

Financing Business Expansion Through Tax-Exempt Private Activity Bonds

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	Page
I. Background	1
II. The Statutory Framework	1
III. Financing Structure	3
IV. Advantages and Disadvantages	4
V. Procedure Summary	5
VI. Bond Financing Options	6

FINANCING BUSINESS EXPANSION THROUGH TAX-EXEMPT PRIVATE ACTIVITY BONDS

I. BACKGROUND

Before 1987, industrial development bonds (also known as industrial revenue bonds) were widely available as a tax-exempt tool for economic development. The federal Tax Reform Act of 1986 eliminated industrial development bonds, but replaced them with a new category, tax-exempt private activity bonds ("Private Activity Bonds"). The terminology is somewhat confusing, but most people use the terms IDB, IRB, and private activity bond interchangeably.

- A. Private Activity Bonds are a hybrid of municipal and corporate finance.
- B. In essence, the municipality lends its name and tax-exempt status to a private company to enable it to finance a project that will create jobs in the municipality and/or expand its economy and tax base.
- C. Private Activity Bonds are not a direct obligation of the municipality. No tax money or other municipal revenues are pledged for their retirement. Private Activity Bonds are paid solely from revenues generated by the industrial project and other security provided by the private user.
- D. Nonetheless, many municipalities scrutinize projects carefully since their name is on the bonds and their credit rating is at least indirectly at stake. There is ample reason for municipal scrutiny. While municipalities are generally exempt from the liability provision of the Securities Act of 1933 and the Securities and Exchange Act of 1934, municipalities are not exempt from the Section 17(a) antifraud provisions of the 1933 Act. This antifraud provision is directed against making false or misleading statements in connection with certain securities transactions. In addition, Section 10(b) of the 1934 Act and Rule 10b-5 have been used in actions against the issuers of municipal securities. Thiele v. Shields, 131 F. Supp, 416 (S.D.N.Y. 1955); see generally, Doty and Petersen, The Federal Securities Laws and Transactions in Municipal Securities, 71 N.W.U.L. Rev. 283 (1976). Accordingly, municipal issuers of Private Activity Bonds may not safely ignore the terms of a financing transaction or the undertaking of the project being financed.

II. THE STATUTORY FRAMEWORK

- A. Section 103 of the Internal Revenue Code of 1986, as amended ("IRC") affords federal tax-exempt status to certain obligations of states and their political subdivisions. If an obligation is deemed to be a "private activity bond," however, interest will not be tax-exempt unless the obligation fits within certain well-defined exceptions. Private activity bonds will be tax-exempt if they fall within one of the following three categories:

1. Manufacturing/Processing
 - (a) \$1 Million Small Issue. (IRC § 141(d)(1)(D) and 144(a)(1)) The principal amount of the Private Activity Bond issue (together with the amount of certain outstanding Private Activity Bond issues, if any, for the same borrower in the same municipality) is \$1 million or less; or
 - (b) \$20 Million Small Issue. (IRC §§ 141(d)(1)(D) and 144(a)(4)) The sum of (i) the principal amount of the Private Activity Bond issue (together with the amount of certain outstanding Private Activity Bond issues, if any, for the same borrower in the same incorporated municipality), (bond size is limited to \$10 million) and (ii) all non-bond financed capital expenditures made by or for the borrower in the incorporated municipality during the six-year period beginning three years before the date of the Private Activity Bond issue and ending three years after said date, is and will be \$20 million or less.
2. Charitable/Nonprofit Issues. (IRC § 145). These bond issues generally are available for health care, education and housing.
3. Exempt Facilities. (IRC § 142) If the project qualifies as one of a number of specified "exempt facilities" (as applied to industrial projects, the most significant are airports, docks, wharves, mass commuting facilities, sewage and solid waste disposal facilities, local furnishing of electrical energy and qualified hazardous waste facilities), Private Activity Bonds can be issued on a tax-exempt basis without limit as to dollar amount.
4. Limitations. In recent years, the federal government has limited or eliminated the use of Private Activity Bonds for commercial purposes and added a public hearing requirement. In addition, a state-by-state annual volume cap on total Private Activity Bonds issued has been imposed. Private Activity Bonds may not be used to acquire existing buildings or used equipment unless substantial rehabilitation is done. Facilities financed with Private Activity Bonds no longer may be depreciated on an accelerated basis.

B. Washington state law, Ch. 39.84 RCW, authorizes public corporations to be created by municipalities solely for the purpose of issuing Private Activity Bonds for certain enumerated industrial development facilities.

1. Cities, towns, counties and port districts may create public corporations.
2. Not all projects that would qualify for federal tax-exempt status are permitted to be financed under state law. RCW 39.84.020.
3. State law limits qualified projects to "industrial development facilities" and manufacturing, processing, production, transportation, solid waste disposal and energy facilities are among those facilities that also continue to qualify under federal tax law.
4. If it is determined that a project is eligible, all capital expenditures (land, buildings and equipment), construction expenses (surveying, architects and engineering fees),

issuance costs (title policy, trustee and legal fees), as well as interest during construction (and six months' thereafter) may be financed with proceeds of the Private Activity Bonds. RCW 39.84.020(9).

5. Almost any new construction or equipment acquisition project for manufacturing, processing, fabricating, assembly or printing enterprises will qualify.
6. Warehousing and distribution facilities, shopping centers, office buildings, convention or trade centers, and other retailing or wholesaling facilities do NOT qualify.
7. "Facilities" include, but are not limited to:
 - a. Land, rights in land, buildings, structures;
 - b. Machinery and transmission equipment;
 - c. Approaches, roadways and parking;
 - d. Handling and storage areas;
 - e. Landscaping and utilities; and
 - f. Similar ancillary facilities.
8. Not all costs of the foregoing type of improvements are eligible for Private Activity Bond financing.
 - a. The theory of Private Activity Bond financing is to promote new development.
 - b. The municipality or public corporation must adopt a resolution or "some other similar official action" (Treas. Reg. § 1.103-8(a)(5)(ii) and (iii)) to qualify after-incurred capital expenditures.
 - c. Hence, refinancing of facilities is not permitted. Only those costs incurred after a public corporation adopts an inducement resolution are eligible.

III. FINANCING STRUCTURE

- A. Private Activity Bonds may be used for construction or turnkey financing.
- B. Principal and interest on the Private Activity Bonds is paid solely from the revenues of the project or other security provided by the borrower. No public funds may be used to pay debt service. The interest rate on Private Activity Bonds may be fixed or variable.
- C. Most early Washington issues were structured as secured loan arrangements where the security was a deed of trust (mortgage) on land and buildings and a security agreement covering equipment (plus additional collateral if required by the lender/bond purchaser).

- D. Third party credit enhancement techniques are sometimes used. Examples include letters of credit from banks and municipal bond insurance.
- E. While Private Activity Bond structuring may take many forms, the most typical loan format and documentation can be summarized as follows:
 - 1. The public corporation issues a bond or bonds on behalf of the company and sells them to a purchaser (e.g., bank, investment banker or institutional investor) pursuant to the terms set forth in a purchase contract.
 - 2. The public corporation lends the proceeds from the sale of the bond or bonds to the company pursuant to the terms set forth in a loan agreement. The borrowing will be secured with a first deed of trust (mortgage) on the land and buildings and a security agreement covering equipment purchased for the project.
 - 3. The public corporation is not involved in administration of the loan after closing. It assigns its duties, rights and enforcement responsibilities either to a trustee on behalf of the bond purchaser or directly to the bond purchaser itself. The public corporation enters into a trust indenture with a bank trustee or a depository agreement with the bond purchaser or other bank and assigns the deed of trust, security agreement and its interest in the loan agreement for security purposes to the bank or bondowner.
 - 4. The public corporation, thus, receives none of the loan repayments. The company makes loan repayments directly to the trustee or bondowner. If there is a trustee, the trustee will, in turn, make principal and interest payments on the bonds to the bondowner(s).

IV. ADVANTAGES AND DISADVANTAGES

A. ADVANTAGES

- 1. Comparatively lower interest rate; and
- 2. Long term credit--maturities can extend to 35 years or more (depending on the project's useful life); and
- 3. Depending on the bond purchaser, 100% financing may be possible.

B. DISADVANTAGES

- 1. Front money costs--on small issues, issuance cost can outweigh low interest rate advantage, especially if credit enhancement mechanisms are used; and
- 2. Public sector involvement and public disclosure requirements; and
- 3. Capital expenditure limitations on small issue bonds.

V. PROCEDURE SUMMARY

- A. Once a person or company (hereinafter the "borrower") determines that Private Activity Bond financing should be considered, a preliminary eligibility determination must be made. Bond counsel is consulted.
- B. The borrower should determine the willingness and availability of the public corporation to issue bonds.
- C. The search for purchasers starts with the borrower's bank of account. Depending on the interest and expertise of the local banker, and the nature of the deal, a financial advisor or underwriter may be retained.
 1. Bank purchase--similar to direct commercial or mortgage loan.
 2. Private placement--a financial consultant or investment banker structures the issue for direct placement with an investor or investors.
 3. Underwriting--an investment banker structures the issue for purchase by the investment banker for resale to the public.
- D. The board of directors of the public corporation adopts an "official action resolution" also known as an inducement resolution (drafted by bond counsel) indicating its intention to issue Private Activity Bonds to finance the borrower's project. It is essential that the official action resolution be adopted prior to any equipment purchases or ground breaking. See Treas. Reg. § 1.103-8(a)(5)(v)(ii) and (iii). The official action resolution does not commit the borrower to proceed any further.
- E. The official action resolution is approved by the creating municipality.
- F. Application to the State Department of Commerce and Economic Development is made.
- G. The borrower and the purchaser negotiate the amount, interest rate, maturities, collateral security and other economic terms of the financing. If the borrower decides to proceed, bond counsel is instructed to draft all necessary documents for review by the purchaser, the borrower and the borrower's counsel. Agreement is reached.
- H. Approval of the planning jurisdiction in which the project is located must be obtained.
- I. Federal law imposes an annual volume cap upon the issuance of most Private Activity Bonds. The volume cap, \$50 per person, applies to most types of Private Activity Bonds as well as housing bonds, bonds for certain electric projects and bonds for other public/private facilities. The State Legislature has enacted a system of allocating the available volume cap, and the State's Department of Community Development administers the process. The available volume cap is scarce, and there is no assurance that a proposed bond issue will be able to obtain the necessary volume cap allocation.
- J. Federal law also requires that a public hearing be held prior to issuance of all Private Activity Bonds. The hearing must be preceded by published notice reasonably designed to apprise

residents of the municipality of the proposed Private Activity Bond issue. Notice must be published in the official newspaper no less than 14 days before the scheduled date of the hearing. The hearing should be conducted in a manner that provides a reasonable opportunity for citizens with differing views to be heard regarding both the issuance of the Private Activity Bonds and the location and nature of the proposed facility.

- K. The final terms are presented to the public corporation for consideration. The governing body of the public corporation approves issuance of the Private Activity Bond by adoption of a "bond resolution." The bond resolution also must be approved by the governing body of the creating municipality within 60 days of its adoption.
- L. The documents are executed and the Private Activity Bonds are issued and sold at a single closing. If adequate lead time is given, the closing can be scheduled to occur at any time between project commencement and project completion.

VI. BOND FINANCING OPTIONS

A. PUBLIC SALE

1. Distribution. This type of distribution is typically handled by a securities underwriter or investment banker.
2. Size of Bond Issue. Because of the relatively high issuance costs involved, the size of publicly sold Private Activity Bond issues are normally in excess of \$1,000,000.
3. Umbrella Bonds. In some cases, and if the authority and mechanisms are in place, smaller issues can be combined under "umbrella" programs and sold at a public sale.
4. Credit Enhancement. Depending on the financial strength of the borrower and the familiarity of the borrower's name to potential purchasers, publicly sold issues customarily are secured by a bank letter of credit to facilitate the sale. An alternative type of credit enhancement is sometimes available in the form of municipal bond insurance.
5. Parties In A Public Sale. Publicly sold issues involve a number of parties and the costs of issuance can be significant; however, if the issue is large and the costs are amortized over a relatively long term, the impact is diminished. Typically the parties involved include:
 - a. Bond counsel;
 - b. Underwriter and underwriter's counsel;
 - c. Company (borrower's) counsel;
 - d. Trustee and trustee's counsel;
 - e. Rating agency;

- f. Letter of credit bank (or insurer) and counsel;
 - g. Issuer's counsel (not always required); and
 - h. Purchasers.
6. Issuance Costs. Issuance costs include all legal fees, insurer's fees, first year trustee's fee, first year letter of credit fee, insurance premium and the rating agency fee. No more than 2% of Private Activity Bond proceeds may be used to pay costs of issuance.
7. Ongoing Costs. Included in annual costs are issuer's fees (if required), trustee's fees and letter of credit fees. Ongoing costs are generally not financeable with Private Activity Bond proceeds.
8. Interest Rates. Rates for publicly sold Private Activity Bonds reflect tax-exempt rates available to investors for like maturities and risk. However, Private Activity Bonds bear interest at rates somewhat higher than other tax exempt bonds. This occurs primarily because interest on Private Activity Bonds is subject to corporate and individual alternative minimum taxes.

B. PRIVATE PLACEMENT

1. Distribution. Private placements can be negotiated by a securities underwriter or a commercial bank. In a private placement the underwriter or bank acts as an agent for the borrower and places the Private Activity Bonds with investors who make their own, independent investment decision based on their own analysis and evaluation.
2. Size Of Bond Issue. The size may vary more than a public sale, and smaller issues can be placed at an economic advantage to the borrower.
3. Credit Enhancement. Again this depends on the credit strength of the borrower; however, if the buyer of the bond(s) is a financial institution accustomed to making credit decisions on the financial strength of the borrower, credit enhancement may not be necessary.
4. Parties To A Private Placement. Depending on the structure of the placement, the parties in a private placement can be as numerous as a public sale. On the other hand, in a very straightforward placement involving only one or a few purchasers, the parties can be reduced to:
- a. Bond counsel;
 - b. Placement agent (and perhaps the agent's counsel);
 - c. Borrower's counsel;
 - d. Issuer's counsel (again, not always required);

- e. Trustee (optional); and
 - f. Purchaser(s).
5. Issuance Costs. In general, the fewer the parties the lower the cost; however, a complex private placement can generate sizable issuance costs.
 6. Ongoing Costs. These are similar to the public sale, but in some cases credit enhancement/letter of credit fees and trustee fees are not required.
 7. Rates. Rates tend to reflect the more narrowly defined market of the bond purchaser(s) involved in the placement.

C. TERM BOND FUNDS

1. Distribution. Individual bonds are accumulated by an investment banker to assemble a unit investment trust. Once assembled (\$50,000,000 is a typical size) the trust is sold to individual investors of \$1,000 or \$5,000.
2. Size Of The Bond Issue. Individual issues within the trust are typically in the \$500,000 to \$3,000,000 range.
3. Credit Enhancement. Each individual issue is backed by a letter of credit, bond insurance, a bank repurchase agreement or guarantee such that the unit trust is rated Aaa/AAA.
4. Parties Involved. In addition to bond counsel and company counsel, the investment bank marketing the trust will be represented by counsel. Additionally, the party providing credit enhancement may be represented by its counsel and, as with a public sale, there will also be a trustee.
5. Issuance Costs. All legal fees including the investment bank's counsel, first year credit enhancement costs, trustee's fees and issuer's fees.
6. Ongoing Costs. Annual credit enhancement, trustee's fees and issuer's fees, if any, are the normal annual costs for this type of distribution.
7. Rates. Rates for the trusts can be floating or fixed, but floating rates are more common.

D. TAX-EXEMPT MONEY MARKET FUNDS/LOW FLOATERS

1. Distribution. This is a rapidly growing market that allows the borrower to obtain funds at rates keyed to short-term tax-exempt rates. This is accomplished by allowing the fund a 7 to 14 day "put" back to a "remarketing agent" and ultimately back to a third party guarantor-- typically a bank providing a letter of credit and repurchase agreement to buy the bonds if they cannot be remarketed. By having the credit strength of a bank letter of credit and the liquidity backup of a repurchase agreement, this structure allows the borrowers to pay interest only throughout the life of the bond, or this structure may also permit conversion to an amortizing bond at a predetermined, future date.
2. Size Of Bond Issue. Normally \$1,200,000 is a workable minimum size (because of the complexity of setting up the structure).
3. Credit Enhancement. A bank letter of credit and a remarketing agreement are required.
4. Parties To The Financing. All of the parties involved in a public sale with the underwriter/investment banker serving as the remarketing agent.
5. Issuance Costs. All of the costs associated with a public sale.
6. Ongoing Costs. Letter of credit fees, trustee's fees and remarketing fees plus issuer's fees (if required).
7. Rates. Rates are keyed to short-term tax-exempt rates; however, the cost of the letter of credit and the remarketing fees must be added to determine the interest rate.

E. DIRECT PURCHASE BY A BANK

1. Distribution. Banks may buy Private Activity Bonds for their own portfolio. Normally they are purchased as part of an ongoing relationship with an existing bank customer. At times the purchase is made as a means to establish a new customer relationship. While banks historically purchased a vast majority of these types of bonds, the Tax Reform Act of 1986 has all but eliminated commercial banks from this market. Banks that acquire Private Activity Bonds after August 7, 1986 are denied 100% of their ordinary interest deductions to the extent of tax exempt interest received on Private Activity Bonds. In order to compensate for this loss of interest deductions, banks charge higher interest rates, closely approximating taxable rates.
2. Size of The Bond Issue. This approach can work well for smaller issues (as low as \$400,000 to \$500,000) as well as larger issues.
3. Credit Enhancement. Not normally required because the bank tends to make its credit decision on the basis that the project would be financeable at taxable rates. In certain instances Private Activity Bonds are purchased with another bank's letter of credit as a credit backup.

4. Parties To A Direct Bank Purchase. Here the number of parties to the financing can be pared down to bond counsel, the borrower and its counsel, the bank and its counsel, and issuer's counsel (if required by the issuer). A trustee may or may not be required.
5. Issuance Costs. Legal fees and bank loan fees (optional: trustee fees).
6. Ongoing Costs. Typically only trustee's fees (if a trustee is used) and issuer's fees (if any).
7. Rates. Either floating or fixed rates, with floating being far more prevalent.

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