

Federal holidays. An informal docket may also be examined during normal business hours at the office of the Regional Air Traffic Division, AWP-520, 15000 Aviation Boulevard, Lawndale, CA 90261.

Persons interested in being placed on a mailing list for future NPRM's should contact the FAA's Office of Rulemaking, (202) 267-9677, for a copy of Advisory Circular No. 11-2A, Notice of Proposed Rulemaking Distribution System, which describes the application procedure.

### The Proposal

The FAA is proposing an amendment to Title 14 Code of Federal Regulations (14 CFR) part 73 (part 73) to revise and expand the dimensions of the current San Onofre MOAs over the Camp Pendleton, CA, area. The USMC has requested these changes because the existing special use airspace does not permit essential large-scale amphibious assault activities (including artillery live-fire, fixed-wing close air support, and remotely operated aircraft operations).

The existing restricted areas over Camp Pendleton are R-2503A, extending from the surface up to 2000 feet mean sea level (MSL); R-2503B, extending from the surface up to 15,000 feet MSL; and R-2503C, extending from 15,000 feet MSL to FL 270. These areas will not be changed. The San Onofre High and Low MOAs lie adjacent to the restricted areas from 2,000 feet MSL up to, but not including 8,000 feet MSL. This proposed amendment would convert the San Onofre High and Low MOAs, and the associated CFA to R-2503D, which would extend from 2,000 feet MSL up to 11,000 feet MSL. The San Onofre MOA and CFA designations would be revoked.

The time of designation for R-2503D would be intermittent by NOTAM 24 hours in advance, and limited to a maximum use of 20 days per year from 0600 to 2400 hours local time, and no more than 90 days per year between 0001 and 0600 local time. The restricted area would be available for joint-use and scheduled for training operations on an as needed basis subject to the maximum use limits.

The FAA has determined that this proposed regulation only involves an established body of technical regulations for which frequent and routine amendments are necessary to keep them operationally current. Therefore, this proposed regulation: (1) Is not a "significant regulatory action" under Executive Order 12866; (2) is not a "significant rule" under DOT Regulatory Policies and Procedures (44 FR 11034; February 26, 1979); and (3)

does not warrant preparation of a regulatory evaluation as the anticipated impact is so minimal. Since this is a routine matter that will only affect air traffic procedures and air navigation, it is certified that this rule, when promulgated, will not have a significant economic impact on a substantial number of small entities under the criteria of the Regulatory Flexibility Act.

### Environmental Review

This proposal will be subject to the appropriate environmental analysis in accordance with FAA Order 1050.1D, Policies and Procedures for Considering Environmental Impacts, prior to any FAA final regulatory action.

### List of Subjects in 14 CFR Part 73

Airspace, Navigation (air).

### The Proposed Amendment

In consideration of the foregoing, the Federal Aviation Administration proposes to amend 14 CFR part 73 as follows:

### PART 73—SPECIAL USE AIRSPACE

1. The authority citation for part 73 continues to read as follows:

**Authority:** 49 U.S.C. 106(g), 40103, 40113, 40120; E.O. 10854, 24 FR 9565, 3 CFR, 1959-1963 Comp., p. 389.

#### § 73.25 [Amended]

2. § 73.25 is amended as follows:

\* \* \* \* \*

#### R-2503D Camp Pendleton, CA [Added]

Boundaries. Beginning at lat. 33°22'42" N.; long. 117°36'45" W.; to lat. 33°27'13" N.; long. 117°34'17" W.; to lat. 33°18'41" N.; long. 117°23'58" W.; to lat. 33°17'30" N.; long. 117°16'43" W.; to lat. 33°14'09" N.; long. 117°26'38" W.; to the point of the beginning by following a line 1 NM from and parallel to the shoreline.

Designated altitudes. 2,000 feet MSL to 11,000 feet MSL.

Time of designation. Intermittent by NOTAM 24 hours in advance not to exceed 20 days per year from 0600 to 2400 local time and not more than 90 days per year between 0001 and 0600 local.

Controlling agency. FAA, Southern California TRACON.

Using agency. U.S. Marine Corps, Commanding General, MCB Camp Pendleton, CA.

\* \* \* \* \*

Issued in Washington, DC, March 18, 2004.

**Reginald C. Matthews,**

*Manager, Airspace and Rules.*

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## DEPARTMENT OF THE TREASURY

### Internal Revenue Service

#### 26 CFR Part 1

[REG-121475-03]

RIN 1545-BC61

### Qualified Zone Academy Bonds; Obligations of States and Political Subdivisions

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Notice of proposed rulemaking and notice of public hearing.

**SUMMARY:** This document contains proposed regulations that amend the final regulations on qualified zone academy bonds. These regulations provide guidance to State and local governments that issue qualified zone academy bonds and to banks, insurance companies, and other taxpayers that hold those bonds. These regulations provide guidance on the maximum term, permissible use of proceeds, and remedial actions for qualified zone academy bonds. This document also provides notice of a public hearing on these proposed regulations.

**DATES:** Written or electronic comments on this rule must be received by June 24, 2004. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for July 21, 2004, at 10 a.m., must be received by July 12, 2004. Comments on the collection of information should be received by May 25, 2004.

**ADDRESSES:** Send submissions to CC:PA:LPD:PR (REG-121475-03), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-121475-03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the IRS Internet site at: <http://www.irs.gov/regs>. The public hearing will be held in room 7218, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

**FOR FURTHER INFORMATION CONTACT:** Concerning the regulations, Timothy L. Jones or Zoran Stojanovic, (202) 622-3980; concerning submissions of comments, the hearing, and requests to be placed on the building access list to attend the meeting, Guy R. Traynor, (202) 622-3693 (not toll-free numbers).

**SUPPLEMENTARY INFORMATION:**

### Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP; Washington, DC 20224. Comments on the collection of information should be received by May 25, 2004. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (*see below*);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in this proposed regulation is in § 1.1397E-1(h). This collection of information is required by the IRS to verify compliance with section 1397E. This information will be used to identify issuers of qualified zone academy bonds that have established a defeasance escrow as a remedial action taken because of failure to satisfy certain requirements of section 1397E. The collection of information is required to obtain or retain a benefit. The likely respondents are states or local governments that issue qualified zone academy bonds.

*Estimated total annual reporting burden:* 3 hours.

*Estimated average annual burden hours per respondent:* 30 minutes.

*Estimated number of respondents:* 6.

*Estimated annual frequency of responses:* varies.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information

unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

### Background

Section 1397E(a) of the Internal Revenue Code (Code) provides that 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 credit against Federal income tax for the taxable year that includes the credit allowance date. In general, a qualified zone academy bond is a bond issued by a State or local government to finance certain eligible public school purposes under section 1397E(d). Section 1397E(b) provides that the amount of the qualified zone academy bond credit equals the product of the credit rate and the face amount of the bond held by the taxpayer on the credit allowance date. Under section 1397E(b)(2), the credit rate is determined by the Treasury Department and equals the percentage that the Department estimates generally will permit the issuance of qualified zone academy bonds without discount and without interest cost to the issuer. Section 1397E(f)(1) defines *credit allowance date* as the last day of the one-year period beginning on the date of issuance of the issue and the last day of each successive one-year period thereafter. Under section 1397E(d)(3), the maximum term of a qualified zone academy bond is determined by the Treasury Department and equals the term that the Department estimates will result in the present value of the obligation to repay the principal on the bond being equal to 50 percent of the face amount of the bond.

Section 1397E(g) provides that the amount of the qualified zone academy bond credit allowed to the taxpayer is included in the taxpayer's gross income.

Section 1397E(e) imposes a national limitation on the amount of qualified zone academy bonds that may be issued for each calendar year. The limitation is allocated by the Treasury Department among the States on the basis of their respective populations of individuals below the poverty line.

Temporary regulations (TD 8755) interpreting section 1397E were published on January 7, 1998 (63 FR 671), and amended on July 1, 1999 (TD 8826; 64 FR 35573). Final regulations

under section 1397E (TD 8903) (the final regulations) were published on September 26, 2000 (65 FR 57732). This document contains proposed regulations (the proposed regulations) that would amend the final regulations.

### Explanation of Provisions

#### I. Maximum Term

Section 1397E(d)(3) provides that the Secretary of the Treasury Department shall determine, during each calendar month, the maximum term for qualified zone academy bonds issued during the following calendar month. Section 1397E(d)(3) states that the maximum term shall be the term that the Secretary estimates will result in the present value of the obligation to repay the principal on the bond being equal to 50 percent of the face amount of the bond. Section 1.1397E-1(d) of the final regulations provides that 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 applicable Federal rate (AFR), compounded semi-annually, for the month in which the bond is issued. The IRS publishes the long-term adjusted AFR each month in a revenue ruling.

Section 1397E(b)(2) provides that the Secretary shall determine, during each calendar month, a credit rate for qualified zone academy bonds issued during the following calendar month. Section 1.1397E-1(b) provides that the Secretary shall determine monthly (or more often as deemed necessary by the Secretary) the credit rate the Secretary estimates generally will permit the issuance of a qualified zone academy bond without discount and without interest cost to the issuer. Notice 99-35 (1999-2 C.B. 26) indicates that, until further notice, the credit rate for a qualified zone academy bond will be published daily by the Bureau of Public Debt on its Internet site for State and Local Government Series securities (<http://www.publicdebt.treas.gov>). Notice 99-35 also provides that the credit rate shall be applied to a qualified zone academy bond on the first day on which there is a binding contract in writing for the sale or exchange of the bond. Notice 99-35 states that the credit rate will be determined by the Treasury Department based on its estimate of the yield on outstanding AA rated corporate bonds of a similar maturity for the business day immediately prior to the date on which there is a binding contract in writing for the sale or exchange of the bond.

Questions have been raised regarding the maximum term of a qualified zone

academy bond that is sold in one month and issued in another month. Section 1.1397E-1(d) provides that the maximum term is determined based on the month in which the bond is issued. However, under Notice 99-35, the credit rate for a qualified zone academy bond is determined based on the first day on which there is a binding contract in writing for the sale or exchange of the bond. The credit rate and maximum term should be determined on the same day because the credit rate for a bond depends on its maximum term. Accordingly, the proposed regulations amend § 1.1397E-1(d) to provide that the maximum term for a qualified zone academy bond is determined based on the first day on which there is a binding contract in writing for the sale or exchange of the bond.

## II. Use of Proceeds and Remedial Actions

### A. In General

Section 1397E(d)(1)(A) provides that a bond issued as part of an issue is a qualified zone academy bond only if, among other requirements, at least 95 percent of the proceeds of the issue are to be used for a qualified purpose with respect to a qualified zone academy established by an eligible local education agency (as defined in section 1397E(d)(4)(B)). Section 1397E(d)(5) defines *qualified purpose*, with respect to any qualified zone academy, as (i) rehabilitating or repairing the public school facility in which such academy is established, (ii) providing equipment for use at such academy, (iii) developing course materials for education to be provided at such academy, and (iv) training teachers and other school personnel in such academy. Section 1397E(d)(4)(A) defines *qualified zone academy* as any public school (or academic program within a public school) that is established by and operated under the supervision of an eligible local education agency to provide education or training below the postsecondary level if: (1) The public school or program is designed in cooperation with business in accordance with section 1397E(d)(4)(A)(i); (2) students in the public school or program will be subject to the same academic standards and assessments as other students educated by the eligible local education agency; (3) the comprehensive education plan of the public school or program is approved by the eligible local education agency; and (4) the public school is located in an empowerment zone or enterprise community (as defined in section 1393), or there is a reasonable

expectation (as of the date of issuance of the bonds) that at least 35 percent of the students attending the school or participating in the program will be eligible for free or reduced-cost lunches under the school lunch program established under the Richard B. Russell National School Lunch Act.

### B. Compliance With 95-Percent Test

#### 1. In General

Comments have been received requesting guidance on compliance with the 95-percent test in section 1397E(d)(1)(A). The proposed regulations provide that, in general, an issue must satisfy three requirements to comply with section 1397E(d)(1)(A). First, the issuer must reasonably expect, as of the date of issuance of the issue, that at least 95 percent of the proceeds of the issue will be expended with due diligence. Second, the issuer must reasonably expect, as of the date of issuance of the issue, that at least 95 percent of the proceeds of the issue will be used for a qualified purpose with respect to a qualified zone academy for the entire term of the issue (without regard to any redemption provision). Third, except as otherwise provided in the remedial action provisions of the proposed regulations, discussed below, at least 95 percent of the proceeds of the issue must actually be used for a qualified purpose with respect to a qualified zone academy for the entire term of the issue (without regard to any redemption provision). For these purposes, any unspent proceeds are treated as used for a qualified purpose with respect to a qualified zone academy during any period that the issuer reasonably expects that those proceeds will be expended with due diligence for a qualified purpose with respect to a qualified zone academy.

#### 2. Proceeds Expended for Rehabilitation, Repair or Equipment

Section 1397E(d)(5)(A) and (B) provides that the term *qualified purpose* with respect to any qualified zone academy includes rehabilitating or repairing the public school facility in which such academy is established, and providing equipment for use at such academy. The proposed regulations specify that, if proceeds of an issue are expended for a purpose described in section 1397E(d)(5)(A) or (B) with respect to a qualified zone academy, then those proceeds are treated as used for a qualified purpose with respect to the academy during any period after such expenditure that (1) the property financed with those proceeds is used for the purposes of the academy and (2) the

academy maintains its status as a qualified zone academy. For this purpose, the retirement from service of financed property due to normal wear or obsolescence does not cause the property not to be used for a qualified purpose with respect to a qualified zone academy.

#### 3. Proceeds Expended To Develop Course Materials or Train Teachers

Section 1397E(d)(5)(C) and (D) provides that the term *qualified purpose* with respect to any qualified zone academy includes developing course materials for education to be provided at such academy, and training teachers and other school personnel in such academy. The proposed regulations provide that, if proceeds of an issue are expended for a purpose described in section 1397E(d)(5)(C) or (D) with respect to a qualified zone academy, then those proceeds are treated as used for a qualified purpose with respect to the academy during any period after such expenditure.

#### 4. Special Rule for Determining Status as Qualified Zone Academy

Section 1397E(d)(4)(A)(iv) provides that a public school (or academic program within a public school) is a qualified zone academy only if, among other requirements, the public school is located in an empowerment zone or enterprise community, or there is a reasonable expectation (as of the date of issuance of the bonds) that at least 35 percent of the students attending the school or participating in the program (as the case may be) will be eligible for free or reduced-cost lunches under the school lunch program established under the Richard B. Russell National School Lunch Act. For purposes of determining whether an issue complies with section 1397E(d)(4)(A)(iv), the proposed regulations provide that a public school is treated as located in an empowerment zone or enterprise community for the entire term of the issue if the public school is located in an empowerment zone or enterprise community on the date of issuance of the issue.

### C. Remedial actions

#### 1. In General

Comments have been received requesting guidance specifying remedial actions that may be taken to cure a violation of the 95-percent test in section 1397E(d)(1)(A).

The proposed regulations specify two remedial actions that may be taken in certain circumstances if less than 95 percent of the proceeds of an issue is actually used for a qualified purpose

with respect to a qualified zone academy. These remedial actions are available only if the issuer reasonably expected on the date of issuance of the issue that: (1) at least 95 percent of the proceeds of the issue would be expended with due diligence; and (2) at least 95 percent of the proceeds of the issue would be used for a qualified purpose with respect to a qualified zone academy for the entire term of the issue (without regard to any redemption provision).

As discussed below, the two remedial actions specified in the proposed regulations are (1) redemption or defeasance of the nonqualified bonds and (2) alternative use of the disposition proceeds. If the applicable requirements are met, the *redemption or defeasance* remedial action is available to cure any failure to satisfy the 95-percent test that was not reasonably expected as of the date of issuance. The *alternative use of disposition proceeds* remedial action applies only to certain dispositions of financed property for cash.

## 2. Redemption or Defeasance of Nonqualified Bonds

A *redemption or defeasance* remedial action is taken if: (1) All of the nonqualified bonds of the issue (determined by applying the principles of § 1.142-2(e)) are redeemed within 90 days after the date on which the failure to properly use proceeds occurs; (2) if any nonqualified bonds of the issue are not redeemed within 90 days after the date on which the failure to properly use proceeds occurs (the unredeemed nonqualified bonds), a defeasance escrow is established for the unredeemed nonqualified bonds within 90 days after the date on which the failure to properly use proceeds occurs; or (3) if the failure to properly use proceeds is a disposition of financed property described in section 1397E(d)(5)(A) or (B) and the consideration for the disposition is exclusively cash, all of the disposition proceeds (as defined in § 1.141-12(c)(1)) are used within 90 days after the date of the disposition to redeem, or establish a defeasance escrow for, a pro rata portion of the nonqualified bonds of the issue.

For proceeds that are not spent, a failure to properly use proceeds occurs on the earlier of: (1) The first date on which the public school (or academic program within the public school) does not constitute a qualified zone academy; and (2) the first date on which the issuer reasonably expects that less than 95 percent of the proceeds of the issue will be expended with due diligence for a qualified purpose with respect to a

qualified zone academy. For proceeds that have been spent for rehabilitation, repair or equipment described in section 1397E(d)(5)(A) or (B) with respect to a qualified zone academy, a failure to properly use proceeds occurs on the earlier of: (1) The first date on which the public school (or academic program within the public school) does not constitute a qualified zone academy; and (2) the first date on which an action is taken that causes less than 95 percent of the proceeds of the issue to be used for a qualified purpose with respect to a qualified zone academy. If proceeds have been spent for course materials or training described in section 1397E(d)(5)(C) or (D) with respect to a qualified zone academy, no event subsequent to such expenditure shall constitute a failure to properly use such proceeds.

A defeasance escrow is defined as an irrevocable escrow established to retire bonds on the earliest call date after the date on which the failure to properly use proceeds occurs in an amount that is sufficient to retire the bonds on that call date. At least 90 percent of the weighted average amount in a defeasance escrow must be invested in investments (as defined in § 1.148-1(b)), except that no amount in a defeasance escrow may be invested in any investment the obligor (or any person that is a related party with respect to the obligor within the meaning of § 1.150-1(b)) of which is a user of proceeds of the bonds. All purchases or sales of an investment in a defeasance escrow must be made at the fair market value of the investment within the meaning of § 1.148-5(d)(6).

In addition, the issuer must pay to the United States, at the same time and in the same manner as rebate amounts are required to be paid under § 1.148-3 (or at such other time or in such other manner as the Commissioner may prescribe), 100 percent of the investment earnings on amounts in the defeasance escrow. For this purpose, the first computation period begins on the date on which the failure to properly use proceeds occurs.

Proceeds of qualified zone academy bonds (other than unspent proceeds of the issue for which the failure to properly use proceeds occurs) are not permitted to be used to redeem or defease the nonqualified bonds. The issuer must provide written notice to the Commissioner of the establishment of the defeasance escrow within 90 days of the date the defeasance escrow is established.

## 3. Alternative Use of the Disposition Proceeds

The *alternative use of disposition proceeds* remedial action has four requirements. First, the failure to properly use proceeds must be a disposition of financed property described in section 1397E(d)(5)(A) or (B) and the consideration for the disposition must be exclusively cash. Second, the issuer must reasonably expect as of the date of the disposition that: (1) All of the disposition proceeds, plus any amounts received from investing the disposition proceeds, will be expended within two years after the date of the disposition for a qualified purpose with respect to a qualified zone academy; or (2) to the extent not expected to be so expended, used within 90 days after the date of the disposition to take a *redemption or defeasance* remedial action. Third, the disposition proceeds, plus any amounts received from investing the disposition proceeds, must be treated as proceeds for purposes of section 1397E. Fourth, if all of the disposition proceeds, plus any amounts received from investing the disposition proceeds, are not actually expended for a qualified purpose within the two-year period beginning on the date of the disposition (or used within 90 days after the date of the disposition to take a *redemption or defeasance* remedial action), the remainder of such amounts must be used within 90 days after the end of that two-year period for a *redemption or defeasance* remedial action.

### D. Definition of Proceeds

In general, § 1.148-1(b) defines sale proceeds as any amounts actually or constructively received from the sale of an issue, including amounts used to pay underwriters' discount or compensation. The proposed regulations provide that, for purposes of the qualified zone academy bond provisions (other than the private business contribution requirement, discussed below), proceeds means sale proceeds as defined in § 1.148-1(b), plus any amounts received from investing sale proceeds. Thus, under the proposed regulations, the requirement in section 1397E(d)(1)(A) that at least 95 percent of the proceeds of an issue be used for a qualified purpose with respect to a qualified zone academy is applied by taking into account not only the sale proceeds of the issue, but also any amounts received from investing those sale proceeds.

Section 1397E(d)(1)(C)(ii) provides that a bond is a qualified zone academy bond only if, among other requirements,

the issuer certifies that it has written assurances that the private business contribution requirement of section 1397E(d)(2) will be met with respect to the qualified zone academy. Section 1397E(d)(2)(A) provides that the private business contribution requirement is met if the eligible local education agency that established the qualified zone academy has written commitments from private entities to make qualified contributions (as defined in section 1397E(d)(2)(B)) having a present value (as of the date of issuance of the issue) of not less than ten percent of the proceeds of the issue. The proposed regulations provide that, for purposes of the private business contribution requirement of section 1397E(d)(2), proceeds means sale proceeds as defined in § 1.148-1(b). Thus, the private business contribution requirement is applied by taking into account only the sale proceeds of the issue without regard to any amounts received or expected to be received from investing those sale proceeds.

#### *E. Payment of Principal, Interest or Redemption Price*

The proposed regulations provide that the use of proceeds of a bond to pay principal, interest or redemption price of the bond or another bond is not a qualified purpose within the meaning of section 1397E(d)(5). Thus, the use of proceeds of a bond to refund another bond is not a qualified purpose. In addition, the use of proceeds of a bond to fund a sinking fund to repay the bond is not a qualified purpose.

#### **Proposed Effective Dates**

The proposed regulations are proposed to apply to bonds sold on or after the date that is 60 days after publication of final regulations in the **Federal Register** (the effective date). Issuers may apply the proposed regulations in whole, but not in part, to bonds sold before the effective date, except that: (1) issuers may apply the proposed regulations without regard to § 1.1397E-1(h)(8) (relating to the definition of proceeds) to bonds sold before the effective date; and (2) § 1.1397E-1(d) (relating to the maximum term of a qualified zone academy bond) and § 1.1397E-1(h)(2) (relating to reimbursement of expenditures with proceeds of a qualified zone academy bond) may not be applied to bonds issued before July 1, 1999.

#### **Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined

in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. As previously noted, it is estimated that each year only six issuers of qualified zone academy bonds will be required to report the establishment of a defeasance escrow, and the estimated burden of each such reporting is only 30 minutes. In addition, the establishment of a defeasance escrow need only be reported once. Therefore, a regulatory flexibility analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

#### **Comments and Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments that are submitted timely (preferably a signed original and eight copies) to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for July 21, 2004, at 10 a.m. in room 7218, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the lobby more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, *see* the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit written comments by June 24, 2004, and submit an outline of the topics to be discussed and the amount of time to be devoted to each topic by July 12, 2004.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has

passed. Copies of the agenda will be available free of charge at the hearing.

Comments are requested on all aspects of the proposed regulations.

#### **Drafting Information**

The principal authors of these regulations are Timothy L. Jones and Zoran Stojanovic, Office of Associate Chief Counsel, IRS (Tax Exempt and Governmental Entities), and Stephen J. Watson, Office of Tax Policy, Treasury Department. However, other personnel from the IRS and the Treasury Department participated in their development.

#### **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

#### **Proposed Amendments to the Regulations**

Accordingly, 26 CFR Part 1 is proposed to be amended as follows:

#### **PART 1—INCOME TAXES**

**Paragraph 1.** The authority citation for part 1 continues to read in part as follows:

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

**Par. 2.** Section 1.1397E-1 is amended by:

1. Revising the last sentence in paragraph (a).
2. Revising paragraphs (d) and (h).
3. Redesignating the text of paragraph (k) as paragraph (k)(1) and adding a heading for newly designated paragraph (k)(1).
4. Adding paragraph (k)(2).

The revisions and additions read as follows:

#### **§ 1.1397E-1 Qualified zone academy bonds.**

(a) \* \* \* This section also provides other rules for qualified zone academy bonds, including rules governing the credit rate, the private business contribution requirement, the maximum term, use of proceeds, remedial actions, and eligible issuers.

\* \* \* \* \*

(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 sold. 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. A bond is sold on the first day on which

there is a binding contract in writing for the sale or exchange of the bond.

\* \* \* \* \*

(h) *Use of proceeds*—(1) *In general.* Section 1397E(d)(1)(A) provides that a bond issued as part of an issue is a qualified zone academy bond only if, among other requirements, at least 95 percent of the proceeds of the issue are to be used for a qualified purpose with respect to a qualified zone academy established by an eligible local education agency (as defined in section 1397E(d)(4)(B)). Section 1397E(d)(5) defines *qualified purpose*, with respect to any qualified zone academy, as rehabilitating or repairing the public school facility in which such academy is established, providing equipment for use at such academy, developing course materials for education to be provided at such academy, and training teachers and other school personnel in such academy. Section 1397E(d)(4)(A) defines *qualified zone academy* as any public school (or academic program within a public school) that is established by and operated under the supervision of an eligible local education agency to provide education or training below the postsecondary level and that meets the requirements of section 1397E(d)(4)(A)(i), (ii), (iii) and (iv).

(2) *Use of proceeds requirements.* An issue meets the requirements of section 1397E(d)(1)(A) only if—

(i) The issuer reasonably expects, as of the date of issuance of the issue, that—

(A) At least 95 percent of the proceeds of the issue will be expended with due diligence; and

(B) At least 95 percent of the proceeds of the issue will be used for a qualified purpose with respect to a qualified zone academy for the entire term of the issue (without regard to any redemption provision); and

(ii) Except as otherwise provided in paragraph (h)(7) of this section, at least 95 percent of the proceeds of the issue is actually used for a qualified purpose with respect to a qualified zone academy for the entire term of the issue (without regard to any redemption provision).

(3) *Unspent proceeds.* For purposes of paragraphs (h)(2)(i)(B) and (h)(2)(ii) of this section, unspent proceeds are treated as used for a qualified purpose with respect to a qualified zone academy during any period that the issuer reasonably expects that those proceeds will be expended with due diligence for a qualified purpose with respect to a qualified zone academy.

(4) *Proceeds expended for rehabilitation, repair or equipment*—(i)

*In general.* Section 1397E(d)(5)(A) and (B) provides that the term *qualified purpose* with respect to any qualified zone academy includes rehabilitating or repairing the public school facility in which such academy is established, and providing equipment for use at such academy. If proceeds of an issue are expended for a purpose described in section 1397E(d)(5)(A) or (B) with respect to a qualified zone academy, then those proceeds are treated as used for a qualified purpose with respect to the academy during any period after such expenditure that—

(A) The property financed with those proceeds is used for the purposes of the academy; and

(B) The academy maintains its status as a qualified zone academy under section 1397E(d)(4).

(ii) *Retirement from service.* The retirement from service of financed property due to normal wear or obsolescence does not cause the property not to be used for a qualified purpose with respect to a qualified zone academy.

(5) *Proceeds expended to develop course materials or train teachers.*

Section 1397E(d)(5)(C) and (D) provides that the term *qualified purpose* with respect to any qualified zone academy includes developing course materials for education to be provided at such academy, and training teachers and other school personnel in such academy. If proceeds of an issue are expended for a purpose described in section 1397E(d)(5)(C) or (D) with respect to a qualified zone academy, then those proceeds are treated as used for a qualified purpose with respect to the academy during any period after such expenditure.

(6) *Special rule for determining status as qualified zone academy.* Section 1397E(d)(4)(A)(iv) provides that a public school (or academic program within a public school) is a qualified zone academy only if, among other requirements, the public school is located in an empowerment zone or enterprise community (as defined in section 1393), or there is a reasonable expectation (as of the date of issuance of the bonds) that at least 35 percent of the students attending the school or participating in the program (as the case may be) will be eligible for free or reduced-cost lunches under the school lunch program established under the Richard B. Russell National School Lunch Act. For purposes of determining whether an issue complies with section 1397E(d)(4)(A)(iv), a public school is treated as located in an empowerment zone or enterprise community for the entire term of the issue if the public

school is located in an empowerment zone or enterprise community on the date of issuance of the issue.

(7) *Remedial actions*—(i) *General rule.* If less than 95 percent of the proceeds of an issue is actually used for a qualified purpose with respect to a qualified zone academy, the issue will be treated as meeting the requirements of section 1397E(d)(1)(A) if the issue met the requirements of paragraph (h)(2)(i) of this section and a remedial action is taken under paragraph (h)(7)(ii) or (iii) of this section.

(ii) *Redemption or defeasance*—(A) *In general.* A remedial action is taken under this paragraph (h)(7)(ii) if the requirements of paragraphs (h)(7)(ii)(B) and (C) of this section are met.

(B) *Retirement of nonqualified bonds*—(1) *In general.* The requirements of this paragraph (h)(7)(ii)(B) are met if—

(i) All of the nonqualified bonds of the issue (determined by applying the principles of § 1.142–2(e)) are redeemed within 90 days after the date on which the failure to properly use proceeds occurs (as determined under paragraph (h)(7)(ii)(D) of this section); or

(ii) If any nonqualified bonds of the issue are not redeemed within 90 days after the date on which the failure to properly use proceeds occurs (the unredeemed nonqualified bonds), a defeasance escrow is established for the unredeemed nonqualified bonds within 90 days after the date on which the failure to properly use proceeds occurs.

(2) *Special rule for dispositions for cash.* If the failure to properly use proceeds is a disposition of financed property described in section 1397E(d)(5)(A) or (B) and the consideration for the disposition is exclusively cash, the requirements of this paragraph (h)(7)(ii)(B) are met if all of the disposition proceeds (as defined in § 1.141–12(c)(1)) are used within 90 days after the date of the disposition to redeem, or establish a defeasance escrow for, a pro rata portion of the nonqualified bonds of the issue.

(3) *Definition of defeasance escrow.* For purposes of this section, a defeasance escrow is an irrevocable escrow established to retire bonds on the earliest call date after the date on which the failure to properly use proceeds occurs in an amount that is sufficient to retire the bonds on that call date. At least 90 percent of the weighted average amount in a defeasance escrow must be invested in investments (as defined in § 1.148–1(b)), except that no amount in a defeasance escrow may be invested in any investment the obligor (or any person that is a related party with respect to the obligor within the

meaning of § 1.150–1(b) of which is a user of proceeds of the bonds. All purchases or sales of an investment in a defeasance escrow must be made at the fair market value of the investment within the meaning of § 1.148–5(d)(6).

(C) *Additional rules—(1) Limitation on source of funding.* Proceeds of qualified zone academy bonds (other than unspent proceeds of the issue for which the failure to properly use proceeds occurs) must not be used to redeem or defease nonqualified bonds under paragraph (h)(7)(ii)(B) of this section.

(2) *Rebate requirement.* The issuer must pay to the United States, at the same time and in the same manner as rebate amounts are required to be paid under § 1.148–3 (or at such other time or in such other manner as the Commissioner may prescribe), 100 percent of the investment earnings on amounts in a defeasance escrow established under paragraph (h)(7)(ii)(B) of this section. For this purpose, the first computation period begins on the date on which the failure to properly use proceeds occurs under paragraph (h)(7)(ii)(D) of this section.

(3) *Notice of defeasance.* The issuer must provide written notice to the Commissioner, at the place designated in § 1.150–5(a), of the establishment of the defeasance escrow within 90 days of the date the defeasance escrow is established.

(D) *When a failure to properly use proceeds occurs—(1) Proceeds not spent.* For proceeds that are not spent, a failure to properly use proceeds occurs on the earlier of—

(i) The first date on which the public school (or academic program within the public school) does not constitute a qualified zone academy; and

(ii) The first date on which the issuer reasonably expects that less than 95 percent of the proceeds of the issue will be expended with due diligence for a qualified purpose with respect to a qualified zone academy.

(2) *Proceeds spent for rehabilitation, repair or equipment.* For proceeds that have been spent for a purpose described in section 1397E(d)(5)(A) or (B) with respect to a qualified zone academy, a failure to properly use proceeds occurs on the earlier of—

(i) The first date on which the public school (or academic program within the public school) does not constitute a qualified zone academy; and

(ii) The first date on which an action is taken that causes less than 95 percent of the proceeds of the issue to be used for a qualified purpose with respect to a qualified zone academy.

(3) *Proceeds spent for course materials or training.* If proceeds have been spent for a purpose described in section 1397E(d)(5)(C) or (D) with respect to a qualified zone academy, no event subsequent to such expenditure shall constitute a failure to properly use such proceeds.

(iii) *Alternative use of disposition proceeds.* A remedial action is taken under this paragraph (h)(7)(iii) if all of the requirements of paragraphs (h)(7)(iii)(A) through (D) are met—

(A) The failure to properly use proceeds (as determined under paragraph (h)(7)(ii)(D) of this section) is a disposition of financed property described in section 1397E(d)(5)(A) or (B) and the consideration for the disposition is exclusively cash;

(B) The issuer reasonably expects as of the date of the disposition that—

(1) All of the disposition proceeds (as defined in § 1.141–12(c)(1)), plus any amounts received from investing the disposition proceeds, will be expended within two years after the date of the disposition for a qualified purpose with respect to a qualified zone academy; or

(2) To the extent not expected to be so expended, used within 90 days after the date of the disposition to redeem or defease bonds in a manner that meets the requirements of paragraph (h)(7)(ii) of this section;

(C) The disposition proceeds, plus any amounts received from investing the disposition proceeds, are treated as proceeds for purposes of section 1397E; and

(D) If all of the disposition proceeds, plus any amounts received from investing the disposition proceeds, are not actually used in the manner described in paragraph (h)(7)(iii)(B) of this section, the remainder of such amounts are used within 90 days after the end of the two-year period described in paragraph (h)(7)(iii)(B)(1) of this section for a remedial action that meets the requirements of paragraph (h)(7)(ii) of this section.

(iv) *Allocating disposition proceeds among multiple funding sources.* For purposes of this paragraph (h)(7), if property has been financed with an issue of qualified zone academy bonds and one or more other funding sources, any disposition proceeds from that property are allocated to the issue under the principles of § 1.141–12(c)(3).

(8) *Definition of proceeds—(i) In general.* Except as provided in paragraph (h)(8)(ii) of this section, for purposes of section 1397E and this section, proceeds means sale proceeds as defined in § 1.148–1(b), plus any amounts received from investing sale proceeds.

(ii) *Private business contribution requirement.* For purposes of the private business contribution requirement of section 1397E(d)(2), proceeds means sale proceeds as defined in § 1.148–1(b).

(9) *Payment of principal, interest or redemption price.* The use of proceeds of a bond to pay principal, interest or redemption price of the bond or another bond is not a qualified purpose within the meaning of section 1397E(d)(5).

(10) *Reimbursement.* An expenditure for a qualified purpose may be reimbursed with proceeds of a qualified zone academy bond. For this purpose, rules similar to those in § 1.150–2 shall apply.

\* \* \* \* \*

(k) *Effective dates—(1) In general.*

\* \* \*

(2) *Special effective dates for paragraphs (d) and (h)—(i) In general.* Except as otherwise provided in this paragraph (k)(2), paragraphs (d) and (h) of this section apply to bonds sold on or after the date that is 60 days after publication of final regulations in the **Federal Register**.

(ii) *Permissive application—(A) In general.* Except as provided in paragraphs (k)(2)(ii)(B) and (C) of this section, issuers may apply paragraphs (d) and (h) of this section in whole, but not in part, to bonds sold before the date that is 60 days after publication of final regulations in the **Federal Register**.

(B) *Definition of proceeds.* Issuers may apply paragraphs (d) and (h) of this section, without regard to the definition of proceeds in paragraph (h)(8) of this section, to bonds sold before the date that is 60 days after publication of final regulations in the **Federal Register**.

(C) *Bonds issued before July 1, 1999.* Paragraphs (d) and (h)(10) of this section may not be applied to bonds issued before July 1, 1999.

**Mark E. Matthews,**

*Deputy Commissioner for Services and Enforcement.*

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## DEPARTMENT OF THE TREASURY

### Internal Revenue Service

#### 26 CFR Part 1

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#### Allocation and Apportionment of Expenses; Alternative Method for Determining Tax Book Value of Assets

**AGENCY:** Internal Revenue Service (IRS), Treasury.