purchase contract for the issue is executed:

<https://www.treasurydirect.gov/GA-SL/SLGS/selectQTCDDate.htm>. The tax credit rate is updated daily and the final maturity date and permitted sinking fund yield are updated monthly.

#### ***What is the timing and amount of the tax credit?***

The tax credit is received quarterly in an amount equal to the product of the published credit rate for the date on which the QSCB is sold times the outstanding principal amount of the QSCB on the relevant credit allowance date, divided by four. The credit allowance dates are March 15, June 15, September 15, and December 15.

**What is the rate of return on a QSCB?**

The overall rate of return to an investor will be a combination of the applicable tax credit plus supplemental coupon interest or accreted discount, if any, that the bond may bear. Whether or not the issuer augments the tax credit with taxable supplemental interest or discount pricing is determined on a case-by-case basis depending on market conditions at the time of sale.

<b>Example of Calculating Tax Credit Benefit for Investors (35% Marginal Tax Rate)</b>		
(A)	Principal Amount	\$ 50,000.00
(B)	Annual Tax Credit Rate	5.76% *
(A x B = C)	Annual Tax Credit Amount	\$ 2,880.00
(C / 4)	Eligible Tax Credit Per Quarter	\$ 720.00
<b>Calculation of Tax Credit on Tax Return (tax credit must be claimed against income)</b>		
<b>Assuming an Investor in the 35.0% Marginal Tax Rate</b>		
(C = D)	Total Annual Income = Annual Tax Credit Amount	\$ 2,880.00
(D x .35 = E)	Total Federal Tax Liability	\$ 1,008.00
(D - E = F)	Total Annual After Tax Benefit	\$ 1,872.00
(F / A = G)	Effective Tax-Exempt Equivalent Yield	3.74%

\*Rate as on November 30, 2009. The tax credit rate is a national rate adjusted and published daily by the U.S. Treasury Department for all QCSBs. The rate published on the day of pricing determines the tax credit amount for the life of the Tax Credit Bonds. The example above shows the tax-exempt equivalent yield for the tax credit only; the example calculation does not include the additional yield from supplemental interest, if any.

Tax credits will be treated by the IRS similarly to the way withheld taxes are treated for federal income tax purposes: the credits will reduce the amount of a taxpayer's subsequent estimated tax payments, if any, or final tax liability, as reflected on the tax return for the related tax year. (Treatment of Tax Credit Bonds generally is defined in Sections 54A and 54AA of the IRS Tax Code.)

**Can the tax credit be separated from the QSCB?**

Eventually, yes. This feature is allowed by law but the IRS is working to provide guidance on how to implement the provision. Once approved, it will be possible to "strip" the tax credit from the bond at issuance, so that the credit will become a tax credit certificate that is separately registered from the principal component of the QSCB and is transferable. Generally the bond issuer will enter into an agreement with the trustee to provide a mechanism for the registration, transfer, and exchange of the tax credit strips by the tax credit bond owners. The strips may be sold at closing or in the secondary market.

**Are QSCBs subject to redemption prior to maturity?**

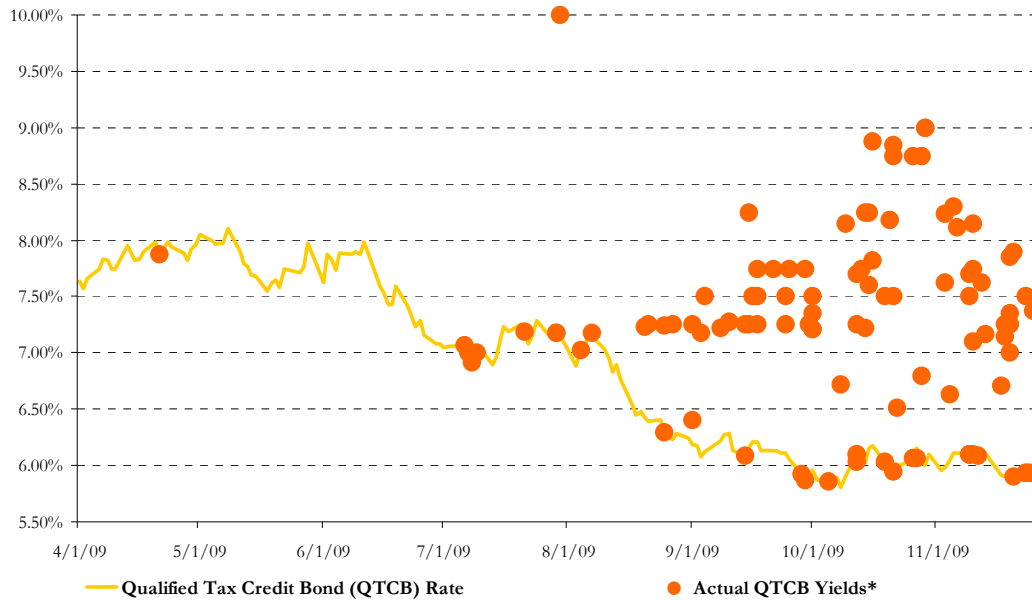
QSCBs are not subject to optional redemption prior to maturity. Under the ARRA, QSCBs may be subject to mandatory redemption under certain extraordinary circumstances, such as failure of the issuer to spend all of the bond proceeds within three years from the date of issue (absent any extension granted by the IRS) or if the QSCBs lose their tax credit status (as a result of, for example, bond proceeds not being spent on school facilities). Each issue's Official Statement will provide detail on redemption provisions.

**What is the expected volume of QSCBs?**

Under the ARRA, \$11 billion of Qualified School Construction Bond allocations were awarded to the 50 states in 2009 and a like amount will be awarded in 2010. (At present there is no authority under the ARRA to issue QSCBs after 2010.) Large school districts received 40% of the allocation directly from the federal government, while the 60% balance went to the states to be further allocated. Stone & Youngberg expects to bring to market approximately ten QSCB transactions for California school districts through the 1<sup>st</sup> quarter of 2010. In Arizona, the firm is assisting four school districts with the sale of QSCBs in the same period.

**Comparison of Qualified Tax Credit Bond Rates and Actual Yields**

(April 1, 2009 – November 25, 2009)

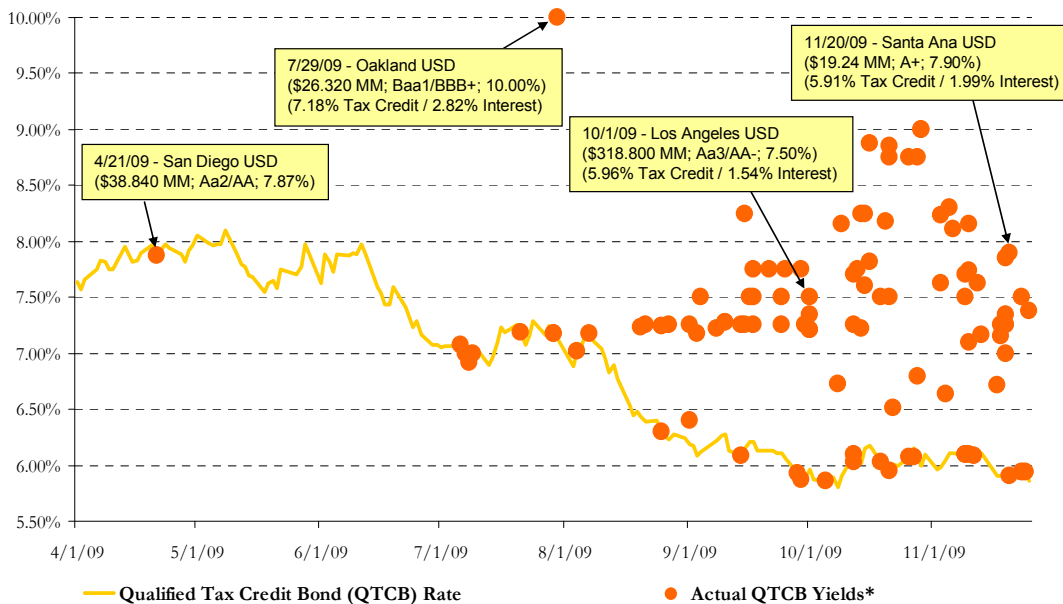


\* Represents yield including supplemental coupons and discount pricing, if any.

Sources: TreasuryDirect, Bloomberg, EMMA and Official Statements.

**Comparison of Qualified Tax Credit Bond Rates and Actual Yields**

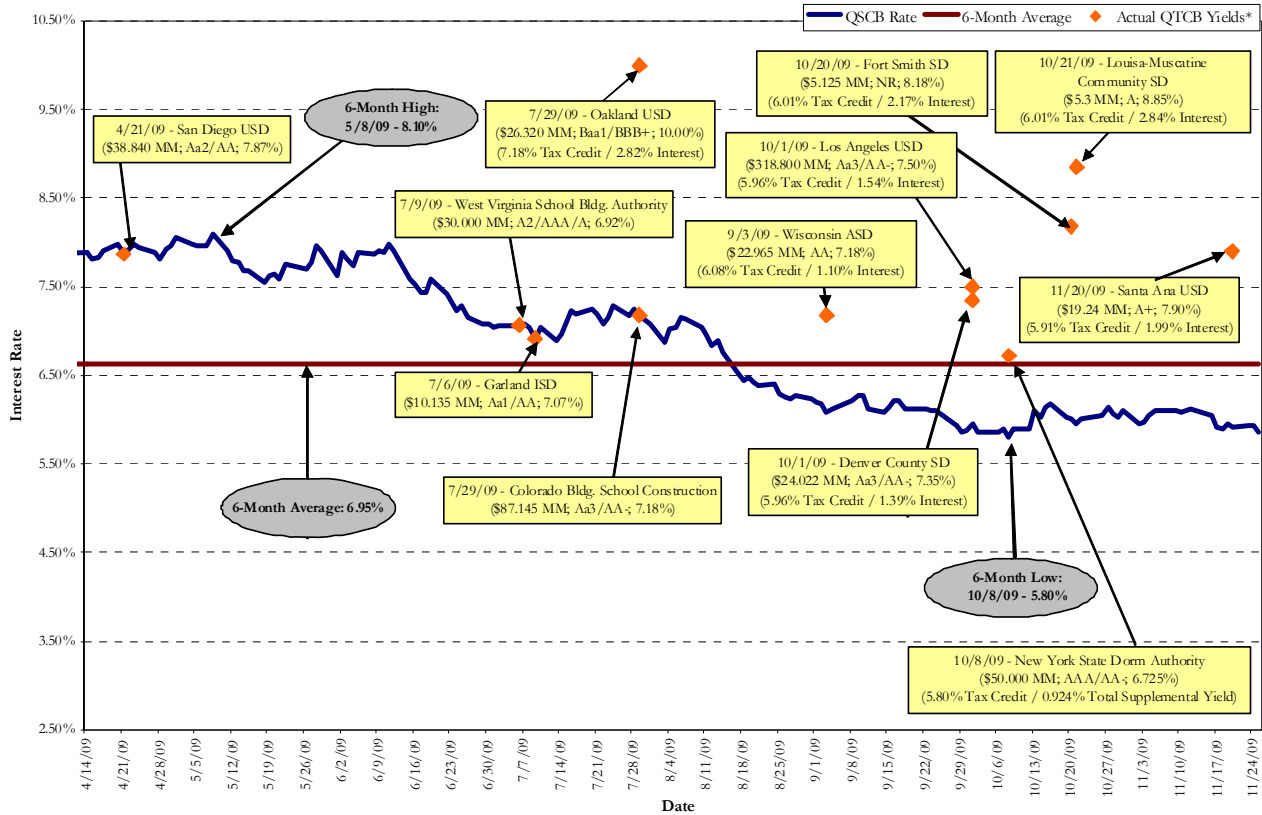
(April 1, 2009 – November 25, 2009)



\* Represents yield including supplemental coupons and discount pricing, if any.

Sources: TreasuryDirect, Bloomberg, EMMA and Official Statements.

**Qualified School Construction Bond (QSCB) Tax Credit Rates and Tax Credit Bond Sale Results**  
 (Select Issues - April 14, 2009 to November 25, 2009)



\*Yields shown are the tax credit yields or composite yields if Bonds included supplemental interest.

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