Industrial Development Bonds

Industrial Development Bonds are really corporate bonds disguised to look like municipal bonds. Industrial Development Bond (IDB) financing is a technique whereby a state or local government allows a private user, like a manufacturing company, to benefit from the government's status as a tax-exempt entity and its ability to issue debt obligations at tax-exempt rates. As the ultimate recipient of the proceeds of the bonds, the private user benefits because the interest on the obligations is tax-exempt and therefore bears a lower interest rate than comparable taxable financing. For example, IDBs may sell at rates 30% below Prime on a variable interest rate basis or 2-4 percentage points lower than taxable alternatives. This "conduit" financing technique has been around for more than 70 years, but only over the last 25 years has it become readily available in almost every state. IDBs are typically issued through state or local Industrial Development Bond issuers on a "conduit " basis, meaning the issuer does not back or secure repayment of the bonds.

Prior to the Tax Act of 1986, the Tax Code permitted the issuance of tax-exempt Industrial Development Bonds for many types of projects including manufacturing, commercial, and wholesale and distribution facilities, among others. In the past, Pollution Control Bonds were also referred to as IDBs but these bonds are no longer permitted under the Tax Code. In addition, so called "Exempt Facility" bonds may also be referred to as IDBs but this paper is limited to the successor IDBs that are now called Qualified Small Issue Bonds. Qualified Small Issue bonds are limited to manufacturing facilities.

History of Industrial Development Bonds

Industrial Development Bonds actually had their genesis 70 years ago in American state and local finance as offshoots of lease financings. Through a 1936 Mississippi industrial development program termed "Balance Agriculture with Industry" (see Robert Lamb and Stephen Rappaport, *Municipal Bonds*, 1987), the state authorized the first U.S. industrial revenue bonds. These bonds were issued by the city of Durant for the construction of a Realsilk Hosiery Mill factory. Just as today, this financing was designed to draw or retain industry into communities for employment and economic benefits through the use of tax-exempt financing. The financing structure was a lease and the security for the bonds were limited to the company's lease payments. Capital lease structures are still common today.

In 1954 the IRS formally acknowledged the tax-exempt status of industrial development bonds. Prior to 1954, state court decisions upheld their tax-exempt status as states had the power to determine what was a "public purpose."

Basic Qualified Small Issue Legal Requirements

This section reviews some of the basic Tax Code previsions governing the issuance of qualified Small Issue Bonds. The requirements reviewed here are by no means complete, and readers are advised to seek professional help from a bond counsel for a more thorough analysis of all Tax Code requirements. In addition, beyond meeting basic federal Tax Code requirements reviewed in this section, to issue IDBs a state or local government or more commonly their political subdivisions in the form of Industrial Development Authorities, must meet certain state government specifications as well. For example, there may be a requirement that a project demonstrate a clear economic benefit to the community through such measures as job creation or retention. Other statutes may limit the type of projects that can be financed.

The Tax Code only permits the issuance of qualified small issues for manufacturing facilities. A "manufacturing facility" means any facility used in the manufacturing or production of tangible personal property (including processing resulting in a change in the condition of such property). A manufacturing facility includes facilities, which are directly related to and ancillary to a manufacturing facility, if such facilities are located on the same site as the manufacturing facility, and not more than 25 percent of the net proceeds of the issue are used to provide such facilities.

A "manufacturing facility" may be comprised of many different components or facilities performing different functions. In addition to the production line where actual processing takes place ("core manufacturing"), there may be space or buildings on the same site devoted to office space, storing raw materials and finished product, laboratories to test products, packaging areas, etc. An eligible project must devote not more than 25% of net bond proceeds to directly related and ancillary facilities, which are subordinate but integral to core manufacturing or production facilities and located on the same site. Thus, it must be determined which parts of a project constitute "core manufacturing facilities" which may be financed without limitation (except for the capital expenditure limitation - see below), which constitute directly related and ancillary facilities that may not exceed 25% of bond proceeds, and which facilities are not eligible for tax-exempt financing at all (although equity contributions or taxable tails may pay for ineligible costs).

Other Tax Code Requirements limit the amount of bond proceeds that may be used to acquire land (not more than 25% of bond proceeds), and in the case of acquisition/rehabilitation projects, where, for example, an existing manufacturing plant is purchased, an amount equal to at least 15% of the acquisition cost minus the land cost must be spent on rehabilitation within the footprint of the existing facility.

Issuers of IDBs must take "Official Action." Bonds may be issued to reimburse eligible project costs paid prior to the date bonds are issued, if the issuer of the bonds (and not the company) takes "official Action," typically in the form of a resolution also commonly called an "Inducement Resolution or Declaration of Intent," within 60 days after the date such expenditures are paid. Generally, there is an expressed restriction against using bond proceeds to refinance project costs incurred more than 60 days prior to the date an issuer takes official action

There are two categories of qualified Small Issue bonds that may be issued under the IRC: $1 million or less, and over $1 million up to $10 million issues. Separate rules apply to each category.

To determine whether a project falls under the $1 million vs. $10 million categories (these are technically called "exceptions"), the issuer must first assess the amount of any outstanding tax-exempt obligations currently outstanding to fund facilities located in the same jurisdiction of the proposed project, including prior Small Issues or Exempt facility bonds, allocable to the borrower and any principal users or related persons. Prior issues are ones that funded facilities located in the same political subdivision (city or county of the proposed project, including in some cases facilities located in contiguous cities or counties) that are used by the same principal user(s) or related persons of a proposed project.

If the par amount of proposed bonds together with prior outstanding issues (outstanding principal balance) in the same jurisdiction of the proposed issue exceeds $1 million but no more than $10 million, the company/manufacturer must comply with the $20 million capital expenditure limit ($10 million in 2006). The $20 million capital expenditure limit is determined by inclusion of not just the proposed issue and prior outstanding issues in the same jurisdiction but also certain other capital expenditures. These include expenditures that were paid or incurred other than with bond proceeds, during a six-year period, beginning three years before the date of the proposed new bond issue and ending three years after the date of such proposed new bond issue; i.e., a six year window. While the capital expenditure limitation was increased to $20 million on December 31, 2006 the maximum amount of bonds that may be issued or outstanding remains at $10 million.

Qualified Small Issues are a category of Private Activity Bond. The IRC limits the amount of Private Activity Bonds that can be issued in every state. This is called the "volume cap" and a qualified small issue will need an allocation of their state's volume cap on Private Activity Bonds.

Methods of Sale and Credit Enhancement

IDBs are primarily structured and sold two ways: (1) by direct purchase without any credit enhancement, or (2) as variable rate demand obligation bonds (VRDO) secured by a direct pay bank letter of credit (LOC).

The direct purchase of non-bank qualified, private activity bonds like qualified small issues by commercial banks or finance companies may be an attractive method of sale, particularly for smaller bond issues in the $500,000-$2 million range. With this approach, an issuer directly places bonds with a commercial bank or finance company like GE Capital. Professional fees, which can make smaller deals uneconomical, are substantially reduced because there is typically no placement agent, remarketing agent, letter of credit bank (and all their additional associated legal fees), rating, and possibly no trustee (or the bank that purchases the bonds will act as trustee and paying agent) as well on these transactions. On the other hand, bond pricing is higher than VRDO structures reviewed below but offset by the lower fees that can have a significant impact on the effective cost of borrowing for smaller deals.

Many IDBs are sold as variable rate demand obligation bonds (VRDO) secured by a rated bank letter of credit. Unlike direct purchase where bonds are placed with commercial banks or finance companies on either a fixed or variable rate basis, the interest rate on VRDO bonds are typically priced every seven days on the nation's capital markets through a remarketing agent. This is typically the lowest interest rate available to IDB users but cost of issuance is higher than direct purchase as more bond professionals are involved in these transactions and a LOC fee must be paid to the LOC bank annually.

Under the reimbursement agreement between a bank LOC provider and a conduit borrower, the LOC provider, in exchange for payment of an LOC fee (typically .5%-2% of the outstanding principal amount annually) issues a LOC payable to the bond trustee. The LOC requires that the provider (almost all are domestic or foreign banks, although GE Capital also provides AAA-rated LOCs), for the term of the LOC, to pay to the trustee an amount equal to the full principal of the issue, plus a specified amount of interest such as 40 days or more. The bond trustee will draw upon the LOC either to make all debt service payments (a "direct pay" LOC) or to cover issuer default (a "standby" LOC). The borrower must reimburse payments made by the LOC provider.

In a VRDO bond issue, a LOC is also used to provide a "liquidity facility." VRDO bonds such as weekly low-floaters have a demand feature whereby the bondholder may require purchase of their bonds at par plus accrued interest either periodically or at will—often on 7-30 days notice to the issuer. In the event the remarketing agent cannot sell the bonds to another holder, the liquidity facility is drawn upon to purchase the put bonds.