

FEDERAL RESTRICTIONS ON TAX-EXEMPT INDUSTRIAL DEVELOPMENT BONDS

Congress has been restructuring the use of tax-exempt Industrial Development Bonds (IDBs) since their inception. Over the years, IDBs were used to finance non-traditional projects and thus acted to escalate the controversy over tax-exempt financing for private industry. Opponents of IDBs in Congress enacted laws to restrict the uses of IDBs to small businesses, to curb abuses and to recapture tax dollars that opponents contended were lost by the U.S. Treasury.

Among the areas hardest hit by the new provisions in the 1986 tax act were the so called “private activity bonds”. Typically, these bonds were used to fund projects where (1) more than ten percent of the proceeds of an issue were used either directly or indirectly in a trade or business, or by a person other than a governmental unit, and (2) where payments of interest and principal were secured by the property used for a private business. IDBs are classified as private activity bonds and are now limited to manufacturing or processing facilities. The only exception to the manufacturing restriction is if the project materially benefits a federally designated Enterprise Community, such as the Blytheville area or parts of Monroe, Cross, St. Francis and Lee Counties.

Although IDB financing has become more complicated, it is still an excellent vehicle for providing below market, fixed-rate development capital for qualifying activities. As the market for, and the uses of, IDBs have become more restrictive, the intention of the Arkansas Development Finance Authority (ADFA) is to continue to apply its efforts and resources to meet the challenge of these changes.

The specific federal regulations concerning IDB financing include the following:

Declaration of Intent – (Inducement Resolution) – This official action by the issuer is requested by the Internal Revenue Service to show “intent” to use tax-exempt revenue bond financing for a particular project. Commencing a project prior to signing of the Inducement Resolution may render any funds spent before that date ineligible for bond financing.

Use of Bonds Proceeds – At least ninety-five percent of the “net proceeds” of the bonds must be used for the exempt purpose of the borrowing. These purposes include the purchase of land, buildings and equipment. New construction and new equipment are not subject to any restrictions, but the following exempt activities have limitations:

- **Land Acquisition** – Limited to a maximum of twenty-five percent of bond issue amount.
- **Existing Buildings**- Borrower is required to spend an amount equal to at least fifteen percent of the purchase price on renovation within 24 months of purchase.
- **Used Equipment**- Borrower is required to spend an amount equal to one hundred percent of the used equipment’s purchase price on renovation unless the used equipment is purchased as part of an existing building; and,

when used equipment is considered a part of an existing building the Borrower is required to spend an amount equal to fifteen percent of the total price on renovation.

Cost of Issuance- Related to the “use of proceeds” requirement referenced above, the costs of issuance of IDBs are now considered “net proceeds” of an issuance. Such costs may be paid out of the five percent of the issuance proceeds not used for the exempt purpose of the borrowing, but only to the extent that they do not exceed two percent of the face amount of the bond issue. Those costs subject to the two percent limitation include (but are not limited to) (i) underwriter’s discount (ii) bond counsel fees, (iii) financial advisor fees, (iv) rating agency fees, (v) trustee fees, (vi) printing costs, and (vii) costs of engineering, appraisal and feasibility studies. Bond guaranty fees and certain letter of credit fees may be treated as interest on tax-exempt bonds. These credit enhancement costs, which are treated as interest, may be financed out of bonds proceeds over and above the two percent limitation, but are limited to the remaining three percent of the face amount of the bond issue.

IDB Maturing Limits- The average maturity of the bond issue cannot exceed one hundred twenty percent of the reasonably expected economic life of the facility financed with the proceeds of the issue. This provision may not be restrictive for the purchase of new equipment or new construction, but may restrict bond issues which finance existing buildings.

\$20 Million Capital Investment- Borrowers are ineligible for the tax-exempt benefit if a \$20 million capital expenditure limit is exceeded during any three year period starting three years before the date of the bond issue to three years after the date of the bond issue (six year consideration) with the political subdivision (i.e. city or County) where the project is located. However, a bond issue cannot exceed \$10 million at a time.

\$40 Million in Bonds Outstanding – Borrowers cannot have in excess of \$40 million in bonds outstanding nationwide.

Depreciation- When using IDBs to finance all or any portion of a facility, the borrower must depreciate the property on a straight line (level yearly) basis. The useful life is determined by using an alternative depreciation system with terms of 5, 9.5, 10, 12, 15, 24, 27.5, 40 and 50 years. Real estate generally has a 40 year term.

TEFRA Hearing- It is required that a TEFRA hearing to be held in the largest or most inclusive political subdivisions having proposed jurisdiction over the location of the project being financed with tax-exempt bonds. Approval of the bond issue must then be provided by the applicable elected representative following the public hearing.

Volume Cap- Since 1989, IDBs have had a 33% share of the State’s yearly allocation. The remaining volume cap is divided between private activity bonds, single-family housing, multi-family housing, and student loan bond issues. Of the \$256,235,000 allocation for the year 2007, \$84,557,550 was designated for IDBs in Arkansas.

Principal User- Any entity using ten percent of the facilities financed with bond proceeds is considered a “principal user of the facilities” and is the benefactor of the tax-exempt

financing. All principal users of the facilities are subject to the restrictions concerning IDB financing.

Bank Carrying Cost Deductibility- Banks are no longer allowed to deduct the interest costs they incur in buying and carrying tax-exempt bonds. This restriction has eliminated a traditional purchaser of IDBs. Past experience has shown that banks historically purchased nearly ninety percent of all industrial development bonds issued.

Arbitrage and Rebate Requirements- Complex new rules now require the rebate to the U.S. Government of all investment earnings which result from obtaining a yield on the bond proceeds which is in excess of the yield on the bonds.

Restrictions- None of the proceeds of the bonds can be expended for a golf course, country club, massage parlor, tennis club, skating facility, racquet sports facility, hot tub facility, suntan facility, racetrack facility, airplane, sky box, private luxury box, gambling facility, any store primarily use for the sale of alcoholic beverages for consumption off premises, or health club facility. Not more than 25% of the proceeds of the bonds can be used to provide a facility of which, during the term of the agreement, the primary purpose is retail of food and beverage service, automobile sales or service or the provision of recreation or entertainment. Under state law, no IDB can be issued for shopping centers or other retail stores. Elections must be held before bonds can be issued for office buildings, hotels, motels or tourist attraction facilities.