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Public Finance Primer

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Federal Tax law[1] provides that interest on certain state and local bonds is not included in gross income of investors holding these obligations and receiving interest. State and local bonds are obligations of states or political subdivisions (*e.g.*, cities, towns, counties, as well as entities formed to issue bonds on their behalf or for specific purposes, such as economic development agencies).[2]

Interest on a state and local bond is excluded from gross income, only if the bond is:

- a "governmental" (*i.e.*, a "non-private activity") bond; or
- a "qualified" private activity bond.

A governmental bond is one that does not meet both the "private business use" and "private security or payment" tests described under Governmental Bonds, below.

A qualified private activity bond is a bond that does meet both tests, but nonetheless qualifies for tax-exempt treatment under a specific provision of the Code.

Governmental Bonds

A governmental bond is one that is issued to finance public (*i.e.*, non-private) purposes. If the bond meets the "private business use" and "private security or payment" tests described below, the bond does not constitute a governmental bond and may only be financed on a tax-exempt basis if it qualifies for one of the exceptions contained in the Code specifically authorizing such "private activity bond" to be issued on a tax-exempt basis.

A bond is a private activity bond if it meets both a:

- "private business use" test; and
- "private security or payment" test.[3]

[1] References to federal tax law are to the Internal Revenue Code of 1986, as amended (the Code) and the Treasury Regulations promulgated thereunder, or under the Internal Revenue Code of 1954, as amended (the Regulations).

[2] Code § 103.

[3] Code § 141.

Private Business Use

A bond meets the private business use test if more than 10 percent of the proceeds of the bond are used for a private business use (*i.e.*, use in a trade or business carried on by any person other than a governmental unit, excluding use as a member of the general public). Two examples should make the distinction clear:

(a) A bank leases the first floor of a four-story county office building. The bank's use of the space is a private business use.

(b) A trucking company carries goods on a state highway. The company's use is not private business use, but the same as use by all other drivers: the company's use is as a member of the general public.

Private Security or Payment

A bond meets the private security or payment test if more than 10 percent of the bond proceeds are:

- Secured by an interest in:
  - property to be used for a private business use; or
  - payments in respect of such property; or
- To be derived from payments in respect of property (or borrowed money) to be used for a private business use.

If a private user makes rental payments for use of property, secures its use with a mortgage on the property or otherwise uses the property as collateral for a borrowing, this test is met.

The 10 percent limitation is reduced to 5 percent where the private business use, in relation to the governmental use, is either:

- unrelated; or
- related, yet disproportionate.

Two examples:

(a) A 501(c)(3) Organization uses a portion of a State hospital for offices in which it provides counseling to patients and families: Such use is private use that is related to the governmental use (subject to the 10 percent limitation).

(b) A local chapter of the Girl Scouts uses space in a building otherwise used to house a city's offices: Such use is "unrelated" to the governmental use (subject to the 5 percent limitation).

The "related, yet disproportionate" use arises less frequently and does so where the amount of private use financed in a bond issue exceeds the amount of the governmental use.

Where there is both related and unrelated private use, each is permitted a 5 percent limitation. 5 percent of the bonds may finance unrelated private use and 5 percent may finance related private use.

Private Loan

A bond is also a private activity bond if the proceeds of the bond are used to make or finance loans to persons other than governmental units in an amount greater than:

The lesser of:

- 5 percent of the proceeds of the bond; or
- $5 million.

Once it has been determined that the bonds meet the tests described above and, therefore, constitute private activity bonds, interest on the bonds will not qualify for tax-exempt treatment unless the bonds constitute one of the types of "qualified private activity bonds" described under Qualified Private Activity Bonds, below.

Qualified Private Activity Bonds

Private activity bonds are bonds that are issued to finance purposes of, or facilities owned and/or used by, private entities in a private trade or business. Unless a private activity bond qualifies under one of the Code's particular exceptions, interest on such bonds is not tax-exempt.

The various types of private activity bonds that are nevertheless entitled to the beneficial "tax-exempt" treatment are described below.

Qualified 501(c)(3) Bonds

Exempt Purpose. Federal tax law provides that an organization is exempt from taxation if it is organized and operated exclusively for:

- religious;
- charitable;
- scientific;
- testing for public safety;
- literary; or
- education purposes.

A nonprofit corporation organized for one of these purposes may be the beneficiary of proceeds of qualified 501(c)(3) bonds only if the corporation has received a Determination Letter from the Internal Revenue Service as to its 501(c)(3) status.

In order to qualify under this provision:

- The bond proceeds must be used in furtherance of the 501(c)(3) organization's charitable purposes;
- all bond-financed property must be owned by either a 501(c)(3) organization or state or local governmental unit; and
- no more than 5 percent of the net proceeds of the bonds may be used in a private business use.

For purposes of "Qualified "501(c)(3) Bonds," a use is a private business use if it is:

> by a non-governmental unit (*e.g.*, a for-profit entity); or

> by a 501(c)(3) Organization but in furtherance of the entity's "unrelated trade or business."

Two examples:

(a) if a private university that qualifies as a 501(c)(3) Organization builds an athletic facility, use by the university's teams would be considered "in furtherance of" the university's educational purposes.

(b) If, however, the university leases such facility to non-university users, the leasing of such space might constitute an unrelated trade or business and might affect the facility's qualification for financing with tax-exempt bonds.

Use of Proceeds. A 501(c)(3) Organization is able to use proceeds for many purposes. Unlike in the case of other private activity bonds (discussed below), which may only be used to finance costs that are chargeable to capital account, Qualified 501(c)(3) Bonds may be used even to finance a 501(c)(3) Organization's working capital needs as long as the proceeds are used in furtherance of the organization's exempt purposes.

Limitation on Bonds. While the Code once contained a $150 million limit on the amount of tax-exempt Qualified 501(c)(3) Bonds that may be outstanding on behalf of any one 501(c)(3) Organization (and its related persons) unless the bonds were issued to finance hospital facilities, this provision changed in 1997. Under the rule as it currently stands, Qualified 501(c)(3) Bonds are not subject to this limitation (in other words, do not count toward the $150 million limitation) if 95 percent or more of the proceeds are used to finance capital expenditures.

Exempt Facility Bonds

Use of Proceeds. A private activity bond may qualify as an "exempt facility bond" if 95 percent or more of the net proceeds of the bond are used to provide one of the types of facilities specified in the Code.[4] Proceeds must be used to finance capital expenditures (unlike governmental and Qualified 501(c)(3) Bonds, which may also be used to finance working capital costs).

Serve the General Public. In addition, qualified exempt facilities must serve or be available on a regular basis for general public use. Thus, an airport hangar may be financed, even if used by a private airline, if that airline carries members of the general public, but if it houses a private corporation's fleet of jets, it will not qualify.

[4] Code §142(a).

Specific Types of Exempt Facilities

Airports[5]

A facility qualifies for financing under this provision if it is directly related and essential to:

> Servicing aircraft or enabling aircraft to take off and land (*e.g.*, terminals, hangars, maintenance facilities, food preparation facilities); or

> Transferring passengers or cargo to or from aircraft (*e.g.*, monorail systems, cargo facilities).

In order to qualify, the particular facility must be:

> Located at, or in close proximity to, the take-off and landing area in order to perform its function;

> Of a character and size commensurate with the character and size of the airport at or adjacent to which the facility is located;

> Governmentally owned; and

> Used either by a governmental entity or by a private entity that serves the general public (*e.g.*, a commercial airline).

Certain facilities that are governmentally owned and privately used will nonetheless not qualify for tax-exempt financing. These are:

> Lodging facilities;

> Retail facilities (including for food and beverage) that are larger than necessary to service passengers and employees at the airport;

> Other retail facilities (except parking) located outside the airport terminal;

> Office buildings that are not for governmental employees or employees of the airport operating authority; and

> Industrial parks or manufacturing facilities.

Docks and Wharves[6]

The requirements (and limitations) for financing docks and wharves are essentially the same as those for financing airport facilities. The facilities must be:

> Governmentally owned; and

> Only operated by private entities that serve the general public (*e.g.*, cruise ship line that carries passengers).

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[5] Code § 142(a)(3); Regulations § 1.103-8(e)(2).

[6] Code § 142(a)(2).

Property at a dock and wharf that qualifies for financing includes structures alongside which vessels dock, equipment needed to receive and discharge cargo and passengers from the vessel (*e.g.*, cranes and conveyors), related storage, handling, office and passenger areas, and similar facilities.

Mass Commuting Facilities[7]

The requirements (and limitations) for financing mass commuting facilities are essentially the same as those for financing airport facilities, and docks and wharves. The facilities must be:

- Governmentally owned; and
- Only operated by private entities that serve the general public (*e.g.*, bus or train carrier).

Mass commuting facilities include property used to serve the general public commuting on a day-to-day basis by bus, subway, rail, ferry or other conveyance that moves over prescribed routes. Both real and personal property (including machinery, equipment and furniture on the property) are included, as well as facilities considered functionally related and subordinate to the mass commuting facilities, such as terminals, parking garages, car barns and repair shops.

Facilities for the Furnishing of Water[8]

Privately owned and operated facilities for the furnishing of water qualify for tax-exempt financing if:

- The water will be made available to members of the general public (which includes electric utility, industrial, agricultural or commercial users) on reasonable demand; and
- Either of the following is met:
  - the facility is operated by a governmental unit; or
  - the rates for the sale or furnishing of the water have been established or approved by a State, political subdivision thereof, federal agency, public service, or utility commission or other similar body.

Such facilities include artesian wells, reservoirs, dams, related equipment and pipelines, and other facilities used to furnish water for domestic, industrial, irrigation or other purposes.

Sewage Facilities[9]

Bonds may also be issued on a tax-exempt basis to provide sewage facilities, defined to mean any property used for one of the following:

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[7] Code § 142(a)(3); Regulations § 1.103-8(e)(2).

[8] Code § 142(e); Regulations § 1.103-8(h).

[9] Code § 142(a)(5); Regulations §§ 1.103-8(f)(2); 1.142(a)(5)-1.

- > The secondary treatment of wastewater;
- > The preliminary and/or primary treatment of wastewater;
- > The advanced or tertiary treatment of wastewater;
- > The collection, storage, use, processing, or final disposal of either wastewater or sewage sludge removed during preliminary, primary, secondary, advanced or tertiary treatment;
- > The treatment, collection, storage, use, processing, or final disposal of seepage; or
- > Property that is functionally related to any of the above property (such as sewage disinfection property).

Federal tax law imposes various limitations on and requirements for what constitutes "sewage" for purposes of this provision (with requirements as to such things as the "average daily raw waste load concentration of biochemical oxygen demand)."

Unlike other exempt facility bonds (such as those to provide airports, and docks and wharves), where the private entity utilizing the bond-financed property must serve the general public or the facility itself must be available on a regular basis for general public use, sewage facilities are deemed to "serve the general public" even if such facility is part of a nonpublic facility (*e.g.*, a manufacturing facility) that is used solely in the trade or business of a private entity.

Solid Waste Disposal Facilities[10]

Exempt facility bonds may be issued to finance privately owned and operated solid waste disposal facilities, defined to include any property or portion thereof used for the collection, storage, treatment, utilization, processing or final disposal of solid waste. Where a facility has a solid waste disposal function and other functions (*e.g.*, the conversion of waste to energy), only the portion that qualifies as solid waste disposal will be eligible for financing under this provision.

The waste brought into the facility must have no value in the place where it is obtained (*e.g.*, discarded lumber from a construction site or paper from an office building). If a person is willing to purchase the property, at any price, the property will not constitute waste. In addition, where a facility disposes of solid waste by reconstituting, converting or otherwise recycling it into material that is not waste, that facility qualifies under this provision if solid waste constitutes at least 65 percent (by weight or volume) of the total materials introduced into the recycling process.

Under Regulations, solid waste is defined as garbage, refuse and other discarded solid materials, including solid waste materials resulting from industrial, commercial and agricultural operations, as well as from community activities. Solid waste does not include, however, solids or dissolved materials in domestic sewage or other significant pollutants in water (such as silt, dissolved or suspended solids in industrial waste water effluents, and the like).[11]

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[10] Code § 142(a)(6); Regulations §§ 1.103-8(f)(2); 17.1.

[11] There are Proposed Regulations that would alter the definition of "solid waste" and change the types of facilities (or portions thereof) that may qualify for financing, but those regulations are not yet final and, therefore, not yet effective.

Qualified Residential Rental Projects[12]

Bonds may be issued to finance residential rental facilities (essentially, apartment buildings) that are privately owned and operated, as long as certain requirements are satisfied:

> The facility's owner must set aside a certain minimum percentage of the units for rental to low-income tenants (the income levels vary depending upon where the project is located) for the life of the bonds;

> The units must be occupied on a nontransient basis (*i.e.*, minimum lease terms of 30 days); and

> Each unit must contain separate and complete facilities for

- living
- sleeping
- eating
- cooking
- sanitation.

Thus, although a building may have central heating or air conditioning, each unit must have its own kitchen and bathroom facilities.

This provision does not permit tax-exempt bonds to be issued for privately owned hotels, motels, dormitories, fraternity or sorority houses, rooming houses, hospitals, nursing homes, sanitariums, rest homes, and trailer parks and courts for use on a transient basis.

Facilities for the Local Furnishing of Electric Energy or Gas[13]

Until 1997, exempt facility bonds could be issued to finance facilities for the local furnishing of electric energy or gas, as long as the entity furnishing the energy or gas served a "service area" consisting solely of a city and one contiguous county (designed to apply to the five boroughs of New York City and Westchester County) or two contiguous counties (known as the "two-county rule").

The facilities that could be financed under this provision had to be property that was:

> Subject to depreciation;

> Used to produce, collect, generate, transmit, store, distribute or convey electric energy or gas;

> Used in the trade or business of furnishing electric energy or gas; and

> Part of a "two-county" system described above.

The output of such facility had to be available for use by members of the general public and that requirement was deemed to be satisfied if the owner or operator of the facility was obligated, by legislative enactment, local ordinance, regulation or the equivalent, to furnish electric energy or gas to all persons who desired such services and who were within the two-county service area.

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[12] Code § 142(d); Regulations § 1.103-8(b).

[13] Code § 142(f); Regulations § 1.103-8(f).

The Code changed in 1997 to permit service providers to service people outside their two-county areas, as long as they took steps to defease (and repay) outstanding issues of tax-exempt bonds and complied with new limits on tax-exempt financing of new local furnishing facilities.

Beginning in 1997, no exempt facility bonds may be issued to finance facilities for the local furnishing of electric energy or gas unless:

> The facility will be:

  - used by a person who was engaged in the local furnishing of that energy source on January 1, 1997; and
  - used to provide service within the area served by such person on January 1, 1997 (or within a county or city any portion of which is within such area); or
  - the facility will be used by a successor in interest to such person for the same use and within the same service area as described above.

Other Qualified Exempt Facilities

The Code provides that certain other types of facilities also may be financed on a tax-exempt basis with qualified "exempt facility bonds."

These facilities include the following:

> Local District Heating or Cooling Facilities;

> Qualified Hazardous Waste Facilities;

> High-speed Intercity Rail Facilities;

> Environmental Enhancements of Hydro-Electric Generating Facilities;

> Qualified Public Educational Facilities;

> Qualified Green Buildings and Sustainable Design Projects; and

> Qualified Highway or Surface Freight Transfer Facilities.

A detailed discussion of these types of exempt facilities is beyond the scope of this Primer. If you have questions with respect to any of these, please do not hesitate to contact me.

Qualified Mortgage Bonds[14]

The Code provides that interest on "qualified mortgage bonds" is excluded from gross income of the owners of such bonds. Bonds are qualified mortgage bonds if they meet the following requirements (among others):

> All bond proceeds are used to make loans to finance owner-occupied residences.

[14] Code § 143; Regulations §§ 6a.103A-2; 1.143(g)-1.

The Code deems “all” to be “95 percent” if:

- The bond issuer makes a good faith effort to comply with all requirements;
- 95 percent of the proceeds make loans that comply with all the requirements; and
- Any failure to comply is corrected within a reasonable period of time.
- Financed residence is a single-family residence (up to four units) located in the bond issuer’s jurisdiction;
- Financed residence is reasonably expected to become mortgagor’s primary residence;
- Mortgagors are “first-time homebuyers” (*i.e.*, they have not owned a home within three-year period prior to execution of bond-financed mortgage);
- Price of home falls within established “purchase price” limitations for area in which home is located (as set by the Treasury Department);
- Mortgagors do not have incomes in excess of federally established maximum incomes for area in which particular home is located;
- Bonds satisfy the arbitrage requirements (described under Arbitrage Requirements and Limitations Applicable to Tax-Exempt Bonds, below);
- Yield on mortgage loan is no more than 1.125 percent above yield on bonds; and
- A percentage of loans financed by bonds is set aside to finance loans in “targeted areas” (*i.e.*, federally recognized areas of economic distress).

In general, loans must be made within three years of bond issuance, or else unexpended proceeds must be used within 42 months of issuance to redeem bonds.

Typically, proceeds of the bonds must be used to make “new” mortgage loans (that is, not to refinance existing loans) although the Code provides an exception to this rule for certain qualifying subprime mortgage loans and for certain home improvement loans.

Qualified Small Issue Bonds[15]

Manufacturing

Bonds may be issued on a tax-exempt basis to finance qualifying manufacturing facilities. Manufacturing facilities are defined as being any facilities used in the manufacturing or production of tangible personal property (including the processing resulting in a change in condition of such property).

[15] Code § 144(a).

It should be noted that for calendar years 2009 and 2010 (pursuant to the American Recovery and Reinvestment Act of 2009, effective February 17, 2009), manufacturing facilities also include facilities used in the production of "intangible" property such as patents, copyrights, formulas, processes, designs, etc.

$10 Million Limit

In order for bonds to qualify under this section:

> The face amount of the bonds is limited to $10 million; and

> The face amount of the bonds, when added to all capital expenditures made by the borrower (and all related persons) in the same jurisdiction (*e.g.*, town, city) in which the bond-financed facility is to be located, during the six-year period:

- beginning 3 years before date of issuance; and
- ending 3 years after date of issuance;

> Does not exceed $20 million.

$40 Million Outstanding Bonds Limit

As an additional restriction, the same borrower (including all such borrower's related persons) may not have outstanding at any one time, more than $40 million of tax-exempt small issue bonds and exempt facility bonds.

Related Persons. As a general rule, persons are deemed to be related persons if there is more than 50 percent ownership in an entity, or there is more than 50 percent joint ownership of different entities (*e.g.*, if the same two people own more than 50 percent of two different entities, those people are related to the entities and the entities are related to one another).

Prohibited Facilities

The Code limits the use of bond proceeds for certain specified purposes, which are recounted here, though the requirement that the bonds be issued to finance "manufacturing facilities" essentially renders this provision unnecessary. No small issue bond proceeds may be used to finance any of the following:

> Any facility the primary purpose of which is:

- retail food and beverages;
- automobile sales or service; or
- the provision of recreation or entertainment;

> Any of the following:

- private or commercial golf course;

- country club;
- massage parlor;
- tennis club;
- skating facility (including roller skating, skateboard, and ice skating);
- racquet sports facility (including any handball or racquetball court);
- hot tub facility;
- suntan facility; or
- racetrack.

In addition to these restrictions applicable specifically to Small Issue Bonds, there are restrictions applicable to private activity bonds. Those restrictions are described below.

Qualified Student Loan Bonds

A detailed discussion of this type of financing is beyond the scope of this Primer. For any questions with respect to the issuance of student loan bonds, please do not hesitate to contact me.

Qualified Redevelopment Bonds

A detailed discussion of this type of financing is beyond the scope of this Primer. For any questions with respect to the issuance of redevelopment bonds, please do not hesitate to contact me.

Non-Arbitrage Requirements and Limitations Applicable to Private Activity Bonds

In addition to the specific requirements applicable to a particular type of bond described above (*e.g.*, that airport bonds finance property that must be located at or near an airport or that bonds for residential rental housing provide facilities that contain units with separate and complete facilities for living, sleeping, eating, cooking and sanitation), the Code contains requirements that are applicable to all (or most) types of qualified private activity bonds. These requirements and limitations are described here.

Unless otherwise indicated, these requirements and limitations do not apply to governmental bonds.

Additional requirements relating to “arbitrage” and “rebate” are described under Arbitrage Requirements and Limitations Applicable to Tax-Exempt Bonds, below.

95/5 Test

At least 95 percent of the proceeds of a qualified private activity bond must be used:

- To finance or "provide" the facility; and
- To finance capitalizable costs.

In other words, no more than 5 percent may be used for other purposes (*e.g.*, working capital, soft costs), but this 5 percent figure is further limited, as discussed under Costs of Issuance, below.

Costs of Issuance[16]

No more than 2 percent of the proceeds of the qualified private activity bond may be used to finance costs of issuance. Costs of issuance include all costs connected with the issuance of the bond, including (but not limited to):

- Bond counsel fee
- Underwriter's discount
- Underwriter's counsel fee
- Printing costs
- Borrower counsel fee
- Trustee fee
- Bond issuer fee
- Trustee counsel fee

This 2 percent limit fits within the overall 5 percent limitation described above. Thus, although 5 percent of the proceeds may be used to finance non-capitalizable (or other non-qualified) costs, no more than two-fifths of that 5 percent may be used to finance costs of issuance.

Land Acquisition[17]

The Code provides that the amount of bond proceeds used to acquire land (or an interest in land) must be less than 25 percent of the proceeds of the bonds.

This 25 percent limitation does not apply to Qualified 501(c)(3) Bonds.

Acquisition of Existing Property.[18] As a general rule, proceeds of private activity bonds may not be used to acquire existing property unless the "substantial rehabilitation" requirement is satisfied. Property is considered existing property unless the first use of that property is pursuant to the bond-financed acquisition.

Existing property may be purchased with bond proceeds if the property undergoes "substantial rehabilitation." Substantial rehabilitation occurs if:

- During the two-year period beginning on the later of:
  - the date of the bond issue; or
  - the date of the building's purchase;
- The taxpayer spends on "qualifying rehabilitation expenditures" an amount equal to at least 15 percent of the portion of the building's acquisition financed with proceeds of the bonds.

[16] Code § 147(g).
[17] Code § 147(c).
[18] Code § 147(d).

For example, if $1 million of a $5 million bond issue is used to finance the acquisition of an existing building, the substantial rehabilitation requirement is met if 15 percent of that $1 million portion (or $150,000) is used to rehabilitate the building.

For this purpose, rehabilitation expenditures include any property chargeable to capital account incurred by the building's acquirer (or even the seller, under the terms of a sales contract).

Expenditures must rehabilitate (rather than enlarge) an existing building in order to qualify.

This limitation does not apply to Qualified 501(c)(3) Bonds.

Substantial User Limitation[19]

The interest on private activity bonds is not excluded from gross income during any time in which such bonds are held by someone who is a substantial user of the property financed with proceeds of the bonds, or a related person to such substantial user.

For example, if bonds are issued to finance a manufacturing facility to be used by XYZ Corporation, interest on the bonds will not be tax-exempt if XYZ Corporation (or a related person to XYZ Corporation) holds the bonds.

For purposes of this limitation, anyone who owns more than a 50 percent interest in another entity is considered to be a "related person" to that entity.

This limitation does not apply to Qualified 501(c)(3) Bonds. Thus, a 501(c)(3) Organization may hold bonds that are issued to finance a facility owned or operated by such 501(c)(3) Organization, without impacting the tax-exempt status of those bonds.

120 percent Test[20]

The Code limits the maturity of private activity bonds by the average economic life of facilities financed with the proceeds of the bonds. This limitation, referred to as the "120 percent test," provides that:

> the average maturity of bonds issued to finance assets may not exceed 120 percent of the average reasonably expected economic life of the facilities financed with the net proceeds of the bonds.

Economic Life

The calculation of economic lives of the assets financed is done on an aggregate, average basis.

For example, if the following assets are financed (assuming the following economic lives), the average is as follows:

	A			B
Building	$5,000,000	x	40-year life =	$200,000,000
Equipment	$ 1,000,000	x	10-year life =	$ 10,000,000
Furniture	$ 100,000	x	7-year life =	$ 700,000
	$ 6,100,000			$ 210,700,000

[19] Code § 147(a).
[20] Code § 147(b).

To determine the average, the total in column B (the weighted lives) is divided by the total in column A (the total cost).

$$\frac{\$210,000,000}{\$\ 6,100,000} = 34.426 \text{ years}$$

Economic lives may be determined by appraisals or by various guidelines published by the Internal Revenue Service or other independent means.

Weighted Average Maturity

Even though a bond issue may extend for 30 years, the weighted average maturity of that bond issue may be far shorter. The weighted average maturity is computed by multiplying:

- The principal amount of the bonds redeemed in each year (known as sinking fund payments or installments); by
- The number of years elapsed from the date of issue until the date of such "redemption."

The weighted average maturity is usually calculated by the underwriter, a financial advisor or even bond counsel. For a discussion of the parties involved in a typical bond deal, see Bond Issuances – The Parties and The Players, below.

Public Approval[21]

Private activity bonds must be approved:

- By an authorized governmental representative;
- After a public hearing has been held with respect to the bonds and the project to be financed; and
- The hearing may only be held after adequate notice of such hearing has been published in the requisite newspapers.

This requirement is known as the "TEFRA" requirement, named after the 1982 statute that introduced it – The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

Notice must:

- be published in newspapers of general circulation that, serve the area where the facility is to be located, and
- be designed to inform the public as to the project and the bonds.

Such notice must:

- describe the project (*i.e.*, the purpose for the bond issue);
- identify the location;
- identify the initial owner or operator of the project;

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[21] Code § 147(f).

> state the maximum amount of bonds expected to be issued; and

> be published at least 14 days prior to the hearing date.

(Treasury Regulations have been proposed that would reduce the 14-day requirement to seven business days, but those Regulations are not yet effective.)

After a hearing is held, the authorized representative (often, the governor for a statewide issuer, the mayor for a city-wide issuer, etc.) must approve the issue and then bonds may be issued.

No approval is necessary, however, for a current refunding bond (see Refunding Bonds, below) unless the refunding bond has an average maturity date later than that of the bonds to be refunded.

Miscellaneous Prohibited Facilities[22]

The Code identifies certain facilities that are specifically prohibited from being financed with proceeds of private activity bonds.

(Note that, with respect to small issue bonds, these prohibited facilities are in addition to those described under Qualified Small Issue Bonds, above.)

No bond proceeds may be used to provide any of the following:

> Airplane;

> Skybox or other private luxury box;

> Facility primarily used for gambling;

> Store the principal business of which is the sale of alcoholic beverages for consumption off premises; or

> Health club facility (this restriction does not apply to Qualified 501(c)(3) Bonds).

Volume Cap Allocation[23]

The Code limits the amount of tax-exempt private activity bonds that may be issued in a given calendar year. The limit applies on a state-by-state basis and is set as the greater of:

> A particular state's population (multiplied by $75); or

> A set amount of $225 million.

This volume cap limitation does not apply to governmental bonds and does not apply to all private activity bonds.

The following types of bonds do not require an allocation of volume cap under the cited Code section:

> Non-private activity bonds (*i.e.*, governmental bonds)

[22] Code § 147(e).

[23] Code § 146(a).

> Qualified 501(c)(3) Bonds;

> Refunding bonds that do not exceed the face amount of the bonds to be refunded; and

> Exempt facility bonds for:

- airports;
- docks and wharves;
- mass commuting facilities;
- solid waste disposal facilities (if governmentally owned);
- qualified public educational facilities;
- qualified green buildings and sustainable design projects; and
- qualified highway or surface freight transfer facilities.

It should be noted that the last three items above are subject to their own, specific, volume cap limitations.

Information Reporting[24]

In connection with the issuance of a private activity bond, the issuer must file IRS Form 8038, which sets forth certain information with respect to the bond. This form must generally be filed within six weeks of the close of the calendar quarter in which the bonds are issued.

This requirement applies to governmental bonds, but for such issues, the form is IRS Form 8038-G.

Federal Guarantee[25]

With certain limited exceptions, payment of debt service on an issue of bonds may not be federally guaranteed, which means:

> Payment of debt service may not be guaranteed, in whole or in part, by the United States (or any agency or instrumentality thereof), either directly or indirectly; and

> The proceeds of the bonds may not be invested in federally insured deposits or accounts.

Bonds are not considered "federally guaranteed" if they are guaranteed by certain insurance programs, including those of the Federal Housing Administration, Fannie Mae, the Federal Home Loan Mortgage Corporation and the Government National Mortgage Association, to name a few.

This restriction applies equally to governmental bonds.

Refunding Bonds

[24] Code § 149(e).

[25] Code § 149(b).

Bonds may be issued to refund (*i.e.*, redeem the principal of) outstanding bonds. There are two types of refunding under the Code, depending upon how long after issuance of the "refunding" bonds the prior outstanding bonds are redeemed.

Advance Refunding

> A refunding bond is considered an "advance" refunding if the proceeds of such bond are used more than 90 days after issuance to refund the outstanding bonds. This type of bond is most often used when the outstanding bonds are not callable (*i.e.*, may not be refunded) until some date in the future.

> Typically, the proceeds of the advance refunding bond are placed in escrow, and the prior bonds and the refunding bonds remain outstanding simultaneously until the maturity date(s) of the principal amounts of the prior bonds (on which dates, the prior bonds, or refunded bonds, are "called" (or redeemed)).

> With the exception of Qualified 501(c)(3) Bonds, private activity bonds may not be advance refunded.

> For those bonds that may be advance refunded (governmental bonds and Qualified 501(c)(3) Bonds), an outstanding bond may be advance refunded either once or twice, depending upon when the original bonds had been issued:

- Where an original bond was issued prior to 1986, it may be advance refunded twice;
- Where an original bond was issued after 1985, it may be advance refunded once.

Current Refunding

> A refunding bond is considered a "current" refunding if the proceeds of such bond are used within 90 days after issuance to refund the outstanding bonds.

> All bonds may be refunded pursuant to a current refunding, assuming all requirements are satisfied.

Official Action[26]

As a general rule, proceeds of bonds must be used to finance expenditures that are made after the bonds are issued. Bond proceeds may be used to finance (actually, reimburse) costs paid or incurred before the date of issuance of the bonds, but only if the issuer of the bonds (or the borrower, if the borrower is a 501(c)(3) Organization), has passed what is called a "declaration of intent" with respect to the bonds and the project to be financed.

A declaration of intent is a resolution or other "official action" that identifies a project and expresses the intention to finance the project with proceeds of a long-term borrowing. Any expenditures paid within 60 days prior to the date of passage of the "official action" are deemed to be expended after its passage, and may be reimbursed with proceeds of

[26] Regulations § 1.150-2.

the bonds as long as:

> The reimbursement occurs (*i.e.*, the bonds are issued) within 18 months of the later of:

  - the date the original expenditure is paid; or
  - the date the project is placed in service (or abandoned).

> In no event, however, may the reimbursement occur more than 3 years after the expenditure has been made.

The official action should contain a general description of the purpose for the bond issuance and the maximum amount of bonds expected to be issued.

This "official action" requirement does not apply to "preliminary expenditures," which consist of architectural, engineering, surveying, soil testing, reimbursement bond issuance and similar costs incurred prior to the start of a project, as long as such preliminary expenditures do not exceed 20 percent of the bonds.

This requirement applies equally to governmental bonds.

Arbitrage Requirements and Limitations Applicable to Tax-Exempt Bonds

In addition to the restrictions and requirements relating to the use of proceeds of the bonds and the use of the bond-financed facilities described in the preceding section, the Code imposes certain limits and restrictions on the investment of bond proceeds (and other amounts related to the bond issue), as well as the investment of amounts expected to be used to pay debt service on the bonds and, in some cases, requires certain amounts to be rebated to the federal government.

Many of these restrictions apply to private activity bonds and governmental bonds alike. These "arbitrage" and "rebate" requirements are described in this section.

Investment Limitation[27]

As a general rule, proceeds of tax-exempt bonds may not be invested at a yield in excess of the yield on the bonds. This limitation might be violated by using proceeds to acquire "higher-yielding investments" (*e.g.*, using bond proceeds to acquire (*i.e.*, finance) a mortgage loan) or using proceeds to acquire securities (as an investment) intended to be used for any number of purposes. The limitation is violated if the proceeds (or certain other related amounts) are invested in "materially higher-yielding investments."

If this prohibition is violated and the bonds do not qualify for an exception (as described below) the bonds will be considered "arbitrage bonds" and the interest on the bonds will lose their tax-exempt qualification.

Materially Higher-Yielding Investments – Purpose Investments

Federal tax law contains different definitions for "materially higher" for different types of

[27] Code § 148(a); Regulations § 1.148-2.

bonds and different types of investments. Initially, investments are divided into "purpose" investments and "non-purpose" investments.

"Purpose investments" are those investments that are acquired to carry out the governmental purpose of an issue. For example, if bonds are issued and the proceeds are used to make a loan to a borrower, with the borrower using the loan proceeds to finance its project or in furtherance of its authorized purposes, that "loan" is deemed to be a "purpose" investment.

Other investments are considered to be "non-purpose" investments.

In brief:

> Loans to borrowers to provide residential housing or to borrowers that are qualified 501(c)(3) Organizations may have a yield that exceeds the yield on the bonds by 1.5 percent.

> Loans for single family mortgages (funded with proceeds of mortgage revenue bonds), may have a yield that exceeds the yield on the bonds by 1.125 percent.

> Loans to other borrowers with proceeds of private activity bonds may have a yield that exceeds the yield on the bonds by no more than 0.125 percent.

Investment Options

Investments must not only be made to satisfy yield-restriction requirements, but also must be acquired at "fair market value." The Treasury Regulations set forth certain "safe harbors" for determining when certain investments (*e.g.*, certificates of deposit, guaranteed investment contracts, escrows for defeasing outstanding bonds) are acquired for their fair market value.[28]

Issuers of bonds have options for investing bond proceeds (and other amounts related to a bond issue) that make it easier to comply with the investment limitations. Some of these are:

> Tax-Exempt Bonds. Proceeds of bonds invested in qualifying tax-exempt bonds are deemed not to be invested pursuant to the Code. Because they are deemed not to be invested, such amounts are:

- not subject to yield restriction; and
- not subject to the Rebate Requirement.

Tax-exempt bonds are qualified for this purpose, as follows:

> Governmental bonds, Qualified 501(c)(3) Bonds and any other "non-AMT" bonds (as described under Factors Affecting Marketability of Bonds, below) must be invested in other "Non-AMT" bonds.

> Private activity bonds (and any other "AMT" bonds) may be invested in any tax-exempt bonds (whether AMT or Non-AMT).

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[28] See Regulations § 1.148-5(d)(6).

> U.S. Treasury Securities – State and Local Government Series (SLGS). Bond proceeds and other amounts that are subject to yield restriction in connection with a bond issue may be invested in these types of securities, with interest rates established to maximize return on the investments without exceeding the permitted yield.

Materially Higher-Yielding Investments – Non-Purpose Investments

Non-Purpose Investments are those that are not made to carry out the governmental purpose of the issue. For example, if proceeds of bonds are used to acquire a mortgage loan, the loan is considered a "purpose" investment. If the proceeds are invested in interest-bearing securities or an interest-bearing account until the proceeds are needed for the construction of a project, the interest-bearing securities or interest-bearing account constitutes a "non-purpose" investment subject to the Code's limitation on "materially higher-yielding" investments.

In general, except during a specified "temporary period" (described below), bond proceeds and other related amounts may not be invested at a yield more than 0.125 percent above the yield on the bonds.

Temporary Periods

Prior to the time proceeds of bonds are spent to finance a project (*e.g.*, acquisition or construction of a building, acquisition or installation of equipment, etc.), or other amounts are spent for bond-related purposes (*e.g.*, to pay debt service on the bonds), those amounts are often invested pending use. The Code permits certain "temporary periods" where those amounts may be invested without restriction as to yield.

Some of these "temporary periods" are as follows, assuming satisfaction of certain requirements:

> For capital projects and single family mortgage loans: Three years from issue date (five years, if engineer or architect opines that more than three years needed);

> For working capital financings: 13 months from issue date;

> For debt service funds: 13 months from deposit into fund;

> For earnings on invested amounts: One year from receipt of earnings; and

> For other amounts: 30 days from date of receipt.

Debt Service Funds, Pledged Funds and Sinking Funds

Certain funds from which amounts are used to pay debt service (principal and interest) on bonds, or even funds that are meant to be available if needed to pay debt service, may be subject to yield restriction, despite the fact that the source of payment of debt service is typically not bond proceeds.

A debt service fund is a fund into which amounts are deposited that are to be used to pay debt service on bonds. If a debt service fund meets the requirements for a "bona fide debt service fund" it is not subject to yield restriction (for a 13-month temporary period).

A fund is a "bona fide debt service" fund if it is:

> Sized to match debt service on a bond for a particular bond year; and

> Depleted at least once a year, except for a reasonable carryover not to exceed the greater of:

- earnings on the fund for the prior bond year; or
- one-twelfth of the debt service payments on the bond for the prior bond year.

A "pledged fund" is an amount that is pledged (either directly or indirectly) to pay debt service on the bonds – one that gives reasonable assurance that it will be available to pay debt service if another source proves inadequate or unavailable.

A "sinking fund" is any fund that is set aside and reasonably expected to be used to pay debt service on the bonds. Both debt service funds and debt service reserve funds constitute sinking funds.

Debt Service Reserve Funds

In some bond issues, an amount (whether funded with bond proceeds or from other sources, or both) must be invested in a "reasonably required reserve fund" in order to secure the payment of debt service on the bonds. In other words, if there is concern that the issuer of the bonds (in a governmental financing) or the borrower (in a private activity bond financing) may not have enough revenues to pay principal of and interest on the bonds, the establishment and funding of a "reserve fund" that can be tapped to cover the debt service payment, if necessary, may be required.

If the debt service reserve fund is not sized in an amount greater than that permitted under the Code (in general, the limit is 10 percent of the proceeds of the bond issue or the amount of debt service on the bonds during the year in which the debt service is greatest during the life of the bonds), the reserve fund will not be subject to yield restriction.

Rebate

Even where bond proceeds and other amounts (such as monies invested in sinking funds or pledged funds) are not subject to yield restriction, but rather, entitled to a temporary period, such amounts may very well be subject to the Rebate Requirement, unless they qualify for an exception thereto, which exceptions are described, below.

The "Rebate Requirement" mandates that amounts earned on nonpurpose investments that exceed what would have been earned by investing at the yield on the bonds, must be rebated (*i.e.*, paid) to the federal government. Among the provisions of the Rebate Requirement are the following:

> Rebate must be computed every 5 years during the life of the bonds, and again upon the final maturity or redemption of the bonds;

> Rebate payments must be made no later than 60 days after the end of the 5-year period (with 90 percent of the amount owed being paid at that time) and no later than 60 days after the final maturity or redemption of the bonds (with 100 percent of the amount owed being paid at that time); and

> Failure to pay rebate at all, or to pay rebate on a timely basis, may subject the issuer to penalties and may jeopardize the tax status of interest on the bonds.

Exceptions to Rebate

The Code provides that certain bond issues are exempt from the Rebate Requirement, as are certain qualifying funds. These exceptions include:

Spending Exceptions

> Proceeds of the bonds that are expended according to the following schedule, measured from the date of issuance:

- six months;
- 18 months (with certain minimum spending thresholds met every six months[29]); or
- two years (with certain spending thresholds met every six months[30]).

The 18-month and two-year "spending exceptions" are not available for refunding issues.

The two-year spending exception is only available to governmental bonds and Qualified 501(c)(3) Bonds for portions of such issues that constitute "construction issues" (*i.e.*, finance "construction expenditures").

Non-Spending Exceptions

> Bonds of governmental units issuing no more than $5 million of tax-exempt bonds during a calendar year are not subject to the Rebate Requirement.

> Amounts earned on a bona fide debt service fund (defined above) are not subject to the Rebate Requirement if the gross earnings on such fund for a particular bond year are less than $100,000.

Factors Affecting Marketability of Bonds

The Code imposes certain tax consequences on bonds, notwithstanding the "tax-exempt" status of interest on the bonds. Two of those requirements are set forth below. For a full description of all these "collateral tax consequences," please feel free to contact me.

Alternative Minimum Tax

The Code imposes an alternative minimum tax on certain individual and corporate tax-payers. Except as provided below, interest on tax-exempt bonds may be included in the computation of alternative minimum tax, despite the fact that such interest is excluded from gross income.

[29] 15 percent within six months, 60 percent within 12 months, and 100 percent within 18 months.

[30] 10 percent within six months, 45 percent within 12 months, 75 percent within 18 months, and 100 percent within two years.

There are two types of inclusion that may occur:

- Private activity bonds issued after August 7, 1986 are considered AMT bonds. Interest on such bonds is treated as a preference item[31] for purposes of the alternative minimum tax and such treatment may be imposed on both individuals and corporations.
- Governmental bonds, Qualified 501(c)(3) Bonds and refundings of private activity bonds originally issued before August 8, 1986 are considered Non-AMT bonds. The interest on these bonds is not treated as a preference item, but such interest is included in adjusted current earnings[32] in the computation of alternative minimum taxable income for purposes of the alternative minimum tax that may be imposed on certain corporations.

Because of provisions in the American Recovery and Reinvestment Act of 2009 (with exceptions applicable to certain refunding bonds), any tax-exempt bonds issued in 2009 and 2010 are considered Non-AMT bonds and the interest thereon is not included in adjusted current earnings.

Bank Deductibility

Except as provided below, the Code limits the amount of tax deduction available to financial institutions allocable to funds borrowed for the acquisition of tax-exempt bonds.

Issuers of no more than $10 million of governmental bonds and Qualified 501(c)(3) Bonds in a calendar year may designate the bonds as “bank qualified” and thereby increase the percentage of interest deductible by banks for the purchase of such bonds.

Because of provisions in the American Recovery and Reinvestment Act of 2009, governmental bonds and Qualified 501(c)(3) Bonds issued in 2009 and 2010 may be designated as “bank qualified” if the Borrower is not the recipient of more than $30 million of bonds in either such calendar year.

Bond Issuances — The Parties and The Players

Governmental Issues

In the typical issuance of governmental bonds, the issuing entity uses the proceeds for its own purposes (although there are exceptions, such as where a state’s “educational facilities authority” may issue bonds and make a loan of the proceeds to a State-owned university).

Typical issuers may be states, counties, cities, highway authorities, transportation authorities, etc.

- The “Issuer” sells the bonds to an “Underwriter” (or “Placement Agent”) and the Underwriter (or Placement Agent) buys the bonds, often paying slightly less than the face amount of the bonds (the difference in the face amount and the purchase price constitutes the underwriter’s discount or “spread” for the transaction).

[31] Code § 57(a)(5).

[32] Code § 56(c)(1).

> The Underwriter then sells the bonds to investors. In contrast, the Placement Agent places the bonds directly with a particular investor.

> A bank is usually retained to serve as "Trustee" and administers the various funds established in connection with the bond issue, and oversees and handles (i) requisition of bond proceeds for the project purposes, (ii) receipt of monies to be used to pay debt service on the bonds, and (iii) payment of debt service on the bonds.

> In cases where there might be some concern about the Issuer's ability to make its debt service payments on the bonds, a Bond Insurer may be tapped to provide bond insurance on the bonds or a Letter of Credit Bank may be induced to issue a Letter of Credit to secure payment of debt service on the bonds.

In some cases, the Issuer does not sell the bonds to (or through) an Underwriter, but may sell the bonds competitively to the public. In these cases, the Issuer will often retain a "Financial Advisor," rather than an Underwriter.

Each of these parties (except the Financial Advisor) will typically have its own counsel.

Bond Counsel represents the issuer, drafts most of the bond-related documents and renders the opinion as to the tax-exemption of interest on the bonds.

Underwriter's Counsel represents the Underwriter (or Placement Agent) and typically drafts the bond purchase agreement (through which the Underwriter (or Placement Agent) buys the bonds from the Issuer) and whatever offering document is used for the marketing and selling of the bonds to the public, and renders an opinion with respect to matters set forth in the offering document.

Trustee Counsel represents the Trustee bank and ensures that the Trustee is authorized to serve in such capacity in the state in which the Issuer is located.

If bond insurance is provided or a letter of credit is issued in connection with a bond issue, either the Bond Insurer or Letter of Credit Bank will have its own counsel.

Conduit Issues

The primary difference between Conduit Issues and Governmental Issues, in terms of the parties involved, is the existence of a "Borrower" in Conduit Issues.

In Conduit Issues, the Issuer uses the proceeds from the sale of the bonds to make a loan to the entity that is "borrowing" the proceeds to finance its project. [In some cases, the Issuer will finance the project and then lease the project to the Borrower].

There is usually a "Borrower" that is the recipient of any proceeds of Exempt Facility Bonds, Qualified Small Issue Bonds and Qualified 501(c)(3) Bonds.

The Issuer and Borrower typically enter into a "Loan Agreement" in which the Borrower agrees to make payments on the "Loan" that then enable the Issuer to pay debt service on the Bonds.

In Conduit Issues, the same parties described under Governmental Issues will have their counsel present. In addition, the Borrower will retain "Borrower's Counsel" to protect its interests in the financing.

Should you have questions about the information in this Primer, please contact Chuck Katz at (312) 569-1248 or Charles.Katz@dbr.com, or your regular Drinker Biddle contact.

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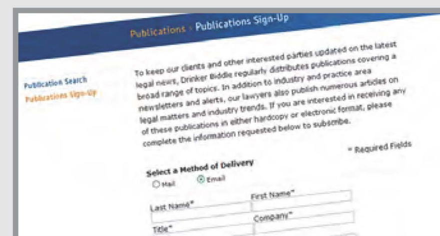

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