CHAPTER 39

CORPORATE TAX-EXEMPT FINANCING

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Private activity bonds (PABs) include any debt obligations issued by a governmental entity to finance the construction or acquisition of facilities for use by a private company. The facilities may be new, rehabilitated, or expanded. As long as the bonds meet certain requirements, interest on the bonds is excludable from gross income for federal income tax purposes and, in some cases, from state income and other local taxes as well. Principal and interest on the bonds are paid from amounts received by the governmental entity from the private company under an agreement such as a lease, loan agreement, or installment sale contract. If necessary, the bonds may be further secured by a mortgage on the fixed assets financed. The governmental entity is not liable for payments on the bonds beyond the revenues received under the agreement or from collateral for the bonds. In addition, the governmental entity cannot use any of its own funds to pay principal, interest, or other costs incurred in connection with the financing.

This type of financing allows corporations to gain access to additional sources of funding. Construction and acquisition projects can be undertaken at markedly lower interest costs than would be possible with other forms of financing. The interest cost savings can be substantial; it can range up to 400 basis points compared with taxable obligations of similar maturities.

Interest cost savings will vary depending on market conditions and the terms of the bonds. The maturities of the bonds, for example, must be set to coincide with the demands of the market as well as the best interest of the borrower. Currently, maturities may range from short-term three-year obligations, for example, to long-term 30- or 35-year obligations. However, since the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the weighted average maturity of the bonds is subject to restrictions. These restrictions are discussed in this chapter under the heading, "Considerations Applicable to All Private Activity Bond Financing." In addition, it is often possible, and in certain situations quite advantageous, to structure the financing with a variable, rather than a fixed, interest rate.

There are further advantages to this type of tax-exempt financing. Typically, tax-exempt bond financing provides 100 percent of the funds required for the project. In contrast with common practice in taxable financing, tax-exempt financings usually do not contain restrictions on company dividends, working capital, debt-equity ratios, or the incurrence of other indebtedness. Tax-exempt financing can be accomplished while retaining the advantages of ownership of the project for tax purposes. Thus, the borrower is entitled to depreciation and investment tax credits (if applicable) on the project even though it is financed with tax-exempt obligations. However, depreciation of facilities financed with private activity bonds is limited, as described later in this chapter. Alternatively, tax-exempt financing may be used to provide the debt component of a leveraged-lease financing, which enables a company to transfer the tax benefits of ownership to another entity.

Sophisticated procedures for enhancing the credit rating on bond issues have also been developed that lower the interest cost to the borrower. This chapter contains a discussion of the general requirements and procedures involved in credit enhancement devices.

ECONOMIC ADVANTAGES

The principal economic advantages of tax-exempt bond financing can be summarized as follows:

Lower Interest Rates

The major advantage is the lower interest rate that can be achieved because of the tax-exempt status of interest on the bonds. A company could expect the interest on tax-exempt bonds issued on its behalf to be at least 2 to 3 percent below the interest rate on its conventional borrowings. At times, the differential may be even greater. With a 2 percent differential on a 30-year, $10,000,000 issue, the interest cost savings is $6,000,000.

Alternate Source of Capital

Tax-exempt bonds often provide an alternate source of capital for financing programs. Since many active purchasers of tax-exempt bonds are the public and financial institutions, such as insurance companies, less reliance may be placed on traditional lending sources, such as commercial banks. In addition, the tax-exempt market will generally provide longer-term financing—often up to 30 year—than is found in the taxable market.

Depreciation

Tax-exempt financing can be accomplished without losing the advantages of tax ownership. This is true even though the facility being financed technically may be "owned" by the issuer of the bonds and "leased" to the company. For federal tax purposes, the property is treated as if it is owned by the company. Thus, it remains eligible for depreciation, although depreciation has been limited somewhat, as discussed in the next section.

FEDERAL TAX LAW

The federal law relating to tax-exempt bond financing is contained in several sections of the Internal Revenue Code of 1986 (the Code) and is amplified, interpreted, and explained in Treasury Regulations, rulings, and announcements.

Section 103(a) provides that gross income for federal income tax purposes does not include interest on obligations of state or other political subdivisions. Section 103(b)(1) provides that, with certain exceptions discussed in the following pages, a "private activity bond" is not treated as an obligation described in Section 103(a). Section 141 defines a "private activity bond" as any obligation that meets either the "private business tests" or the "private loan financing test." The private business tests consist of the private business use test and the private security or payment test. The private business use test is generally met if more than 10 percent of the proceeds of the issue are to be used for any private business use. The private security or payment test is generally met if the payment of the principal of, or the interest on, more than 10 percent of the proceeds of the issue is, under the terms of such issue or an underlying arrangement, directly or indirectly:

1. secured by any interest in property used or to be used for a private business use, or payments in respect of such property, or
2. to be derived from payments (whether or not to the issuer) in respect of property, or borrowed money, used or to be used for a private business use.

If both the private business use test and the private security or payment test are met, the bonds are private activity bonds within the meaning of the Internal Revenue Code and the interest on them is taxable unless one of the exemptions found in Sections 142 through 145 applies to the bonds. It is the exemptions that make the rule for corporate tax-exempt financing.

The private loan financing test is generally met if the amount of the proceeds of the issue which are to be used (directly or indirectly) to make or finance loans to persons other than governmental units exceeds the lesser of 5 percent of such proceeds, or $5,000,000. If that test is met, the bonds are also private activity bonds and taxable unless an exception applies. It is again the exemptions that make the rule for corporate tax-exempt financing.

FACILITIES ELIGIBLE FOR TAX-EXEMPT FINANCING: GENERAL CHARACTERISTICS

As a general matter, federal tax law does not restrict the type of facility that may be financed with private activity bonds. It does, however, require that 95 percent of the net proceeds of the bond issue be used to finance land or depreciable property or other qualifying costs. However, state law may impose stricter limits on the projects that may be financed.

The Code defines net proceeds as the proceeds reduced by amounts in a reasonably required reserve or replacement fund, but not reduced by costs of issuance. Consequently, costs of issuance (including attorneys' fees and underwriter's discount) do *not* count toward satisfaction of the 95 percent requirement. The Code further provides that in order for an issue of private activity bonds to be tax-exempt, costs of issuance "financed by the issue" may not exceed 2 percent of the proceeds of the bonds, and even that 2 percent would have to be charged against the 5 percent that can be used for nonqualifying expenditures. Costs of issuance in excess of that 2 percent may be paid from other sources without adversely affecting the tax exemption of the bonds.

"Qualified small issue" private activity bond financings pursuant to Section 144 of the Code are limited to projects costing less than $10 million, taking into account certain other capital expenditures. Simpler rules apply to small issues of $1 million or less. Issues to finance "exempt facilities" pursuant to Section 142 of the Code are not subject to any dollar limitations. Exempt facilities include airports, docks, wharves, mass commuting facilities, facilities for the furnishing of water, sewage facilities, solid waste disposal facilities, qualified residential rental projects, certain electric generating facilities, and qualified hazardous waste facilities.

A number of specific restrictions have been placed on the financing of certain facilities with tax-exempt bonds. Some facilities are not financeable to any extent with small issue tax-exempt bonds. Such facilities include any private or commercial golf course, country club, massage parlor, tennis club, skating facility (including roller skating, skateboard, and ice skating), and racquet sports facility (including any handball or racquetball court), hot tub facility, suntan facility, or racetrack. Tax-exempt private activity bonds also may not be used to any extent to finance airplanes, skyboxes, or other private luxury boxes, any health club facility, any facility primarily used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises (i.e., a liquor store).

In addition to these prohibitions, small issue bonds cannot be issued if more than 25 percent of the net proceeds of the issue is to be used for a facility that primarily sells automobiles or services them or for a facility that primarily provides retail food and beverage services (including eating and drinking places, but not grocery stores) or recreation or entertainment. Section 147(c) of the Code generally prohibits the use of any portion of small issue bond proceeds for the acquisition of land to be used for farming or the use of 25 percent or more of bond proceeds for the acquisition of non-farm land. An exception is provided to the prohibition on the use of bonds to finance the acquisition of land to be used for farming in the case of a "first time farmer."

Section 147(d) of the Code precludes the use of small issue bond proceeds to finance the acquisition of existing property. An exception is provided for an existing building and the equipment it contains if the cost of rehabilitation expenditures for property incurred within two years after either the building is acquired or the bonds are issued (whichever date is later) equals or exceeds 15 percent of the portion of the cost of acquiring the building (and equipment) financed with bond proceeds. A similar exception is provided for structures other than a building except that the cost of rehabilitating such facilities must exceed 100 percent of the portion of the cost of the facilities financed with bond proceeds.

A rehabilitation expenditure includes any amount properly chargeable to the capital account of the taxpayer acquiring the building for improvements to the property. If equipment was used as part of an integrated operation contained in a building, expenditures to rebuild or replace the equipment with equipment having substantially the same function qualify as rehabilitation expenditures. Rehabilitation expenditures incurred by the seller of existing property under a sales contract may be reimbursed by the purchaser with bond proceeds. "Rehabilitation expenditures" do not include the cost of enlarging a building, expenditures made by a lessee if the lease term is less than 18 years, or expenditures that are allocated to property used by a tax-exempt entity.

SMALL ISSUE EXEMPTION

Section 144 of the Code provides for tax exemption of the interest on private activity bonds that are part of an issue with a face amount of $1 million or less, or, in certain circumstances, $10 million or less. This exemption has expired for bonds issued after December 31, 1986, for nonmanufacturing facilities and is scheduled to expire after December 31, 1989, for manufacturing facilities. However, it appears likely that Congress will approve an extension of the exemption for manufacturing facilities until December 31, 1991.

Exempt Small Issues of $1 Million or Less

The interest on a $1 million small issue is exempt from federal income tax if 95 percent or more of the net proceeds are used (a) for the acquisition, construction, reconstruction, or improvement of land or depreciable property, or (b) to redeem part or all of a previously issued exempt small issue. If more than 5 percent of the net bond proceeds are expended for working capital or to purchase inventory, interest on the bonds will *not* be exempt.

The $1 million limitation includes prior exempt small issue financing for the benefit of a company (and related persons) in a particular governmental unit. An incorporated town or city is a governmental unit, as is all of the unincorporated area of a county. Thus, subject to the $40 million limit discussed below, the same company could utilize up to $1 million of small issue financing in each jurisdiction where it locates facilities. In certain situations, exempt small issues in contiguous governmental units may be counted as well. Unlike small issues under the $10 million limit, which are discussed in the next section, capital expenditures are not included. Thus, an exempt

$1 million issue can be used to finance a portion of a facility costing more than $1 million. A $1 million small issue can no longer be combined with an exempt facility financed under Section 142.

Exempt Small Issues of $10 Million or Less

All of the rules applicable to the $1 million exempt small issue described above also apply to the so-called $10 million exempt small issue. However, in determining compliance with the $10 million limit, capital expenditures paid or incurred during a six-year period, beginning three years before the date of the bond issue and ending three years after the issue, must be included. If the total proposed bond issue plus includable capital expenditures exceeds $10 million at any time within three years after the bonds are issued, interest on such bonds would become taxable on and after such time. However, an issue of up to $1 million may be utilized instead when it is anticipated that the $10 million limit cannot be complied with.

An expenditure, regardless of whether it is paid in cash, notes, or stock in a taxable or nontaxable transaction, is a capital expenditure if:

1. The capital expenditure was financed other than out of the proceeds of the bond issue.
2. The principal user of the facility that the capital expenditure was made for and the principal user of the facility financed by the proceeds of the bond issue in question are the same person or two or more related persons.
3. The facilities referred to in (2) are located in the same governmental unit as of the issue date.

Capital expenditures by or on behalf of all principal users are taken into account. Generally, a person who uses 10 percent or more of the space in a facility, determined on the basis of gross rent value, is a principal user.

A principal user should not be confused with a substantial user. The substantial user prohibition relates to the purchaser of bonds, discussed below, and involves a more restrictive definition than the principal user rules. The difference in treatment may be illustrated by an example in which X, a developer, uses the proceeds of a small issue to construct a shopping center in an incorporated municipality in which space will be leased to A, B, C, and D. A and B will each lease 40 percent, by rental value, of the shopping center; C will lease 15 percent and D 5 percent of the shopping center. E is "related" to A; F is "related" to D. For purposes of determining whether the $10 million limitation has been exceeded, the full amount of capital expenditures made by X, A, B, C, and E must be included. Since D is not a principal user of the facility, capital expenditures made by D and F in regard to facilities located in the incorporated municipality will not normally be included for purposes of determining whether the $10 million limitation has been exceeded. However, since D leases 5 percent of the shopping center, he is a substantial user. Therefore, neither D nor F, who is a related person to D, nor X, A, B, C, and E, may purchase and hold the bonds on a tax-exempt basis.

Capital expenditures to replace property destroyed or damaged by fire, storm, or other casualties are not to be taken into account when they amount to less than a fair market value of the property replaced. Capital expenditures of less than $1 million that are required by circumstances that could not reasonably be foreseen on the date of issue are also not to be taken into account.

One very important exception to the capital expenditure rules relates to leasing. Expenditures may be excluded for purposes of the $10 million limitation if they are made by a person other than the user, a related person, or a governmental unit for personal property leased under a true lease (as distinguished from a financing lease) to the user or a related party. The lessor must be the manufacturer of the property or a person in the trade or business of leasing property the same as or similar to such property, and the property must be of a type which, in general business practice, is ordinarily the subject of a lease. Before the leasing exception can be utilized, detailed findings on each of the preceding points must be made.

Another category of excluded capital expenditure is certain in-house research expenditures for which a deduction was allowed under Section 174(a) of the Code.

Exempt Small Issue for UDAG Projects

Another exception to the $10 million limitation exists for projects for which an Urban Development Action Grant has been made. Under Section 144(a)(4)(F), up to $10 million of additional capital expenditures for such a project may be disregarded, with the result that the project may cost as much as $20 million and still be eligible for tax-exempt financing to the extent of $10 million.

As a prerequisite to the application of this rule, the financed facility should be named on an application for UDAG assistance. In addition, the named company or developer must have made a firm financial commitment to the urban development project. Finally, the IRS requires that the UDAG assistance amount to at least 5 percent of the total cost of the project.

Corporate Acquisitions

In some cases a company may desire to purchase stock of a corporation owning land or depreciable property, rather than purchasing such assets directly. Such purchase can be financed with tax-exempt bonds if the purpose of the stock acquisition is to acquire the underlying assets. Under the pre-TEFRA law, the acquired corporation had to be liquidated under Section 332(b) of the Code (relating to parent-subsidiary corporations), and the basis of the assets acquired upon liquidation had to be determined under Section 334(b)(2) of the Code by reference to the acquiring corporation's cost in acquiring the stock. TEFRA repealed Section 334(b)(2) and replaced it with Section 338. Section 338 achieves the same result as Section 334(b)(2), at the election of the acquiring corporation, but without actually having to liquidate the acquired corporation. The IRS has ruled privately that the treatment of Section 338 transactions in the context of Section 103 is identical to that accorded purchases and liquidations under prior law.

In addition, the proceeds of the bond issue can only be applied to acquire the land or depreciable property of the corporation. The other assets of the corporation, such as inventory and intangibles, must be purchased with funds acquired from other sources. Finally, the rehabilitation requirements, discussed above, would have to be satisfied.

The $10 Million Aggregate Limit for Small Issues

Section 144(a)(10), originally enacted as Section 103(b)(15) of the 1954 Code by the Deficit Reduction Act of 1984 (DRA84), provides for a $40 million cap on the outstanding amount of tax-exempt small issue bonds for any test-period beneficiary for the financing. The $40 million limit is to be distinguished from the $10 million and $1 million small issue limits in that the $40 million limit is determined on a nationwide basis by the aggregation of all tax-exempt facility related bonds (including exempt facilities bonds) issued anywhere in the United States or its territories and possessions of which an entity or related person is a test-period beneficiary. The $40 million limit does not preclude the issuance of exempt facilities bonds, such as solid waste disposal bonds, in excess of the $40 million cap; however, the principal amount of such bonds will count toward the $40 million small issue limit.

A company will be considered the test-period beneficiary of a facility financed with tax-exempt bonds if the company is an owner or principal user of such facilities at any time during the three-year period beginning on the date the facilities are placed in service or the date of the bond issue, whichever is later.

Under the allocation rules of Section 144(a)(10)(C), a company must take into account its "allocated amount" of the aggregate face amount of all bonds of which it is a test-period beneficiary that are outstanding on the date of issuance of the new small issue. The allocated amount for a company is the pro rata amount of the bonds outstanding based upon its percentage of ownership or use of the facilities. All entities or persons who are related to each other under Section 144(a)(3) of the Code are treated as one person for purposes of the allocation rules.

If any test-period beneficiary of a proposed issue has an allocated amount of industrial development bonds outstanding which, when added to his or her allocated amount of the proposed issue, exceeds $40 million, no portion of the issue can qualify for tax-exemption. The General Explanation of DRA84 prepared by the staff of the Joint Committee on Taxation takes the position that the test-period beneficiary taint cannot be removed as long as the tax-exempt bonds are outstanding, regardless of whether the beneficiary is using the financed facility on the date of any later issue. If the $40 million limit is violated with regard to a post-1984 small issue bond, that issue becomes taxable from the date of issuance.

Composite Small Issues

Revenue Ruling 81-216 and related proposed regulations provide that the issuance of multiple lots of bonds will be aggregated and treated as a single large issue rather than as separate exempt small issues if the obligations:

1. Are sold at substantially the same time.
2. Are under a common plan or marketing.
3. Are at substantially the same rate of interest.
4. And if a common or pooled security is either used or available to pay debt service on the obligations.

A statutory exception is provided for issues that would otherwise be treated as a composite issue if no principal user finances more than one facility as part of the same composite issue, and all of the facilities being financed are located in the same state. For this purpose, a franchiser is considered a principal user of the facilities financed.

Refundings

With the enactment of a technical correction, it is now clear that refundings of exempt small issues will be permitted under the Code. Section 144(a)(12) of the Code contains an exception to the December 31, 1986 and December 31, 1989 (or possibly December 31, 1991) sunsets for current refunding of exempt small issue bonds that were issued on or before December 31, 1986, (December 31, 1989, or again, possibly December 31, 1991, for manufacturing and farming) if the refunding bonds amount and average maturity do not exceed those of the outstanding refunded bonds. There does not appear to be a sunset date for the issuance of such refunding bonds. The prior bonds to be redeemed from the proceeds of current refunding bonds are not counted against the $40,000,000 limit pertinent to qualified small issues. For this purpose "current refundings" mean refundings in which the refunding bonds are issued not more than 90 days before the redemption of the refunded bonds. A period of longer than 90 days involves an "advance refunding" and is not permitted by Section 149(d) of the Code.

FACILITIES ELIGIBLE FOR TAX-EXEMPT FINANCING: SPECIFIC CATEGORIES

Pollution Control Facilities

The Tax Reform Act of 1986 (the 1986 Act) repealed the exemption generally permitting tax-exempt financing of pollution control equipment. However, under a special transition rule, such equipment may still be financed if, among other requirements, construction or acquisition of such equipment was in progress on September 26, 1985, and an inducement resolution had been adopted before such date. Under the transition rule these facilities may be financed in the manner permitted under the 1954 Code, with certain modifications, including the requirement that at least 95 percent of the net proceeds are used to provide air or water pollution control facilities. There is no dollar limitation on the size of a bond issue for these purposes.

Under the applicable Treasury Regulations, a pollution control facility is defined as (a) land or depreciable property, (b) used in whole or in part to abate or control water or atmospheric pollution or contamination by removing, altering, disposing or storing pollutants, contaminants, waste or heat, (c) a discrete unit that is not larger in size than needed for its function, and (d) certified by the appropriate local governmental agency for pollution control or designed to meet or exceed applicable federal, state, or local pollution control requirements.

Property is excluded from the definition of a pollution control facility if it is (1) used to avoid or prevent the creation of pollution, (2) used to treat fuels, (3) used to prevent the release of pollutants in a major accident, (4) used to control a nuisance, (5) used to reduce immediate risk of injury, or (6) used to control material in a manner "customarily controlled." In short, the facility must treat a realized pollutant in response to governmental requirements.

If a pollution control facility results in an economic benefit, the qualifying cost of the facility must be reduced according to a formula provided in the Treasury Regulations. The nonqualifying portion cannot be included in the bond issue, except to the extent of the insubstantial portion (not more than 5 percent) of the proceeds. Economic benefit is defined as gross income or cost savings resulting from production of a by-product or any identifiable cost savings such as one resulting from the use, reuse, or recycling of the items recovered. Production efficiencies and extension of the useful life of nonpollution control property are also economic benefits, as are pollution facilities that make unnecessary the use of any production property that otherwise would be necessary.

An allocation is also required for the portion of any pollution control facility used for a nonpollution control purpose, such as employee safety, or installed as a customary practice.

Current refundings of pollution control bonds tax-exempt under prior law are also generally tax-exempt under a transition rule in the 1986 Act as long as the refunding bonds amount does not exceed that of the outstanding bonds and the average maturity of the refunding bond does not exceed 120 percent of the average reasonably expected economic life of the facilities financed (or possibly 17 years, if longer). Again, in this context "current refundings" means refundings in which the refunding bonds are issued not more than 90 days before the redemption of the refunded bonds.

Sewage or Solid Waste Disposal Facilities

Sections 142(a)(5) and (6) of the Code permit the issuance of tax-exempt private activity bonds if at least 95 percent of the net proceeds are used

to provide sewage or solid waste disposal facilities. There is also no dollar limitation on the size of a bond issue for these purposes.

Treasury Regulation §1.103-8(f)(2)(ii) defines "solid waste disposal facilities" as any property or portion of property used for the collection, storage, treatment, utilization, processing, or final disposal of solid waste. Under the legislative history accompanying the 1986 Act, the term solid waste is considered not to include hazardous waste, including any radioactive waste. However, facilities for the disposal of radioactive solid waste may still be financed if they meet the September 26, 1985, "in progress" transition rule described above with respect to pollution control facilities. Similarly, such facilities may be the subject of a transitional current refunding, also as described above.

Solid waste means garbage, refuse, and other discarded solid materials, including solid waste materials resulting from industrial, commercial, and agricultural operations, and from community activities. Material will not qualify as solid waste unless, on the date of issue of the obligations to provide the disposal facility, the material is property that is useless, unused, unwanted, or discarded solid material that has no market or other value at the place where it is located. Thus, if any person is willing to purchase the material, at any price, it is not waste. If any person is willing to remove the material at his own expense, but is not willing to purchase it at any price, the material is waste.

A facility that disposes of solid waste by reconstituting, converting, or otherwise recycling it into material that is not waste also qualifies as a solid waste disposal facility if solid waste constitutes at least 65 percent, by weight or volume, of the total materials introduced into the recycling process. A facility will not fail to qualify as a solid waste disposal facility solely because it operates at a profit. Thus, in contrast to air and water pollution control facilities, generally no allocation and resulting reduction in bond issue size is required as a result of an economic benefit.

The Regulations further provide that where materials are recovered or result from the disposal process, the disposal function includes the processing of the materials to put them into the form in which they are in fact sold or used, but does not include further processing which converts the materials into other products.

Section 142(b)(2) sets forth a rule, applicable to all exempt facilities, on office space. An office will not qualify unless it is located on the premises of the exempt facility and not more than a de minimis amount of the functions to be performed at such an office is not directly related to the day-to-day operations at such a facility.

Docks and Wharves

Section 142(a)(2) permits the issuance of tax-exempt private activity bonds if at least 95 percent of the net proceeds are used to provide docks and wharves or storage or training facilities directly related to such facilities. There is no dollar limitation on the size of a bond issue for these purposes. However, such facilities must be "governmentally owned" and may not include any lodging facility, any retail facility in excess of the size necessary to serve passengers (and persons who meet or accompany them) and employees at the facility, any retail facility (other than parking) for passengers or the general public located outside the exempt facility terminal, any office building for individuals who are not employees of a governmental unit or of the operating authority for the exempt facility, or any industrial park or manufacturing facility. According to the legislative history of the 1986 Act, the general office space rule for exempt facilities, noted above, is subject to the specific office space rule, with respect to docks and wharves. Property is not treated as not owned by a governmental unit solely by reason of a lease to which it is subject if (1) the lessee irrevocably elects (binding on the lessee and all successors in interest under the lease) not to claim depreciation or any investment credit with respect to such property, (2) the lease term is not more than 80 percent of the reasonably expected economic life of the property, and (3) the lessee has no option to purchase the property other than at fair market value.

In order to qualify for tax-exempt financing, a dock, which includes facilities that are functionally related and subordinate to the primary facility, must meet the public use test. This test requires that a facility must serve or at least be available on a regular basis for use by the general public, or by a common carrier that itself serves the general public. The public use test is satisfied, however, if the exempt facility is part of a public port.

The general public is presumably limited to that segment of the public that can make use of the dock. Thus, if the dock is constructed for the shipment of coal, the general public would be those engaged in shipping coal. If the dock or wharf is in fact used by a substantial number of coal shippers, the public use test should be satisfied. On the other hand, if the facility is used exclusively by one company because its remote geographic location precludes its practical use by others, the facility will not meet the public use requirement. Alternatively, if the dock is served by common carriers that in turn serve the public, it should also qualify. Finally, if the dock is located in a public port, it would qualify even if it had only one user. Thus, a pipeline common carrier could use proceeds of tax-exempt bonds to finance a marine oil terminal, since

it is required under Interstate Commerce Commission regulations to accept offers from any oil producer to ship oil products through its dock facilities. A dock used in the construction of ships would not be considered a qualifying dock for this purpose.

The Regulations expand the definition of dock or wharf to include property that is "functionally related and subordinate" to the dock or wharf, such as cranes and conveyors, and related storage, handling, and similar facilities, physically located on or adjacent to the dock or wharf. Examples of storage facilities that would qualify for tax-exempt financing include a grain elevator, silo, warehouse, and oil and gas storage tanks.

Airport Facilities

Section 142(a)(1) permits the issuance of tax-exempt private activity bonds if at least 95 percent of the net proceeds are used to provide airport facilities, or storage or training facilities directly related to such facilities. There is no dollar limitation on the size of a bond issue for these purposes. However, such facilities must also be "governmentally owned" and may not include facilities equivalent to those the financing of which is prohibited with exempt facility docks and wharves bonds.

In addition, Section 1.103-8(e)(2) of the Regulations defines an airport to include terminals, runways, hangars, loading facilities, aircraft repair shops, parking areas, and facilities that are functionally related and subordinate to the airport. Subject to the limitations described above, these may include facilities for the preparation of in-flight meals, as well as restaurants, retail stores, and other facilities functionally related to the needs or convenience of passengers, shipping companies, and airlines. In addition, the Regulations provide that a related storage or training facility may be financed if it is both directly related to an airport and physically located at, or adjacent, to an airport.

The "public use" requirement also applies to airport facility financings. Thus, the term "airport" does not include a landing strip that, through a formal or informal agreement, or because of geographic location, will not be available for general public use.

In addition, a facility that does not need to be located at, or adjacent to, an airport in order for the facility to serve its function is not considered part of an airport and does not qualify for tax-exempt financing. A facility that is functionally related to more than one airport, such as an office building (or office space within a building), or a computer facility that serves a systemwide or regional function of an airline also does not qualify for tax-exempt financing.

Mass Commuting Facilities

Section 142(a)(3) also permits the issuance of tax-exempt private activity bonds if at least 95 percent of the net proceeds are used to provide mass commuting facilities or storage or training facilities directly related to such facilities. There is no dollar limitation on the size of a bond issue for these purposes. However, such facilities must also be "governmentally owned" and also may not include facilities equivalent to those the financing of which is prohibited with exempt facility docks and wharves bonds.

Section 1.103-8(e)(2)(iii) of the Regulations defines mass commuting facilities to include facilities serving the general public commuting on a day-to-day basis by bus, subway, rail, ferry, or other conveyance that moves over prescribed routes, together with terminals and facilities that are functionally related and subordinate to the mass commuting facilities, such as parking garages, car barns, and repair shops.

Water Facilities

Sections 142(a)(4) and 142(e) permit the issuance of tax-exempt private activity bonds if at least 95 percent of the net proceeds are used to provide facilities to furnish water for any purpose as long as two requirements are met. First, the water is or will be made available to members of the general public, including electric utility, industrial, agricultural, or commercial users. Second, the facilities must either be operated by a governmental unit or the rates for the furnishing or sale of the water must be established by a governmental unit or regulatory agency. There is no dollar limitation on the size of a bond issue for these purposes.

Regulations §1.103-8(h)(1) amplify the Code requirement by stating that the public use test is satisfied if the water facility will provide water on reasonable demand to any member of the general public within the service area of the water system of which the facility is a part.

Regulations §1.103-8(h)(2) define water facilities to include artesian wells, reservoirs, dams, related equipment, and pipelines and other facilities used to furnish water for domestic or industrial use, irrigation, or other purposes.

Qualified Hazardous Waste Facilities

Sections 142(a)(10) and 142(h) permit the issuance of tax-exempt private activity bonds if at least 95 percent of the net proceeds are used to provide

qualified hazardous waste facilities. This includes only those which dispose of hazardous waste by incineration or entombment and which are subject to final permit requirements under subtitle C of Title II of the Solid Waste Disposal Act (which appears to rule out financing for Superfund sites). The portion of the hazardous waste facility to be financed by the bonds may not exceed the portion of the facility to be used by persons other than the owner or operator of the facility and any related persons. If 95 percent of the net proceeds of the issue is to be used for the portion not used by the owner, operator, or related persons, the facility is deemed to meet the public use requirement. The legislative history involving this provision states: "The conferees further intend that the term hazardous waste not include radioactive waste. . . . "

Other Exempt Facilities

In addition to the facilities already described, the Code permits the issuance of tax-exempt private activity bonds for other kinds of projects, including facilities for the local furnishing of gas or electricity, qualified residential rental projects, local district heating or cooling facilities (only the distribution facilities), and high-speed intercity rail facilities. Again, there is no dollar limitation on the size of a bond issue for any of these purposes. Under prior law, sports facilities, convention or trade show facilities, and parking facilities could also be financed on a tax-exempt basis. But under current law, these facilities may only be financed on a tax-exempt basis if they meet the September 26, 1985 "in progress" transition rule described above with respect to pollution control facilities. Similarly, such facilities may be the subject of a transitional current refunding, also as described above. In addition, the 1986 Act contains a number of project specific transition rules applying to many types of exempt facilities that would permit tax-exempt financing of the particular described projects.

CONSIDERATIONS APPLICABLE TO ALL PRIVATE ACTIVITY BOND FINANCINGS

Timing Requirements (Get an Inducement Resolution First)

The statutory exemption for qualifying private activity bonds as exempt small issues or exempt facility bonds is based on the use of the bond proceeds "to provide" facilities. Accordingly, Treasury Regulations and rulings provide

that the only qualifying costs that may be financed are those incurred after the issuer adopts a bond resolution or takes "some other similar official action" toward the issuance of the bonds. (Up to 5 percent of the net bond proceeds may be used to finance nonqualifying costs.) The official action or inducement resolution demonstrates the political subdivision's intent to issue bonds to finance the project.

Ideally, official action is taken before construction or acquisition of the facility to be financed actually begins. A model timetable for an industrial development bond financing is found in Appendix A. In any event, official action should be taken by the issuer as early as possible, for only those costs incurred after its adoption may constitute qualifying costs for tax-exempt bond purposes. A form of official action is found in Appendix B.

Frequently, local company officials have contact with officials of the political subdivision where the facility is or is to be located. As such, they are in a better position to ask the political subdivision to take official action. Many times, however, local company officials are not familiar with tax-exempt bond financing and, as a result, may feel uncomfortable about approaching local governmental officials. (A list of questions typically asked by local governmental officials who are not familiar with industrial development bond financing and the answers to those questions is contained in Appendix C.)

Substantial Users or Related Persons

When bonds are held by a "substantial user" of the financed facility or a person related to the substantial user ("related person"), Section 147(a)(1) of the Code provides that the interest on exempt small issues or exempt facility bonds, which would otherwise be tax-exempt, is taxable during those periods. A substantial user is defined in Treasury Regulation §1.103-11(b) to include a person for whom the facility or a part of the facility is specifically constructed or acquired, or one who occupies more than 5 percent of the entire usable area of the facility, or who derives more than 5 percent of the gross revenue derived by all users of the facility. A related person is defined in Code Section 147(a)(2) by reference to other sections of the Code containing detailed rules for family relationships, affiliated corporations, partnerships, estates, and individuals. As a general rule, a more than 50 percent ownership relationship will result in parties being treated as related. A partnership and each of its partners (and their spouses and minor children) are treated as related persons regardless of their interest. An identical provision applies to S Corporations and their shareholders.

Arbitrage

Under Section 103(b)(2) of the Code, the exemption in Section 103(a) does not apply to arbitrage bonds. Arbitrage bonds generally are bonds of which any portion of the proceeds are reasonably expected to be used directly or indirectly, after the expiration of certain temporary periods, to acquire higher-yielding investments. The temporary period rules generally suffice to permit the unrestricted investment of bond proceeds before their use for the actual purpose of the financing.

However, Section 148(f) contains additional rules that eliminate as a practical matter most of the benefit from the three-year temporary period for construction projects during which bond proceeds may be invested without any yield restrictions. While the three-year period still remains available, the new arbitrage rules require that all arbitrage profits be rebated to the United States unless all "gross proceeds" of the bonds are expended for the ultimate purpose of the financing *within six months* of the date the bonds were issued. Although reserve funds in PABs (other than airport financings) are rare, establishment of such a fund would preclude taking advantage of even the six-month expenditure rule since all of the proceeds of the issue would not have been spent at the end of the six-month period. (However, it is possible that this effect of a reserve fund on the six-month expenditure rule may be modified in future regulations.) Also, after the expiration of certain temporary periods, the amount of investments in the reserve fund having a yield higher than the yield on the bonds cannot at any time exceed 150 percent of the scheduled debt service on the bonds during that year. Any such amount that results must be promptly reduced as the aggregate principal amount of bonds outstanding is reduced. The only exception is if a reduction would require the sale of investments at a loss that exceeds the amount that would be paid to the United States under the rebate requirement if a payment were due at that time.

For purposes of the new rules the yield on the bonds is determined on the basis of the price paid by the first purchaser, excluding brokers and other intermediaries. No costs of issuance or underwriters' discount are taken into account. Premiums paid for bond insurance and other credit enhancement fees, in most cases, can be taken into account as additional interest. In addition, under the future value method prescribed in the Regulations, investment earnings on the arbitrage profits are imputed at the bond yield and must also be rebated to the United States. For example, assume that the yield on a $1 million issue of bonds is 7 percent and that $500,000 of the proceeds is drawn down on the date of issuance and spent, while the remaining $500,000 is invested for one year

at 9 percent. The investment of the $500,000 at the yield on the bonds would have produced $35,000, whereas, in fact, the investment produced $45,000. Thus, under the Regulations, the future value at the bond yield of this $10,000 difference (including the earnings imputed on that amount at the bond yield) must be rebated on the United States, despite the fact that the actual earnings do not equal the cost of carrying the bonds ($70,000) for one year.

Earnings of less than $100,000 on a bona fide debt service fund for a bond year need not (and may not) be taken into account for rebate purposes. Notably, this could be disadvantageous if, for example, there was negative arbitrage on such a fund.

As stated earlier, the rebate requirement does not apply when all gross proceeds of a bond issue are expended within six months of issue. The term gross proceeds is broadly defined to include every imaginable kind of proceeds, such as amounts received from investments of original proceeds of an issue (including repayments of principal) and amounts used to pay debt service on the issue. Solely for purposes of the six months exception, payments into a bona fide debt service fund are not treated as proceeds. If the gross proceeds of an issue are not spent within six months after they are issued, all earnings in excess of the amount that would have been earned (using the future value method) if such moneys had been invested at the yield on the bonds from the date of issuance must be rebated to the United States.

The rebate amount is determined annually on a cumulative basis from the date of issuance. Actual payment to the United States of the rebate amount is required at least once every five years. Each payment must be equal to at least 90 percent of the rebate amount determined as to the date of payment. The entire rebate amount must be paid within 60 days after the retirement of the bond issue. The rebate amount is not included in the gross income of the company borrower and therefore its payment is nondeductible.

The following additional rules apply to all exempt small issues and exempt facility bonds.

Reporting to the IRS

The issuer of an exempt small issue or exempt facility bond must file a report with the Internal Revenue Service on Form 8038 and set forth certain specified information (name, date, amount of issue, etc.) for every new issue of bonds. Form 8038 does not have to be filed until the 15th day of the second month after the close of the calendar quarter during which the bonds are issued, but bond counsel generally requires that it be filed at or before the closing of the bond issue.

Registration

All tax-exempt bonds, including exempt small issues and exempt facility bonds, must be issued in registered, rather than bearer, form.

Bond Maturity

The weighted average maturity of any issue of exempt small issue bonds or exempt facility bonds cannot exceed 120 percent of the weighted average economic life of the assets financed by the issue. The ADR midpoint lives used for depreciation before the passage of ACRS (in the case of equipment) or the Rev. Proc. 62-21 guideline lives (in the case of buildings and structures) may be used as "safe harbor" estimates of economically useful lives—that is, if these conservative numbers are used, compliance with the law is assured. Actual useful lives, however, may be used where such lives are longer than the safe harbor lives and where such actual lives can be established by credible evidence such as an engineering appraisal. The cost of acquiring land is ignored except where 25 percent or more of the bond proceeds are used to acquire land, in which case the land is assumed to have a life of 50 years.

Public Hearing and Approval

Before exempt small issues or exempt facility bonds can be issued, the issuers must hold a public hearing regarding the issuance of tax-exempt bonds for the project. Notice of this hearing must be published, generally at least 14 days in advance of the hearing, in one or more newspapers of general circulation in the area where the project is to be located. This is commonly known as the TEFRA hearing after the Tax Equity Fiscal Responsibility Act which mandated it.

After the public hearing, the bond issue must be approved by the highest elected official (or his elected designee) or the legislative body with jurisdiction over the issuer and over the geographical area in which the proceeds of the bonds are to be located. In the case of a public airport financed by the proceeds of an issue, only the issuing governmental unit that is the owner or operator of the airport must approve the issuance of the bonds.

Limits on Depreciation of Financed Facilities

The cost of facilities placed in service after December 31, 1986, and financed by exempt small issues or exempt facility bonds, must be recovered using the straight-line method. The Code generally requires such property to be depreciated over a period equal to (1) 40 years in the case of real property (versus 31.5 years for nonresidential real property that is not bond-financed); (2) the ADR midpoint life (a prescribed period approximating economic life) in the case of personal property (versus somewhat shorter periods if not bond-financed); and (3) 12 years in the case of personal property with no ADR midpoint life. An exception provides that certain specified types of property, including certain technological equipment and automobiles, are treated as having a recovery period of five years. Qualified residential rental projects financed with tax-exempt obligations are treated as having an ADR midpoint life of 27.5 years (the same as if not bond-financed).

The Act modifies the definition of tax-exempt bond-financed property to include any property to the extent that it is financed (directly or indirectly) by an obligation the interest on which is exempt from tax under Section 103(a). For purposes of this rule, the tax-exempt bond-financed portion is allocated to the property first placed in service.

In general, the depreciation provisions described above apply to property placed in service after December 31, 1986, if such property is financed by the proceeds of tax-exempt obligations (including refunding obligations) issued after March 1, 1986. A transitional rule provides relief from the new depreciation provisions in the case of a facility described in an inducement resolution (or comparable preliminary approval) adopted before March 2, 1986 *and* (1) the original use of which commences with the taxpayer, and the construction, reconstruction, or rehabilitation of which began before March 2, 1986, and was completed on or after that date, (2) with respect to which a binding contract to incur significant expenditures (more than 10 percent of the reasonably anticipated cost) for construction, reconstruction, or rehabilitation was entered into before March 2, 1986, and some of such expenditures are incurred on or after that date, *or* (3) acquired on or after March 2, 1986, pursuant to a binding contract entered into before that date. Additional transitional rules are provided for refunding obligations.

Limitation on Aggregate Amount of Private Activity Bonds in Each State

Section 146 of the Code limits the amount of certain private activity bonds that may be issued each year within each state. There are three significant exceptions to the state volume cap.

1. The cap does not apply to any qualified 501(c)(3) bonds that benefit tax-exempt charitable organizations with respect to their activities that do not constitute unrelated trades or businesses.

2. The cap does not apply to bonds the proceeds of which are used to provide airports, docks, or wharves (which, by definition, must be governmentally owned) to governmentally owned solid waste disposal facility bonds or to 75 percent of any bonds the proceeds of which are used to provide high-speed intercity rail facilities.

3. Finally, the state ceiling does not apply to obligations issued to refund other obligations when the amount of the refunding bonds does not exceed the amount of the refunded bonds.

With minor exceptions, during and after 1988, the limit for each state for each calendar year is equal to either $150 million or an amount equal to $50 multiplied by the state's population in the most recent census published before the beginning of the calendar year, whichever amount is greater.

A state's per capita bond cap for any calendar year is allocated by statute to 50 percent to all state issuers and 50 percent to all local issuers. The cap allocated to local issuers is divided among them on the basis of the ratio of the population of the local jurisdiction to the population of the entire state.

If an area is within the jurisdiction of two or more governmental units, the area will be treated as if it were only within the jurisdiction of the unit covering the smallest geographical area. However, the smallest unit may, by written agreement, surrender all or part of its jurisdiction on a yearly basis to the governmental unit with overlapping jurisdiction.

A state may provide a different formula for allocating the state ceiling among the governmental units in the state. Many states have by proclamation or legislation established allocations of the state cap that vary significantly from the statutory allocation.

Denial of Tax Exemption for Federally Guaranteed Obligations

Section 149(b) denies tax exemption for interest on any obligation that is "federally guaranteed." An obligation is federally guaranteed if

1. Payment of principal or interest on the obligation is guaranteed (in whole or in part) by the United States or any agency or instrumentality thereof.

2. The obligation is issued as part of an issue for which 5 percent or more of the proceeds will be used in making federally guaranteed loans or will be invested in federally insured deposits or accounts.

3. The payment of principal or interest on the obligation is otherwise indirectly guaranteed (in whole or in part) by the United States or any agency of the federal government.

Exceptions are made for certain guarantees, including those by the

- Federal Housing Administration
- Veterans Administration
- Federal National Mortgage Association
- Federal Home Loan Mortgage Corporation
- Government National Mortgage Association
- Student Loan Marketing Association

Exceptions are also made for

- Any federal guarantee of student loans.
- Guarantees in connection with obligations to provide qualified residential rental projects pursuant to Section 142(d) or in connection with housing program obligations issued under Section 11(b) of the United States Housing Act of 1937.
- Guarantees in connection with qualified mortgage bonds, Section 143(a), or qualified veterans' mortgage bonds, Section 143(b).

In addition, obligations are not federally guaranteed because proceeds are invested in federally issued deposits for an initial temporary period, because of investments of a bona fide debt service fund or reserve fund, or because of investments in United States Treasury obligations.

An obligation will not be treated as federally guaranteed merely because the proceeds are used in making loans to financial institutions (e.g., as part of a loans-to-lenders program) or because a financial institution guarantees repayment of the loans (e.g., by issuing a letter of credit) unless such a guarantee constitutes a federally insured deposit or account.

Bonds Issued under Other Provisions

Bonds that are tax-exempt under provisions other than the Code, such as bonds issued by Puerto Rico, the Virgin Islands, or Guam, must comply with the requirements of the Code, including the private activity bond and arbitrage restrictions.

Aggregation of Issues for a Single Project

Section 144(a)(9) of the Code, added by the Deficit Reduction Act of 1984, provides for the aggregation of separate small issues that are to be used, in total or in part, for a single building, an enclosed shopping mall, or a strip of offices, stores, or warehouses using substantial common facilities. All of

the small issues for the different portions of such a project are considered a single issue and, therefore, the principal user of each issue will be considered the principal user of the aggregated issue. Thus, separate bond issues will no longer be possible for separate units of a single building or for different stores in a shopping mall or strip center if the aggregation of the issues will cause the $10-million or $40-million small issue limits to be exceeded.

Advance Refunding

Under Section 149(d)(2) of the Code advance refunding of a private activity bond (other than a qualified 501(c)(3) bond) is prohibited. Advance refunding is defined as a bond issue sold more than 90 days before the redemption date of the bonds to be refunded. Current refundings (i.e., bonds sold less than 90 days in advance of a redemption of existing bonds) are permitted. (See "Refundings" above.)

Change in Use

The Code contains a new provision that, to the extent bond proceeds or loans or facilities financed thereby are not, or cease to be, used or owned in the manner that was necessary to qualify for exemption, federal income tax deductions of the taxpayers who are involved in such misuse will be disallowed. The provision does not deal with the exemption of interest on the bonds.

Generally, in the case of exempt facilities and exempt small issues financed with permitted private activity bonds, the Code denies the deduction for interest accrued on the financing to the extent of any portion that is used for a purpose for which such bonds could not have been issued on the date of issuance, for the period of such use.

If facilities that are required to be owned by a governmental unit (e.g., airports, docks and wharves), as a condition of the tax-exemption of obligations, cease to be so owned for any period of time, no deduction is allowed for interest during the period.

In each of the foregoing instances, where the amounts paid for use of a facility are not interest, the disallowance of deduction is applied to the amounts paid or incurred for the use of the facility to the extent that those amounts for any period do not exceed the interest accrued on the financing for that period.

For the foregoing purposes, use of proceeds not required to be used for exempt purposes (e.g., 5 percent "bad money") is not taken into account.

According to the legislative history of this provision, the foregoing consequences apply "in addition to any loss of tax exemption on bond interest provided under present law."

Certain Bonds Subject to the Alternative Minimum Tax

Under the Code, tax-exempt interest on private activity bonds, other than 501(c)(3) obligations, issued after August 7, 1986, is treated as a preference item for purposes of the minimum tax of 21 and 20 percent imposed on individuals and corporations respectively. Also excluded from being treated as a tax preference would be interest on refunding obligations issued to refund bonds issued (or in the case of a series of refundings, originally issued) prior to August 8, 1986, and also certain bonds issued before September 1, 1986, which would not be private activity bonds if certain prior law tests were applied.

If the interest on tax-exempt bonds is not subject to the above preference treatment, that interest will enter into the minimum tax computation for corporations (but not for individuals or other business associations unless treated as corporations for federal income tax purposes) through a new adjustment of alternative minimum taxable income. For taxable years beginning in 1987 through 1989, one-half of the excess of adjusted net book income over alternative minimum taxable income (before the book income adjustment) is added to alternative minimum taxable income subject to the corporate minimum tax. For years after 1989, earnings and profits as determined for federal income tax purposes replace adjusted net book income in the computation, and 75 percent of the excess is added to the alternative minimum taxable income of the corporation. Adjusted net book income is the net income of a corporation, with certain adjustments (none of which affects tax-exempt interest), as shown on the corporation's financial statement that is provided for regulatory (e.g., SEC) or credit purposes, for reporting to shareholders, or for other substantial non-tax purposes. If a corporation has more than one such financial statement, a rule of priority is provided for determining which statement is used for this purpose, with the highest priority given to a financial statement required to be filed with the SEC. If no acceptable financial statement in the first three priorities is available, a corporation can elect to use "earnings and profits" for the taxable year in place of net book income.

The tax base for the alternative minimum tax on corporations is the corporation's regular taxable income, with adjustments, including the above-described adjustment for excess book income, increased by the corporation's tax preferences for the year. The resulting amount, called alternative minimum

taxable income, is reduced by an exemption of $40,000 (reduced, but not below zero, by 25 percent of the amount by which alternative minimum taxable income exceeds $150,000) and is then subject to a 20 percent minimum tax.

While the excess book income adjustment includes tax-exempt interest, for all other purposes of the 1986 Code (e.g., deductions of interest on debt used to purchase or carry tax-exempt obligations), such interest nevertheless is considered tax-exempt.

The alternative minimum tax provisions apply to taxable years of individuals and corporations beginning after December 31, 1986. The corporation book income adjustment does *not* except interest on obligations that were acquired before the grandfather date—that is, interest on all tax-exempt obligations, regardless of when issued or acquired and regardless of type, will be included in book income (earnings and profits for years beginning after 1989). Note that since this book income adjustment is only for the excess over otherwise determined alternative minimum taxable income, if the interest is already included as a preference within the latter, it will not be double-taxed through the book income preference.

Under the Code, interest on private activity bonds may also be subject to an environmental tax imposed on certain corporations for certain taxable years, to a branch profits tax imposed on certain foreign corporations doing business in the United States, and to a tax imposed on excess net passive income of certain S corporations.

Financial Institution Interest Expense Deduction

Under the Code, the prior law provision that prohibits financial institutions from deducting 20 percent of the amount of interest attributable to purchasing or carrying tax-exempt obligations is amended to a general 100 percent disallowance of deduction, effective for interest incurred in taxable years ending after December 31, 1986, with respect to tax-exempt obligations acquired after August 7, 1986.

Property and Casualty Insurance Companies

The Code requires property and casualty insurance companies to reduce deductions for loss reserves by 15 percent of tax-exempt interest income for taxable years beginning after December 31, 1986. Only interest on tax-exempt obligations acquired after August 7, 1986 (regardless of when issued and regardless of type of obligation) are included in the computation.

Qualified Redevelopment Bonds

New provisions in the Code provide for tax-exempt financing in the form of "qualified redevelopment bonds." Satisfying the tests for being a qualified redevelopment bond is necessary only if the bond is a private activity bond, not a governmental bond, because it meets the private business use test and the security interest test or is a private loan bond. According to the legislative history for the 1986 Act, the expanded security interest test includes as payments within the meaning of the security interest test amounts paid by private persons to acquire land for redevelopment purposes from governmental units that used tax-exempt obligations to acquire such land, even though incremental tax revenues are the stated security for repayment of the tax-exempt obligations. While the full intention of this statement is unclear, it may be suggesting that obligations issued to finance urban redevelopment may constitute private activity bonds, even if the private redeveloper pays fair market value for the land (or leases such land for its fair rental value) and even when the obligations which financed acquisition of the blighted land are general obligations of the governmental unit rather than tax increment obligations.

If such a redevelopment bond is a private activity bond, it may be exempt by, among other things, meeting the requirements for being a qualified redevelopment bond under Section 144(c) of the Code. A qualified redevelopment bond is an issue that satisfies a large number of technical and stringent requirements, including that: (1) 95 percent or more of the net proceeds are to be used for "redevelopment purposes" in a "designated blighted area"; (2) the bonds are issued pursuant to a state law that authorizes issuance for redevelopment purposes in blighted areas, and pursuant to a previously adopted redevelopment plan; (3) payment of debt service is primarily secured by general taxes imposed by a general unit of government or by certain tax increments reserved exclusively for debt service on such or similar issues to the extent of such debt service; (4) disposition of property is at fair market value; (5) the "no additional charge" prohibition is satisfied throughout the bond life; and (6) restrictions and prohibitions against use of proceeds for specified purposes are met.

FEDERAL SECURITIES LAW REGULATION

Exemption from Registration Requirements

Generally, the federal securities laws do not require registration of private activity bonds.

The Securities Act of 1933, as amended (the Securities Act), defines private activity bonds formerly known as industrial development bonds as "exempt securities" in Section 3(a)(2). Such bonds are therefore exempt from all pertinent provisions of the Securities Act, including the registration requirements contained in Section 5, except that Section 17(a) — the antifraud provision — has been held applicable to securities that are exempted by Section 3(a)(2) of the Securities Act.

The Securities and Exchange Act of 1934, as amended (the Exchange Act), similarly exempts private activity bonds from its various provisions. Again, however, the antifraud provisions contained in Section 10(b), and Rule 10b–5, have been held to be applicable to any person and all securities whether exempt or not, including private activity bonds and municipal bonds. Rule 10b–5 makes it unlawful "for any person to make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." As interpreted, Rule 10b–5 requires the disclosure of all "material facts." A material fact is a fact that a reasonable investor might consider important in reaching an investment decision.

General Disclosure Obligations

Parties involved in an offering of municipal securities must understand the legal obligations placed upon them by the federal securities laws. The principles of full and fair disclosure may not be disregarded. Although the registration provisions of the Securities Act and the Exchange Act are not applicable to offerings of municipal securities, including private activity bonds, if full and fair information is not given to a bond purchaser, the purchaser may be able to rescind his purchase and participants in the transaction may be subject to both civil and criminal penalties.

It is imperative that each individual participant in a private activity bond offering seek to supply, obtain, and present to potential bond purchasers all possible relevant factors that a prudent investor should know before he or she can evaluate a purchase of the bonds. While in practice the ultimate burden of preparing disclosure documents often falls upon the investment banker and its counsel, all parties should actively seek to ensure that full and fair disclosure is made to every person to whom bonds are offered.

Due Diligence Functions and Financial Reporting

Under the general scheme of the federal securities laws in connection with the underwriting and sale of all securities, various parties have due diligence

obligations and can be liable to investors for violating them. These parties include the officials of the issuer, underwriters, and experts, such as accountants and attorneys. They have the obligation to investigate the information to be disclosed to the same extent that it would have been investigated by a reasonably prudent person in the management of his own property. Issuers (meaning, in this context, a company rather than the municipal entity) may have absolute liability for misstatements and omissions, although it is possible under Rule 10b–5 and the other relevant antifraud provisions that even issuers will be protected if due diligence is performed by their officials. In any case, there is an obligation on the part of all participants in offerings to investigate the adequacy and accuracy of the information disclosed.

One of the basic due diligence activities is the investigation of financial information. This information is usually obtained from audits of a company by independent public or certified accountants who review the procedure followed and the principles applied in the preparation of a company's financial statements and give their opinion as to these matters. Investment bankers may have the obligation to make reasonable inquiry of the scope and nature of the audit, especially where problems exist and where they are known or should be known to the investment bankers.

If due diligence procedures are not performed on the financial disclosures, the participants in such an offering can be viewed as insurers of the success of the offering because of penalties and remedies arising out of federal and state securities laws. In the past, where the risk of investment in a private activity bond was viewed as relatively low, and where market fluctuations were quite small, misstatements or omissions of material information may have seemed irrelevant. In today's society, however, the risk is considerably greater. If a company defaults, or if there is a significant decline in market prices due to a failure to disclose material facts, company officials and all other participants in the offering must view themselves as potentially liable on the securities and concurrently for market losses of investors. These parties are, therefore, in serious need of due diligence protection.

Officials of some companies may not have sophisticated financial experience in this type of financing. Investment bankers or underwriters assist in providing that sophistication to such officials.

To assist company officials and investment bankers in determining what information should be disclosed in a municipal offering, the Municipal Finance Officers Association (MFOA) adopted the MFOA Disclosure Guidelines. However, these are not and should not be deemed an exclusive list of disclosure items. On many occasions, additional "material" information will have to be disclosed, especially in cases involving private activity bonds.

This discussion and the MFOA Disclosure Guidelines focus on the issue of securities of the government entity for which the government entity is primarily liable. However, the Guidelines give one the flavor of the disclosure requirements applicable to a government entity as well as a company in a private activity bond issue. In many instances, the various rules outlined in the Guidelines are applicable to both direct municipal government financing and indirect financings through private activity bonds.

The Materiality Concept

Federal antifraud regulations require disclosure of all "material" facts. Generally, material facts are those that an investor would consider important in making his investment decision. Company officials should make sure that they are familiar with this concept in order to ensure that the offering document fully sets out all the material facts.

Public Offerings

Private activity bonds may be offered by either a limited offering (private placement) or by a public offering. In a public offering, the bonds are offered to the general public through the use of an official statement, which is somewhat like the prospectus used in a public offering of traditional corporate securities. Such an official statement would fully disclose all of the material facts relating to the transaction and the company. The disclosure in the official statement should be designed to comply with the antifraud provisions of the federal securities laws. With such an offering, the bonds could be held by a large number of investors, including individuals.

Private Placement

In a private placement, the bonds are offered to a limited number of sophisticated financial institutions or investors. Information regarding the company would be made available to the offerees and would include recent filings, if any, made with the SEC. The potential investors would be offered the opportunity to obtain any additional information they might request. Under this approach, the bonds would be held by a few investors.

There are two ways to approach disclosure in the areas of private placements. One way entails the preparation of a private placement memorandum and obtaining certain information with regard to the sophistication of the potential investor and subsequent offeree. The private placement memorandum would contain information substantially similar to that in an official statement. In addition, it may contain a section on investor suitability. This section would indicate that the only investor who will be allowed to offer to purchase the bonds are those

1. Who have enough knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of the proposed investment.
2. Or who can bear the economic risks of the investment (i.e., at the time of investment, could afford a complete loss).

In addition to this information, the memorandum frequently includes a discussion of risk factors that highlights the risks to the purchaser of the bonds that may preclude his or her receipt of the payment of principal and interest. If the private activity revenue bonds are privately placed with a "sophisticated person" rather than an institution, certain additional documentation should be obtained. Such information includes an offeree questionnaire. The offeree questionnaire elicits detailed financial and investment experience information from the offeree to enable the underwriter to determine further if this offeree may purchase the bonds. If, as a result of the offeree questionnaire, the underwriter determines that this offeree may offer to purchase the bonds, then a private placement memorandum is distributed to the offeree who may request from the underwriter or the issuer of the company certain additional information which the offeree deems necessary in order to make an informed investment decision.

A second way to proceed in the context of private placements is by means of an investment letter. This practice is fairly common when the underwriter is planning to offer private activity revenue bonds to a limited number of institutional investors. In this context, no private placement memorandum is usually prepared. Rather, the investment banker and the company gather certain pertinent information that the potential investor may require to make an informed investment decision. Such information provided by the investment banker and the company will normally include financial statements of the company and a summary of its operating history. It will, in all likelihood, also include discussions between the potential investor and principals of the company. As protection for the underwriter and bond counsel in this context—since neither the underwriter nor bond counsel has prepared the disclosure materials—an investment letter is normally obtained.

The investment letter states that:

1. The purchaser has been furnished certain business and financial information about the company.
2. The company has given the purchaser the opportunity to obtain additional information to verify the accuracy of the information supplied and to evaluate the risks and merits of the investment.
3. The purchasers have had an opportunity to ask questions of and receive answers from representatives of the company concerning the terms and conditions of the offering and the information supplied by the purchaser.
4. The purchaser is purchasing bonds for its own account, not for the purpose of resale.

The investment letter also states that the purchaser is aware that the bonds have not been registered and that the purchaser has not relied on bond counsel or the underwriter to furnish or verify the information relating to the purchase of the private activity revenue bonds.

Trust Indenture Act

The Trust Indenture Act of 1939 contains certain requirements regarding the information that must be contained in trust indentures. Under Section 304(a)(4) of the Trust Indentures Act of 1939, securities exempted from the provisions of the Securities Act of 1933 by subsection 3(a)(2) are exempted from the requirements of the Trust Indenture Act of 1939.

Note that certain state securities laws, however, require certain information to be included in the Indenture that otherwise might not be otherwise included.

STATE SECURITIES (BLUE SKY) REGULATIONS

State securities, or blue sky laws, are in effect in every jurisdiction in the United States. The typical blue sky law will generally regulate the offer and sale of securities by one or all of the following methods:

1. The registration of securities.
2. The registration of broker-dealers and those persons who offer and sell securities.
3. The prohibition of certain specified acts (antifraud provisions).

Registration of Securities

The Uniform Securities Act (the Uniform Act) has been adopted with varying degrees of modification in over 30 jurisdictions. Important jurisdictions such as California, Florida, Illinois, New York, and Texas have not adopted the Uniform Act. However, since most jurisdictions that have not adopted it have a similar regulatory scheme, the Uniform Act will be used for the purposes of the discussion.

The basic prohibition regarding registration of securities is found in Section 301 of the Uniform Act: "It is lawful for any person to offer or sell any security in this state unless (1) it is registered under this act or (2) the security or transaction is exempt under Section 402."

The most controversial feature of the typical blue sky law is its philosophical approach to the registration of securities. Registration may be denied under many blue sky laws if a state securities administrator determines that an offering is not "fair, just or equitable" to investors. Registration is therefore based upon a merit review of this substance of the particular offering. This merit standard is contrasted with the provisions of the federal Securities Act of 1933, as amended, which is generally considered a disclosure method of regulation.

Regulation of Private Activity Bonds

Section 402(a)(1) of the Uniform Act states that any security (including a revenue obligation) issued by a state or political subdivision of a state is exempt from the provisions requiring registration of securities.

Until recently, most blue sky laws and state securities commissioners took the position that this exemption included private activity revenue bonds and, therefore, the bonds could be offered and sold to the public without registration. Within the last several years, the blue sky commissioners have taken a stricter position on private activity revenue bonds and have either had amendments enacted to their blue sky laws or have adopted interpretative positions that require the bonds to be registered. The regulatory problem is that most private activity revenue bonds are in substance obligations of a nongovernment industrial or commercial enterprise that would be subject to registration if the government entity was not acting as issuer. There have been some well-publicized abuses of private activity revenue bonds and, as a result, an increasing number of states have begun to focus on their regulation.

There are basically two approaches by the states that currently regulate private activity revenue bonds. First, there are states that have amended their statutes, enacted rules, or both. These include Arizona, Iowa, Maine, Montana, Michigan, Minnesota, New Mexico, Ohio, South Dakota, Texas, Washington, and Wisconsin. Second, there are states that have indicated through opinion letters or informal positions that certain types of private activity revenue bonds are not considered exempt. These include California, Oklahoma, and Pennsylvania. This latter group of states normally relies upon a separate security theory. This theory holds that while the bonds themselves may be exempt, the underlying obligations of the company to make payments under the lease, sale, or loan arrangement, or especially obligations under a guarantee, are not exempt. This theory was used by the Securities and Exchange Commission in the late 1960s to require the registration of industrial development bonds (now private activity bonds) but was changed by a 1970 amendment to Section 3(a)(2) of the Securities Act to expressly provide that industrial development bonds would be exempt from federal registration. Although tax-exempt bond issues are generally exempt under New York State Blue Sky Laws, a separate real estate syndication stature may be applicable if the bonds are secured by real estate.

To summarize the current regulatory posture, private activity bonds generally are exempt from registration under most blue sky laws but are subject to various degrees of regulation in approximately 19 states.

Registration of Broker-Dealers

In addition to the regulation of the offer and sale of securities, the Uniform Act also provides for the regulation of the activities of broker-dealers. The primary requirement is that a broker or dealer must be registered in a jurisdiction before engaging in business as a broker-dealer there. As a general rule, the definition of a broker-dealer excludes persons who deal exclusively with other broker-dealers and institutional investors in the jurisdiction in question. It is important to remember, however, that activities of persons dealing in securities, as well as the offer and sale of securities themselves, are regulated under blue sky laws.

Antifraud Provisions

Most blue sky laws contain a provision designed to prevent fraudulent practices by those dealing in securities. Generally, these laws declare fraudulent acts, statements, or omissions unlawful in connection with the offer and sale of securities. The antifraud provisions of the blue sky laws are applicable even though the security is exempt from registration.

OTHER STATE LAWS

Federal tax law provides for the tax exemption on interest earned on qualifying private activity bonds. The ability of a political subdivision to issue such bonds, however, is dependent upon state laws. States provide for the issuance of private activity bonds by the passage of an industrial revenue bond act or some other revenue bond act that permits the issuance of tax-exempt bonds, or by the adoption of a city ordinance. Any of these means are referred to in this document as an Act. Nearly every state has adopted at least one Act. Acts often differ substantially from state to state or even in a single state, particularly in regard to the permitted methods of structuring a financing.

Generally, an Act authorizes certain types of issuers (such as counties, cities, or special authorities) to acquire, construct, dispose of, and finance a wide variety of facilities that are generally referred to as projects. The definition of a project in an Act determines the types of facilities that can be financed under that Act.

Structure of the Financing

The permitted methods of financing a project in a number of states include loan transactions in which the political subdivision simply loans the bond proceeds to the owner of the project and never acquires an interest in the facility. Most states also authorize the use of an installment sale agreement, in which title to the facility typically passes to the user of the facility either upon completion of construction or upon payment in full of the bonds issued to finance the facility and a lease with an option to purchase the facility for a nominal sum at the end of the lease term.

The political subdivision is authorized by the Act to issue its revenue bonds to provide funds to acquire and construct the facility; however, a company actually carries out the acquisition and construction. The principal and interest on the revenue bonds are payable solely from the payments by the company under the loan, installment sale, or lease agreement relating to the facility. As a result, the rating on the bonds depends on the company's credit. Generally, the bonds may bear any interest rate, but they must be sold at public or private sale, and they must mature within 30 to 40 years from the date of their issuance.

Restrictions

Although many state statutes have been simplified and expanded, state laws may still pose significant impediments to tax-exempt bond financing. A number of state and statutes are unduly restrictive and, in some instance, such statutes are based on constitutional provisions and cannot be amended without obtaining approval of a constitutional amendment by the electorate. Further, Acts often contain restrictions as the maximum interest rate or term of the bonds. It is, therefore, essential in structuring each transaction to examine carefully the state statute to ensure that the financing can be undertaken.

ALTERNATIVE METHODS OF STRUCTURING A FINANCING

As noted above, the methods of structuring a tax-exempt bond financing are determined by the applicable state statute. Several basic methods of structuring a financing may be available depending on the statute, including:

1. Loan.
2. Lease (with an option to purchase for a nominal sum at the end of the lease term).
3. Lease-leaseback.
4. Installment sale.

In a loan transaction, which is the simplest method of structuring a financing (but not always available under state law), the issuer lends the proceeds from the sale of the tax-exempt bonds to the company to enable it to construct the facility. The company agrees, either in the loan agreement or in a promissory note issued under the loan agreement, to make loan repayments to the issuer sufficient to permit it to pay the principal of and interest on the bonds.

In a lease transaction, the issuing body (the political subdivision that issues the bonds) uses the proceeds from the sale of the bonds to construct (or cause the company to construct) the facility and leases the facility to the company for rental payments sufficient to pay the principal of and interest on the bonds. The company is given an option to purchase the facility for a nominal sum at the end of the lease term.

In a lease-leaseback financing, the company leases the facility to the issuing body for a "front-end" rental payment equal to the cost of construction of the facility or the proceeds from the sale of the bonds, whichever is less. The issuer simultaneously subleases the facility to the company for subrental payments sufficient to pay the principal of and interest on the bonds. This structure is generally used when the company cannot, for some reason, convey title to the issuing body, such as when the property being financed is subject to the lien of a first mortgage.

In an installment sale agreement, the issuing body uses the proceeds from the sale of the tax-exempt bonds to construct (or cause the company to construct) the facility that it sells to the company for a purchase price sufficient to pay the principal of and interest on the bonds. The obligation of the company to make purchase price payments may be either in the installment sale agreement itself or in a promissory note issued under the installment sale agreement. Title to the facility may pass to the company either upon completion of construction of the facility or upon payment in full of the principal of and the interest on the bonds.

If a lease or lease-leaseback transaction is used, a separate guarantee from the company may be used to improve the marketability of the bonds. By such a guarantee, the company unconditionally guarantees the prompt and full payment of the principal of and interest on the bonds. The guarantee assures the bondholders that they will rank on par with all other unsecured creditors in the event of a bankruptcy or reorganization proceeding; however, changes to the recently passed Bankruptcy Act may make the use of the guarantee in the lease or lease-leaseback situation unnecessary. Nevertheless, the market has been slow to respond to this change and guarantees are still frequently seen in private activity bond financing.

OUTLINE OF AN EXEMPT SMALL ISSUE OR EXEMPT FACILITY BOND FINANCING

For a complete understanding of the transaction, it is helpful to set forth a chronological outline of a typical private activity bond financing supported by the company's credit and without credit enhancement.

First Step: Feasibility, Official Resolution, First Drafts of Financing Agreement

Representatives of the underwriter, special finance counsel, and the financial officers of a company discuss whether the facilities can be financed by tax-

exempt bonds. If so, other parties who will participate in the transaction should be consulted, including company counsel and bond counsel (in situations where special finance counsel cannot act as bond counsel). Such counsel will render an unqualified approving opinion on the tax-exempt status of the bonds and resolve any applicable state law problems involved in the bond issuance and the underlying instruments.

After it is determined that such an issue should be undertaken, the company, the underwriter, and the bond counsel will contact the political subdivision and request it to take official action by adopting an intent resolution. Adoption of an intent resolution is an essential step, for, as already noted, only expenditures on the project after this date may be financed with bond proceeds.

First drafts of the financing agreement (the lease, lease-leaseback, installment sale or loan agreement, and indenture of trust between the political subdivision and the corporate trustee, if any), bond purchase agreement (between the underwriter and the political subdivision) and indemnity letter (from the company to the political subdivision and the underwriter) are then distributed by bond counsel or underwriters' counsel. These documents have, to a large degree, been standardized so preparation is not time consuming.

Second Step: Comments on and Second Drafts of Documents

Comments on the first draft of the financing agreement, indenture of trust, bond purchase agreement, and indemnity letter are received from the parties involved and second drafts are distributed together (in the case of a public offering) with the first draft of the preliminary official statement that will be used to sell the bonds. If bonds are to be publicly offered, the company prepares its portion of the official statement, which is a description of its business and operations, similar to a prospectus.

Third Step: Revised Drafts and Due Diligence

Comments on the second draft of the financing agreement, indenture of trust, bond purchase agreement, and inducement letter and the first draft of the offering document are discussed at a second meeting of the company, its counsel, the underwriter, the underwriters' counsel, and bond counsel, and revised drafts are distributed. A due diligence meeting is held between the underwriter and the company regarding the company's portion of the offering document if this is deemed necessary.

Fourth Step: Closing Documents and Board Approval

Bond counsel distributes a list of closing documents. Comments on the revised documents are received and revised drafts are distributed, if necessary. The board of directors of the company or a committee of the board approves the transaction and establishes means to approve the financial terms of the bonds and the officials to handle the final negotiations at closing.

Fifth Step: Underwriter Offers the Bonds

In a public offering, the underwriter offers the bonds. Bond counsel mails the bond form to the printer and prepares and circulates the closing documents.

Sixth Step: Pricing Conference, Public Hearing, Political Approval

In a public offering the company and the underwriter hold a pricing conference to approve the final terms of the bonds. The corporate trustees, if not already selected, are chosen. The issuing political subdivision publishes notice of a public hearing regarding the project and holds a public hearing. After the hearing, the political subdivision must approve the bonds, adopt the bond resolution, approve the documents and authorize their execution, approve the financial terms of the bonds, and designate officers to handle final negotiations and the closing.

Seventh Step: Prepare for Closing

All parties complete and assemble the remaining documents for the closing.

Eighth Step: Closing and Payments

The closing is held. The corporate trustee authenticates the bonds after proper officials of the political subdivision execute them and the underwriter delivers its check for the bonds. At this time, the company would submit a requisition for reimbursement for expenses previously incurred in connection with the facility.

The optimum time for completing a financing is approximately 6 to 10 weeks. However, frequently it is desirable to allow longer so that the parties have ample time for review of the documents and preparation of the items necessary for the financing.

CREDIT ENHANCEMENT DEVICES FOR BOND ISSUES

Letters of Credit

A letter of credit represents an obligation of the issuing banking institution to pay up to a stated amount to a named beneficiary upon the presentation of specified documentation. Letters of credit are most commonly used in domestic and international commercial transactions in connection with the sale of goods. Increasingly, letters of credit are used in bond transactions to ensure payment of principal and interest to bondholders. By ensuring such payments, the letter of credit effectively enhances the credit of the borrowing company and reduces the credit risk to purchasers of the bonds. The end result is greater marketability of the bonds and, often, a substantially lower interest rate.

Ordinarily, there are three parties to the letter of credit when it is used in a bond transaction: the bank—as issuer of the letter of credit, the borrower—a company as account party whose obligation is ensured by the letter of credit, and the bond trustee—as named beneficiary acting on behalf of bondholders. A reimbursement agreement executed by the issuing bank and the account party will provide for reimbursement of the bank by the company for each payment made by the bank to the bond trustee under the letter of credit. The reimbursement agreement establishes the basic terms of the letter of credit and specifies the terms of the loan transaction between the bank and the company, including the term of the letter of credit, the circumstances under which drawings can be made on the letter of credit, any renewal or extension options, the letter of credit fee, and the interest rate to be applied to amounts drawn under the letter of credit.

The interest rate payable on amounts drawn under the letter of credit will generally be in the range of prime to prime plus 1 percent. The repayment period will generally extend over five years, but will vary depending upon the type of letter of credit. The issuing bank may require a security interest in assets of the company to secure the company's reimbursement obligations for amounts drawn under the letter of credit. If the bank requires such security, it may be necessary under applicable bankruptcy law to provide an equal and ratable security interest in the same assets to bondholders.

The fee commission of the bank for issuing a letter of credit will be based upon the bank's liability under the letter, the term of the letter, and the general credit of the company. The fee for the letter of credit may be paid on an annual basis and is usually determined as a percentage of the outstanding amount owned on the bonds.

The conditions under which drawings may be made under the letter of credit to pay principal, premium, or interest on bonds will vary depending on the type of letter of credit authorized to be issued under the reimbursement agreement. If a standby letter is used, the letter of credit will be drawn upon only if a default occurs and results in an acceleration of payment of the bonds. In such a case, the indenture under which the bonds have been issued will direct the bond trustee to draw upon the standby letter of credit immediately upon acceleration of the bonds, but under no other circumstances. In contrast, if a direct-payment letter of credit is used, all payments of principal, premium, and interest on the bonds will be made through drawings under the letter of credit. The indenture under which the bonds have been issued will direct the trustee to draw on the letter of credit on interest payment dates, fund payment dates, and upon redemption or acceleration of the bonds. The company then reimburses the bank for the amount of the drawing.

Hybrid forms of the two basic types of letters of credit may also be used. For example, the bond financing may be structured so that the trustee is directed to draw upon the letter of credit when "available moneys" are insufficient to pay amounts then payable to bondholders. Available moneys generally refers to funds on deposit with the trustee for a period longer than the preference period specified in applicable bankruptcy law. If such a hybrid form is used, the indenture under which the bonds have been issued will direct the trustee to make the payment to the bondholders first from available moneys and then, if necessary, from amounts drawn under the letter of credit. Direct payment and hybrid form letters of credit are primarily used in conjunction with bonds that have a put feature permitting bondholders to deliver the bonds to the trustee for repurchase.

Generally, a letter of credit is obtained to secure short-term bond financing. In addition, a letter of credit can be used in conjunction with long-term financings. In connection with long-term financings, the maximum initial term of a letter of credit in the municipal finance industry usually does not extend beyond 10 years. Thus, there is a gap between the maximum term of a letter of credit and the usual 20- to 30-year life of long-term bonds. However, a long-term financing secured by a letter of credit can be structured so that after the 10th year the bank issuing the letter of credit has the option to extend or renew the letter on an annual basis. Normally, the financing documents will provide that the bank shall notify the trustee annually of its intent to extend or renew the letter of credit and, if the trustee does not receive such notice by a given date, the trustee will thereafter draw down on the letter of credit in an amount sufficient to pay the bondholders in full. Depending on

the year in which the drawdown occurs, it may be necessary for the company to refinance the debt with a bond issue to repay the bank.

The 10-year letter of credit with an annual renewal option fully protects the bondholder because it allows the trustee to draw on the letter of credit in an amount sufficient to redeem the bonds if the bank does not exercise its renewal option. Unless federal or state banking regulations are modified to require a bank to set aside reserves to cover its potential liability under letters of credit, the bank should be willing to renew annually the letter of credit as long as it receives its fee for doing so subject to continuing credit analysis.

In today's market, where short- and long-term bonds are subject to continuous and often volatile fluctuations in interest rates, it is always advisable to weigh the cost effectiveness of obtaining a letter of credit to secure any bond financing contemplated by the company. In today's market, the cost to the company of obtaining a letter of credit from a high-quality bank may range from approximately ½ percent to 1 percent of the outstanding principal of the bonds. The cost to the company of obtaining a letter of credit for a 10-year period should be less than the annual interest savings to the company that result from the increase in the bond rating to an AAA. Generally, the fees charged by a bank for letter of credit coverage for a short-term bond issue can result in interest savings to the company in excess of the cost of the letter of credit.

Floating Interest Rate Bonds with Puts Secured by Letters of Credit

In recent years, billions of dollars of bond issues have featured floating interest rates with puts, secured by letters of credit or otherwise. These techniques combine the versatility of a commercial paper transaction with the security of a letter of credit.

A put in this context is a right given to a bondholder to demand that a company or other party buy back bonds held by the bondholder at a specified price, usually par. The put, when accompanied by a floating or variable interest rate, in essence turns a long-term bond into a short-term obligation by giving the bondholder a guaranteed market for sale of the bond at a specific price before maturity. The put can provide the bondholder liquidity and protection against a decline in the market value of the bond and usually results in a lower interest rate on the bond.

The put period can be quite short, such as daily, weekly, or monthly; or it can be longer, such as semiannually or annually. Alternatively, there could be only one or a limited number of puts. Finally, it is possible for the put period to be varied.

Similarly,bonds can be issued with provisions for adjusting the interest rate among floating, variable, or fixed rates, along with a put exercisable at each adjustment. There are few restrictions on this structure.

For a put to be attractive to bondholders, there must be a mechanism to ensure that the entity that is obligated to purchase the bonds will have the funds with which to do so. Therefore, it is generally necessary to obtain the credit of a bank to assure the bondholder that sufficient funds will be available to purchase the bond. A letter of credit in hybrid form, as discussed previously, is one method of providing that the bonds directly from the bondholders or the obligation of the company to purchase the bonds will be secured by a standby letter of credit or standby purchase agreement with the bank issued by the bank.

Bond Insurance

In the early 1970s several insurance firms were established to write insurance on municipal bonds. The American Municipal Bond Assurance Corporation (AMBAC) was the first. Others include Municipal Bond Investors Assurance Corporation (MBIA), Financial Guaranty Insurance Company (FGIC) and Bond Investors Guaranty Insurance Company (BIG). For a one-time premium based on a percentage of the total interest and principal of an issue, an issuer may insure the principal and interest payments on the bonds. The ultimate backing of the policies is the net worth of the insurer.

APPENDIX A

FORM OF INTENT RESOLUTION

WHEREAS ____________, County, ____________(the Issuer), a body politic and corporate and a political subdivision of the State of ____________, acting by and through its ____________, is authorized and empowered by the provisions of the ____________ (the Act), to finance a project, as that term is defined in the Act, and to issue its ____________ revenue bonds for the purpose of paying all or part of the cost of acquiring or constructing a project; and

WHEREAS ________, a ________ corporation (the Corporation) proposes to undertake the acquisition and construction of the facilities described in Exhibit A hereto (the Facilities) which will constitute a project within the meaning of the Act and has requested the Issuer to undertake to issue and sell its revenue bonds pursuant to the provisions of the Act for the purpose of financing the Facilities; and

WHEREAS, the Issuer has determined that the issuance of the revenue bonds for such purpose will be in accordance with the Act and wishes to declare its intention to authorize the issue and sell, as and when requested by the Corporation, one or more issues of its revenue bonds for the purpose of paying the cost of financing the Facility, such issuance and sale to be upon such terms and conditions as may then be agreed upon by the Issuer, the Corporation and the purchaser of such bonds.

NOW, THEREFORE, be it resolved by the ________ of the Issuer that it does hereby authorize the issuance and sale of revenue bonds of the Issuer under and in accordance with the Act, in such an amount necessary to pay the cost of the Facilities, presently estimated to be $________ and upon such terms and conditions as may be mutually agreed upon by the Issuer and the Corporation, such terms and conditions to be authorized by resolution of the Issuer at a meeting to be held for such purpose.

Passed and approved this ________ day of ________, 1988.

(NAME OF ISSUER)

By: ________ By: ________
Title: ________ Title: ________

1. The Facilities will be located in and will generally consist of the following: [Description of land and building improvements, equipment, etc.]

APPENDIX B

TYPICAL QUESTIONS ASKED BY OFFICIALS OF ISSUING POLITICAL SUBDIVISIONS

1. *Why should the political subdivision adopt official action?*

The federal tax law and state laws require that the political subdivision issuing the industrial revenue bonds adopt a resolution indicating its intention to issue its bonds (assuming satisfactory agreements can be worked out at a later date) before construction or acquisition of the facility begins. If official action is not taken, the facility cannot be financed with tax-exempt revenue bonds.

2. *Is the official resolution completely binding?*

No. Official action resolutions are not binding on either the political subdivision or the company. Bonds will not be issued unless documents satisfactory to the company, the political subdivision, and the lender or investment banker have been agreed upon. The resolution is only an indication of a general intention on the part of the political subdivision to issue the bonds. When it is time actually to issue the bonds, the political subdivision will be requested to adopt a bond resolution that authorizes the issuance of bonds.

3. *Will the political subdivision be liable for payment of the bonds or any costs?*

No. The issuer will not incur any liability for payment of the bonds or any costs incurred in connection with the issuance of the bonds. The bonds will be revenue bonds payable solely from revenues derived from a financing agreement with the company.

Any costs incurred by the issuer regarding the financing will be paid by the company. In addition, the company will enter into an indemnity agreement with the political subdivision. This agreement will indemnify the political subdivision for any and all costs or expenses incurred by the political subdivision arising from or in connection with the financing.

4. *Why should the political subdivision engage in the financing?*

Financing of the facility will generate employment and add to the tax base, thus directly benefiting the political subdivision. In addition, there may be substantial indirect benefits for other businesses located within the political subdivision.

5. *Why is the company using this form of financing?*

The primary benefit to the company is the lower interest cost because of the tax-exempt feature of the bonds. Lower interest costs result in lower overall financing costs for the company, which helps the company remain competitive.