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Practice Area: Government Finance & Manufacturing

Interest on bonds issued by a state or local government is exempt from federal income tax if the proceeds are used to finance a qualifying project. Because interest is exempt from federal tax, bondholders (banks and other investors) are willing to accept a lower interest rate – typically 80% or less of the rate quoted for a similar conventional (*i.e.*, taxable) financing – resulting in very significant savings over the life of a 15- or 20-year loan.

The three most common types of projects financed by tax-exempt bonds are manufacturing facilities, low-income housing developments, and capital projects for non-profit organizations. This article will focus on manufacturing projects. Bonds issued to finance qualifying manufacturing projects are defined under the tax code as "Qualified Small Issue Bonds" but are traditionally referred to as "Industrial Revenue Bonds," or "IRBs."

What projects are eligible?

Only manufacturing facilities (businesses in NAICS Codes 311111 – 339999) are eligible for financing with Qualified Small Issue Bonds. While these bonds are most often used to finance new construction, they may finance acquisition of a used building (subject to a requirement that an amount equal to at least 15% of the bond-financed purchase price must be spent on rehabilitation expenditures within 2 years after the bonds are issued) and may also be used to finance the modification or expansion of an existing manufacturing facility. Used equipment does *not* qualify.

What is the basic structure of an IRB issue?

Tax-exempt IRBs are issued by a local government (city, town or village), a local development authority or a state-wide bond issuer (in Wisconsin, the Public Finance Authority ("PFA") or the Wisconsin Housing and Economic Development Authority ("WHEDA")). Proceeds from the sale of the bonds are then loaned to a private borrower to finance a qualifying project. The government issuer merely acts as a conduit for the financing and has no real involvement after the bonds are issued.

Where does the money come from?

Contrary to what many people think, the government doesn't have a pool of money set aside to fund IRBs, or any other tax-exempt bonds for that matter. The only subsidy from the federal government is that it foregoes income tax on the interest on the bonds. The money comes from the purchaser of the bonds. IRBs are typically purchased by a bank that already has a lending relationship with the borrower; however, a bank could also provide a Letter of Credit guaranteeing bonds that are then sold to the public. What is most important to remember is that, just as with any conventional loan, you and your project must meet the bank's underwriting standards. The principal benefit of tax-exempt financing is that, because of the lower rate and lower interest payments, your business will show a better projected cash flow which can make a difference in the bank's underwriting decision. Improved cash flow can also enable you to pay the loan off more quickly or borrow more in the first place.

Is the interest exempt from Wisconsin income tax?

No. Only certain low-income housing bonds are tax exempt under Wisconsin law. However, interest on bonds issued by a Wisconsin local government *may* be exempt from income tax in other states.

What costs can be financed?

IRB proceeds can be used to pay for:

- land acquisition (up to 25% of bond proceeds);
- construction (or used building acquisition), expansion and rehabilitation costs;
- offices, common areas and warehousing essential to the manufacturing process (up to 25% of bond proceeds);
- new equipment purchases; and
- issuance costs (up to 2% of bond proceeds).

My company is buying a used building – what do I need to know about the rehabilitation requirement?

The principal rule applicable to financing used facilities with IRBs is that at least 15% of the bond-financed portion of the purchase price must be spent on rehabilitation costs within 2 years of the bond issue. Assume the city is issuing \$1.6 million of IRBs to finance your purchase of a used manufacturing facility for \$2 million. Your rehab requirement would be measured by the \$1.6 million bond-financed amount – you would have to spend at least \$240,000 (15% of \$1.6 million) on rehabilitation costs within the next two years.

Rehabilitation costs are essentially repairs and upgrades to an existing building rather than improvements – for example, paying for a new roof or a new HVAC system is a rehabilitation cost while building an extension or adding loading docks where none existed before would not qualify.

It is important to know that your planned expenditures for rehabilitation can be included in your "bond budget." In the above example, again assuming the bank allows it, you could have \$1,840,000 of IRBs issued – the \$1.6 million purchase price plus \$240,000 in rehabilitation costs.

Doesn't a bond issue take a long time?

Because of local government involvement, a bond issue typically takes 4 to 6 months from start to finish. However, costs incurred prior to the issuance of the bonds, up to 60 days before preliminary action by the government issuer, can be reimbursed out of proceeds when the bonds are issued. The preliminary action is simply a non-binding resolution stating that the local government expects, if the deal comes together, to issue bonds to finance the particular project. Most importantly, you do not have to wait until the bonds are issued to start your project. Most projects break ground with an interim or construction loan (issued by the same bank that is going to buy the bonds) to be taken out by permanent financing in the form of the bond loan.

Isn't a bond issue expensive?

In any lending transaction you, the borrower, will have to pay for the bank's attorneys and other fees and closing costs. A bond issue must be structured carefully in order to take advantage of the tax exemption and, as a result, there will be additional legal and other professional costs over and above what you would have to pay in a conventional loan transaction. However, a payback analysis should be conducted to determine whether interest savings will offset increased issuance costs. In general, in today's rate environment, interest savings on a project of \$2.5 million or more is likely to offset incremental up-front costs in, at most, 18-24 months.

Does the government set the interest rate or the other terms of the loan?

No. As a practical matter, there are effectively no restrictions on the interest rate (which, for example, can be fixed or variable or adjustable according to a formula), loan structure, the loan term, financial and other covenants, amortization, defaults, collateral or guarantees. A tax-exempt bond loan can generally be structured with the same terms as any other conventional financing – and, thus, while you will be borrowing at a lower rate you must otherwise negotiate the loan terms with your bank.

Are there any other restrictions I need to know about?

Yes. In addition to the restrictions described above there are a few others, including:

- A \$20 million limit on the size of a Qualified Small Issue Bond; in calculating the limit you must include all capital expenditures by the project owner in the project municipality in a six-year period beginning three years before and ending three years after the bonds are issued.
- A requirement that you amortize building and equipment acquired with bond proceeds on a straight-line basis.
- A requirement that you spend at least 5% of bond proceeds within 6 months of the issue date and spend all bond proceeds within three years of the issue date.

Other restrictions exist but rarely present a problem – for example, the term of the bonds cannot exceed 120% of the "economic life" of the project being financed. For a building, this is 120% of 39 years, or almost 47 years, which would be unheard of for a commercial mortgage loan.

Will the local government continue to be involved?

In an IRB issue the local government acts as a conduit and, in effect, steps out of the way, leaving you and your lender to deal directly with each other. In general, the only time the local government comes back into the picture is if you and your bank agree to make significant modifications in your loan terms. Of course, as with any privately-owned real estate and manufacturing facility no matter how it is financed, you will still have to comply with local laws, such as the obligation to comply with zoning laws, pay property taxes and satisfy other local requirements.

What if I want to refinance or change banks down the road?

This is generally not a problem. If refinancing involves a significant change in terms (such as a rate reduction), you may need to treat the refinancing as a new bond issue, in which case you will have to demonstrate that your project still qualifies (for example, that you are still engaged in manufacturing) at the time of the refinancing. A change in terms may also involve the formality of having the issuing governmental unit approve amendments to the documents. Refinancing with a new bank is as simple as the new bank buying the bonds from the bank that originally purchased them.

Doesn't having to use straight-line depreciation offset the interest savings?

No and yes. Real estate (buildings and most improvements) have to be depreciated on a straight line basis anyway, no matter how (or even whether) they are financed. Other assets that can be financed with tax-exempt IRBs, such as new manufacturing equipment, may qualify for accelerated depreciation and the straight-line method will be less advantageous. But each situation is different and in many cases it makes economic sense to finance equipment on a tax-exempt basis even though the straight-line depreciation method is required.

I've been told that it doesn't make sense for my corporation to own real estate – does that affect whether I qualify for IRB financing?

No. Owning real estate in a corporation "traps" tax benefits, such as depreciation, and economic benefits, such as income and gain on sale, in the corporation. From a tax standpoint, it makes much more sense to hold commercial real estate in a pass-through entity such as a limited liability company. The majority of IRBs are structured to maximize tax benefits by having an LLC (usually consisting of individual members of the owner's family) own the real estate and lease it to the manufacturing corporation. Once again, much depends on what the bond purchaser – the bank – will allow.

Where do I start?

There are two professionals you should consult with early in the process: your banker and a bond attorney.

- Your banker, will, of course, work with you to determine your financing needs, run projections, quote rates and discuss the terms of the loan. If your banker is familiar with tax-exempt bond financing, all the better, because much of the same loan underwriting process will have to take place whether you use tax-exempt bonds or not.
- An attorney who is experienced in the structuring and tax aspects of IRBs should be asked to perform an initial analysis to determine the basic eligibility and discuss the process.

What does von Briesen & Roper offer? The first thing we do when a client or prospective client asks about a tax-exempt bond issue of any kind is to spend some time – at no cost to you – understanding the project and performing an initial "feasibility analysis" where, among other things, we will calculate the maximum amount of a proposed bond issue, whether proceeds will be used for qualifying costs and other important criteria. We will also map out a timetable and process for obtaining the necessary approvals from the governmental bond issuer.

As experienced bond attorneys we can quickly and efficiently address the basic eligibility issues to determine whether it is worth pursuing a bond issue. It is always a good idea to have your banker participate in this process so that we can identify any special considerations.

As a nationally-recognized bond counsel firm, we can be engaged to perform an independent tax analysis, structure the bond issue and draft the documents necessary to complete the transaction. As bond counsel, our primary function would be, at closing, to issue an unqualified opinion – an opinion that can be relied upon by the bond purchaser in preparing its federal income tax return – as to the tax-exempt status of the bonds.

Ethical rules applicable to bond attorneys allow us to serve in that role as well as represent the borrower in the same bond transaction. Thus, we can represent your interests as well as structure the deal from a tax standpoint. Or, we can work with your regular attorney to insure that the process goes smoothly.

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