# **Development Finance:** Tax-Exempt Debt

Governmental, nonprofit (501c3), gualified "private activity" and "exempt facilities" can be financed with taxexempt bonds.

The Port is a frequent issuer of tax-exempt conduit debt and has completed transactions for 3CDC, the Cincinnati Zoo, and various private schools

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## **Benefits of Tax-Exempt Debt**

WHAT

**KEY REQUIREMENTS** 

The principal advantage of tax-exempt debt is the lower cost of interest. Investors in tax-exempt bonds do not pay federal income tax on interest payments received on the bonds. These investors are willing to accept an interest rate lower than the interest rate on comparable taxable bonds. Some states exempt the interest on tax-exempt bonds from state income taxes, thus magnifying the benefit of tax-exempt financing.

#### **TYPES OF TAX EXEMPT CONDUIT BONDS**

There are many forms of conduit tax-exempt debt. Below are the most common in this market. All of these bonds require a "State or Local" government issuer to issue the bonds.

#### 501(C)(3) BONDS

- 501(c)(3)s are organized for charitable purposes and serve the common good. Facilities owned and used by 501(c)(3)s can be financed with "qualified 501(c)(3) bonds". Note that not all nonprofits and charities will qualify - the borrower must have received a 501(c)(3) determination letter from the IRS.
- QUALIFIED PROJECTS Traditional gualified 501(c)(3) bond projects include:
  - Hospital facilities owned by a 501(c)(3)
  - Cultural facilities owned by a 501(c)(3) (e.g. museum or zoo)
  - School facilities for private 501(c)(3) primary and secondary schools
  - At least 95% of the bond proceeds must be allocated for capital expenditures including land, building, and equipment.
  - The average maturity of the bonds cannot exceed 120% of the average economic life of the assets financed.
  - Proceeds may finance up to 3 years of future capital needs.
  - Reimbursement for prior capital expenditures, subject to certain limits and requirements, including an Issuer board reimbursement resolution or evidence of an interim loan.
  - Gifts from a fundraising campaign that are restricted to pledges related to bond financed facilities will require a paydown of bonds equal to the amount of the gift within 12 months of receipt.

	501(C)(3) BONDS
WHAT	Industrial Revenue Bonds ("IRB"), also known as Industrial Development Bonds ("IDB") or Small Issue Manufacturing Bonds are issued to facilitate economic and industrial development. They are tax-exempt bonds issued by a governmental entity to provide money for the acquisition, construction, rehabilitation, and equipping of manufacturing and processing facilities for private companies.
KEY REQUIREMENTS	<ul> <li>Maximum amount - \$10 million</li> <li>Qualifying Costs - At least 95% of the bond proceeds must be spent on a "manufacturing facility".</li> <li>Manufacturing Facility - a facility used for the manufacturing, production or processing of tangible personal property. No more than 25% of the bond proceeds can be applied to ancillary office, warehouse or other space. Land - No more than 25% of the bond proceeds can be used to acquire land.</li> <li>Acquisition of Existing Manufacturing Facilities - The acquisition of an existing facility can be financed if at least 15% of the portion of the bond amount used to purchase the facility is spent on rehabilitation of the building within a two-year period.</li> <li>Used Equipment - If bond proceeds are used to acquire used equipment, 100% of the cost must be spent on rehabilitation of the equipment within a two-year period.</li> <li>Maturity - Average maturity cannot exceed 120% of the average economic life of the assets financed.</li> <li>No Working Capital or Inventory - Bond proceeds cannot be used to finance working capital or inventory.</li> <li>Historical and forward looking (3 years) capital expenditure limitations apply</li> </ul>
	501(C)(3) BONDS
ELIGIBLE PROJECTS	Airports, docks and wharves; mass commuting facilities; hydroelectric enhancements; water furnishing; sewage facilities, solid waste disposal facilities; residential rental facilities; local electric/gas facilities; local heating/cooling facilities; hazardous waste disposal facilities; high-speed intercity rail facilities; public educational facilities; green buildings; highway or surface freight; transfer facilities; Enterprise Zone facilities; Midwestern Disaster facilities.
KEY REQUIREMENTS	<ul> <li>25% of the proceeds can be used for the acquisition of land.</li> <li>If used to acquire existing structures or equipment, facilities must undergo substantial rehabilitation.</li> <li>Facilities must be depreciated for tax purposes using the straight-line method.</li> <li>Weighted average maturity cannot exceed 120% of the average useful life.</li> </ul>

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- Weighted average maturity cannot exceed 120% of the average useful life. •

Development Finance: Tax-Exempt Debt Terms & Example

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#### **Conduit Issuer**

A private corporation (the "Borrower") is required to have a conduit governmental issuer to issue the bonds.

#### **Inducement Resolution**

An inducement resolution must be passed by the conduit issuer for the taxexempt bonds. This resolution is the first "official action" and indicates an Issuer's intent to issue the bonds. The inducement resolution determines the point after which the project being financed can be reimbursed for capital costs paid or incurred in connection with the acquisition or construction of the project.

#### **Volume Cap Allocation**

Each state is allocated an amount for a tax-exempt bond cap each year. The Company must obtain volume cap approval from the state before proceeding with the financing. (Not applicable to non-profits).

#### **TEFRA Hearing**

Issuer must hold a public Tax Equity and Fiscal Responsibility Act Hearing ("TEFRA Hearing") on the issuance of the bonds, having provided the published notice in advance of the hearing in accordance with applicable state and Federal law.

### **Use Covenants**

The Borrower must comply with all the applicable tax covenants and restrictions on the use of the financed facilities as long as any of the bonds are outstanding. A violation may cause the bonds to lose their tax-exempt status.

## **EXAMPLE PROJECTS**



Mariemont City Schools Village of Mariemont, Ohio



**Cincinnati Zoo** Avondale, City of Cincinnati, Ohio



**12th and Vine Public Parking** Over-the-Rhine, City of Cincinnati, Ohio

# TAX-EXEMPT DEBT EXAMPLE

## Taxable Debt

# \$100,000 @ 6%

Borrower borrows \$100,000 of **taxable debt** at a 6% interest rate

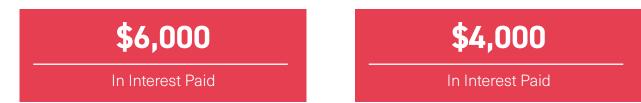
Borrower pays \$6,000 in taxable interest, but bondholder has to pay \$2,000 of that to the IRS. This leaves the bondholder with \$4,000.

# Tax-Exempt Debt

# \$100,000 @ 4%

Alternatively, the borrower can borrow **tax-exempt debt** at a 4% interest rate.

The bondholder receives \$4,000 in taxexempt interest and pays nothing to the IRS.



The bondholder is indifferent, because it received \$4,000 in both scenarios, **but the borrower paid \$2,000 less in interest**. This \$2,000 is, in effect, a subsidy from the federal government (and maybe the state government) to the borrower. Since the federal government is providing the subsidy, it sets the rules that entities must meet to borrow tax-exempt debt.