
Taxable Versus Tax-Exempt Bond Financing For Project Financing: Smith Gambrell & Russell

When an industrial expansion will create jobs, revenues and development, many communities will offer incentives to attract the location. Bonds are an important incentive, authorized by state law to provide advantageous financing for certain businesses. A government body may issue bonds to finance a qualifying project, and the company operating the facility must pay amounts to service the bonds.

Federal tax law changes have restricted the use of tax-exempt industrial development bonds (IDBs) prompting communities to develop alternatives. In many jurisdictions "Taxable Bonds" can be issued with some of the same advantages.

Tax-Exempt IDBs

Interest on qualified IDBs is exempt from regular federal income taxation and, usually, income tax in the state where the bonds are issued. Due to the tax-exemptions, borrowing costs are lower than with conventional loans.

The federal law authorizes tax-exempt IDBs for manufacturing operations. "Manufacturing" includes facilities used in the manufacture, production or processing of tangible personal property, and up to 25% of the financing can be used for on-site related and ancillary office, warehouse and other space. Tax-exempt IDBs are available, without size constraints, also for some transportation, waste-related and other specialized facilities. See our "Overview of Private Activity Bonds and Incentives.

What are Taxable Bonds?

In most jurisdictions, public bodies can issue "Taxable Bonds," bonds that do not qualify for federal income tax exemption. Despite their name, Taxable bonds may bear interest that is exempt from state or local income tax and intangibles tax in the state in which they are issued, and other incentives might be utilized in connection with the bond financing.

Taxable Bonds may be issued without several size limitations imposed on tax-exempt IDBs. Tax-exempt IDBs are subject to an aggregate $1,000,000 limitation in any particular city or county, although this limitation can be increased to $10,000,000 if all capital expenditures in the jurisdiction made by users of the project during the six year period spanning the bond closing date are counted. Every user of tax-exempt IDB-financed facilities is subject to a further aggregate nationwide $40,000,000 limitation. Tax-exempt IDBs also must receive an allocation for a "volume cap" applicable to each state.

Taxable Bonds are not subject to many of the restrictions imposed on tax-exempt IDBs. Taxable Bonds often may be used for other-than-manufacturing projects, including warehouse, distribution, office, and research and development facilities. Tax-exempt IDBs are restricted when financing previously-used facilities, but Taxable Bonds are not. Limitations on and rebate of investment of funds borrowed with tax-exempt IDBs are also inapplicable to Taxable Bonds. Tax-exempt IDBs involve public hearing and approval, state volume cap, allocation and IRS reporting proceedings that are not required for Taxable Bonds.

Financial institutions cannot fully enjoy the benefits of tax-exempt IDBs they fund because their cost of funds is not tax deductible. Some banks buy IDBs at below-prime lending rates, but lesser rates are available when the bonds are sold to other investors. Financial institutions can purchase Taxable Bonds without the disallowance of their cost of funds, and Taxable Bonds can be attractive to banks.

Advantages of Taxable Bonds

Because interest earned on Taxable Bonds may be exempt from state and local income or intangibles taxes imposed in the state in which the bonds are issued, taxpayers in the state may purchase the bonds at reduced interest rates.

Furthermore, the participation of governmental bodies in a bond issue fosters community interest, often at the highest levels, in an industrial location. Government officials are likely to support such a project in other respects.

Perhaps most importantly, a bond issue is part of a total package of incentives in many jurisdictions, and may be a necessary vehicle for the use of some incentives. For example, there may be legal authority for the company to obtain a break in ad valorem taxes if the public body issuing the bonds takes title during the period a project is financed, although the company may be required to pay negotiated amounts in lieu of taxes. Some bond issuers taking title to a facility also may avoid the payment of sales tax on the project components. A community might have authority to contribute or discount land, other property or services in connection with a bond-financed project, or to provide a reduced rent.

Form of Transaction: Loan, Lease or Sale

A bond issuer sells the bonds and applies the proceeds to the project in one of three ways. Some issuers loan the bond proceeds to the company for use on the company’s project, and assign the company’s note to pay the bonds. Other issuers must own the project and lease or sell it on an installment basis to the company. When the latter methods are used, the project site is conveyed to the issuer and the project is constructed or acquired at the direction of the company with the bond proceeds. In such a case, the company enters into a lease or installment sale contract with the issuer which is assigned to pay the bonds, and the company obtains title to the project by the end of the contract term.

Whether a loan, lease or sale is used, the company has essentially the same control over the project as under conventional financing. The company normally is entitled to any depreciation and investment tax credit, is responsible for insurance, taxes and maintenance, and has freedom with respect to design and construction.

How to Obtain Taxable Bond Financing

Although bond financing appears to present a maze of technicalities, it can pay great dividends and Taxable Bonds involve fewer complications. The ability to use Taxable Bonds may exist even where local officials are not familiar with the technique. A company should consult recognized Bond Counsel experienced with Taxable Bonds early in the search process for advice on the availability of bond financing and other incentives in particular jurisdictions.

Bond may be issued by a development authority, board or agency, either at the state or local level.

Usually a simple application is required to obtain an “inducement,” a preliminary approval of the use of bond financing. For tax-exempt IDBs, the inducement should be obtained prior to the incurrence of costs to be financed, but the inducement may not be critical in determining what costs can be financed by Taxable Bonds.

Following inducement the financing must be arranged. Although some bond issuers may handle the placement of the bonds, most serve merely as “conduits” to the bond purchasers and the company must arrange for the placement and sale of the bond through professionals it selects. Usually the governmental unit does not provide credit for the bonds. The bondholders look only to the company and any mortgages or other credit enhancements it provides.

When Bond Counsel has completed all proceedings and documentation, the bond issuer adopts a final authorizing resolution. In some states a further centralized approval or a bond validation is required. However, the transaction will shortly be closed and the proceeds from the sale of the bonds made available for the project.

Growing Awareness of Taxable Bonds

Tax-exempt bonds have long been the favored tool for industrial expansion. With the use of tax-exempt IDBs restricted, awareness is growing that Taxable Bonds can provide many similar cost savings and can be used in conjunction with other development incentives. A company considering expansion sites ought to explore whether the incentives associated with Taxable Bond financing are available.

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The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.