issue brief

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Qualified Zone Academy Bonds (QZABs)

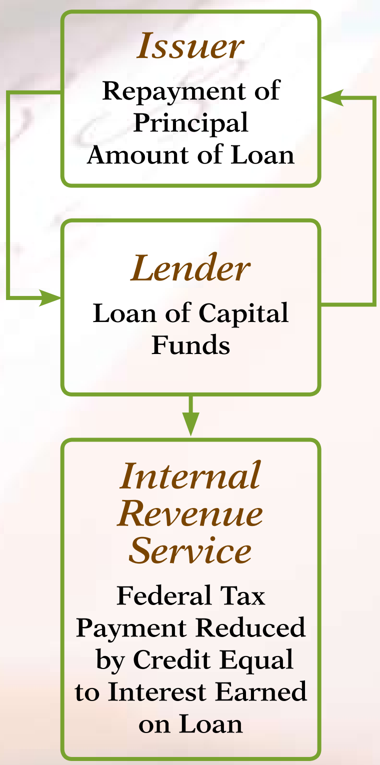
Summary

The Qualified Zone Academy Bond (QZAB) program permits public schools serving large concentrations of low-income families to benefit from interest-free financing to pay for building repair, invest in equipment and technology, develop challenging curricula, and train quality teachers. The federal government provided this tool under the "Taxpayer Relief Act of 1997" to help encourage formation of partnerships between public schools and local businesses.

QZABs Defined

The QZAB program allows schools to issue taxable bonds that provide financial institutions holding the bonds with a federal income tax credit in lieu of interest payments. The annual federal income tax credit received is based on a tax credit rate set by the U.S. Treasury multiplied by the par value of the QZAB bond sold.

As a result, the issuer pays principal only, with the federal government paying a tax credit to the institution. Only financial institutions meeting specific criteria are eligible for the tax credit.



The total QZAB allocation has been fixed at $400 million since 1998 and requires congressional authorization on an annual basis.[1] California has been allocated approximately $50 million (12.5 percent) of the total federal allocation in each of the past seven years.

Issuers are required to have authority under state and local laws to incur this additional debt.

[1] The current authorization is valid through fiscal year 2007.

Eligibility

Participating organizations must meet at least one of the following eligibility criteria before they can participate in the program.

Criteria 1: Public schools must be located in an empowerment zone or an enterprise community.

An empowerment zone (EZ) is a distressed area in need of sustainable community development, while an enterprise community (EC) is designated by the U.S. Department of Agriculture (rural communities) or Housing and Urban Development (urban communities) based on four key principals: economic opportunity, sustainable community development, community partnerships, and strategic vision.

Criteria 2: At least 35 percent of the school's students must be eligible for free or reduced-price lunch under the National School Lunch Act.

Under the National School Lunch Act, free meals are provided for students from families whose income is below 130 percent of the federal poverty level. Reduced-price lunches are provided if the family's income is between 130 percent and 180 percent of the federal poverty level. These eligibility requirements are applied on a school-by-school basis, rather than a system-wide basis.

Qualifications

Once eligible, the organization must meet some specific qualifications to participate.

Public schools must have an education program designed in cooperation with a participating business and receive a business donation that is not less than 10 percent of the net present value of the proceeds of the QZAB bond. The issuer must certify that it has written assurances that the 10 percent business donation requirement will be met with respect to the school.

Programs established with QZABs must have the goal of enhancing the academic curriculum, increasing graduation and employment rates, or better preparing students for college and the workforce. The school should work with its business partner to design a program that will best meet these goals.

A minimum of 95 percent of the bond proceeds of the issue must be used for a "qualified purpose". The term qualified purpose means rehabilitating or repairing the public school facility, providing equipment, developing course materials and training teachers and other school personnel. New construction is not allowed.

In addition, the issuer must reasonably expect to spend 95 percent of the bond proceeds within the first five years after the sale of the bond and to enter into binding contracts with third parties to spend at least 10 percent of the proceeds within the first six months after the sale. Issuers must also comply with arbitrage and information reporting requirements contained in Internal Revenue Code Sections 148 and 149(e).

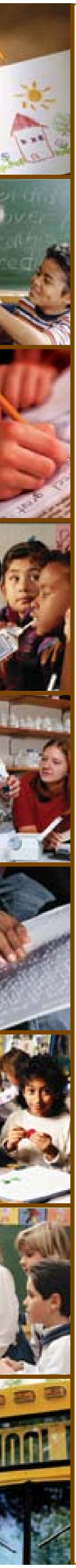
How QZABs Work

The following hypothetical example illustrates the process of utilizing the QZAB program:

ABCTech is a major computer employer located in an EC.

ABCTech has indicated a willingness to cooperate with a school in the same EC to establish a special academic program that will prepare students for jobs at the company. ABCTech is willing to make a donation of computer equipment and to provide internship and mentoring experiences for students.

The school has determined that it needs to renovate a classroom to accommodate the donated equipment. They also need to purchase appropriate instructional materials and train teachers to administer the program. The school estimates that this would cost $500,000.



In order to qualify for and issue a $500,000 QZAB, the school would need to take the following steps:

- The school obtains an estimate from ABCTech of the value of the proposed donation. If the value of ABCTech's donation is equal to at least 10 percent of the gross bond proceeds (10 percent of $500,000 or $50,000), the school could certify that it has a commitment from ABCTech for at least the 10 percent minimum donation requirement.
- School officials contact their financial officer and other school system personnel responsible for debt issuance. In most cases, the likely issuer would be the school district.
- School officials and their financial officer must determine the source of repayment of the $500,000. The QZAB tax credit mechanism may eliminate the interest cost, but the principal amount of the QZAB still must be repaid.
- The school district seeks an allocation from the California Department of Education (CDE) for an amount equal to the borrowing ($500,000). The CDE must then provide a written verification of an allocation of the QZAB volume limitation.
- Arrangements are made for a "qualified lender" to purchase the QZAB. The QZAB issue can be purchased by financial institutions such as banks, insurance companies and corporations actively engaged in the business of lending money.
- The proceeds of the QZAB are used to renovate and equip classrooms.

Administrative Considerations

QZABs are typically structured as private placement bonds with many taking the form of lease-purchase agreements. The private placement memorandum/bond purchase agreement, the business participant's written commitment and the school's spending plan should be reviewed by bond counsel to obtain an opinion for the qualified lender that the transaction has met the QZAB requirements that enable the bondholder to take the tax credit.

The purchaser may require the school system to set aside an amount each year in a sinking fund to ensure that the bond can be repaid when the bond matures.

QZABs are freely transferable. Institutions that do not have sufficient federal income tax liability to fully utilize the credit may sell the QZAB to others that can fully utilize the credit.

QZAB Financing Requirements for the California Department of Education

In cooperation with local educational agencies (LEA), financial advisers, Californians for School Facilities, the California State Treasurer, and the U.S. Department of Education, the CDE administers the QZAB program in California through its School Facilities Planning Division (SFPD).

The CDE has established the following parameters for participation in the QZAB program:

- Applications must be complete, with original signature, and be submitted with all required attachments by March 31st each year. If the program is not oversubscribed, the CDE will extend the application period. Multiple sites may be included in each application as long as each site meets the eligibility requirement.
- Charter schools are eligible to apply either directly or through the district in which they are located.
- The bond authorization cap for LEAs with enrollment of 2,500 or less is not to exceed $1 million; for LEAs with enrollment of 2,501 to 199,999, the cap is not to exceed $5 million.
- The bond issuance must occur six months after authorization, although an extension can be given on a case-by-case basis.
- Within 15 days of issuance, a copy of a placement memorandum or a letter stating the principal amount of issuance, date of issuance, and purchaser must be sent to the SFPD, certifying that the bonds have been issued.

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2004-05 QZAB Allocation Results

The following table provides the top QZAB lottery participants by size of LEA for the 2004-05 fiscal year:

LEA Name	Requested Amount
Local Educational Agency (enrollment less than 2,500)	
New West Charter School	$1,000,000
Firebaugh Las Deltas Unified School District	$1,000,000
Venture Academy	$1,000,000
Central County Occupational Center	$1,000,000
Romoland Elementary School District	$1,000,000
Local Educational Agency (enrollment between 2,500 and 199,999)	
Hemet Unified School District	$5,000,000
Torrance Unified School District	$2,320,000
Santee Elementary School District	$5,000,000
Pomona Unified School District	$5,000,000
Grant Joint Union High School District	$5,000,000
Local Educational Agency (enrollment of 200,000 or greater)	
Los Angeles Unified School District	$10,000,000

Additional Resources

The following are Internet sites containing information on QZABs:

The U.S. Department of Education

- http://www.ed.gov/programs/qualifiedzone/faq.html
- http://www.qzabs.com/

The California Department of Education

- http://www.cde.ca.gov/ls/fa/qz/

Acknowledgements

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