MCGUIREWOODS

INTRODUCTION TO TAX-EXEMPT FINANCING

I. INTRODUCTION

Tax-exempt financing is a financing tool available to eligible borrowers as a means of raising funds for capital needs.

II. THE BASICS

A. What is a tax-exempt bond?

A tax-exempt bond is an obligation of a state or political subdivision the interest on which is exempt from federal income taxation. The interest income is also usually exempt from income taxation of the state in which the issuer of the obligation is located.

B. What are the benefits of tax-exempt bonds?

Interest rates on tax-exempt bonds are considerably lower than interest rates on comparable taxable obligations. For example, an investor in a 25% tax bracket would receive the same after-tax income from a tax-exempt bond bearing interest at 6% that he or she would receive from a taxable obligation bearing interest at 8%.

C. What are the roles of the various parties in a tax-exempt financing?

Bond Counsel. The role of bond counsel in public financing developed in the late nineteenth century as a result of bond issues being declared invalid due to defects peculiar to governmental law. In response to investor concern over such events, investment bankers and investors began requiring that an objective opinion on the validity of a bond issue be obtained from an attorney recognized on the subject of public finance. Today, the opinion of bond counsel still involves passing on the validity of the bonds, but also addresses other issues such as the exemption of interest on the bonds from federal and state taxation. Bond counsel typically prepares most of the resolutions, ordinances and other legal documents relating to the authorization, issuance and sale of the bonds.

Underwriters. The underwriters in a tax-exempt bond transaction are responsible for the offering and sale of the bonds. They are also responsible for structuring the financing and recommending strategies to the issuer of the bonds regarding the security for the bonds, covenants that will be necessary to market the bonds, principal repayment schedules and other business issues that need to be addressed. The underwriters also deal with rating agencies such as Moody's and Standard & Poor's in obtaining ratings on publicly sold bonds, and are primarily responsible for dealing with bond insurers in negotiating premiums and covenants on behalf of the issuer.

Underwriters' Counsel. The primary role of underwriters' counsel is to prepare the offering document used in connection with the sale of the bonds. They are also responsible for ensuring that the offering document contains adequate disclosure information and a description of the potential risks involved in the investment. Underwriters' counsel also prepares the bond purchase agreement between the underwriters and the issuer, as well as the documents relating to the relationship between the lead underwriter and any other underwriters involved in the transaction. Underwriter's counsel also prepares a Blue Sky Survey for the underwriters in order to help ensure compliance with state securities laws.

Banks. In some instances, banks will purchase bonds directly, eliminating the need for an underwriter and a public offering of the bonds. Primarily on variable rate transactions, banks often provide a letter of credit to secure the bonds.

Other Participants. Other participants in a tax-exempt financing typically include (i) an issuer's counsel, who advises the issuer regarding financial covenants and renders an opinion regarding the enforceability of the bond documents against the issuer; (ii) a financial advisor, who is often engaged by the issuer to provide independent advice regarding the structure of the financing and the fairness of the pricing of the bonds by the underwriters; (iii) a bond trustee, who acts as the representative for the bondholders after the bonds are issued, and holds any debt service reserve funds and the other funds and accounts created in connection with the financing; (iv) trustee's counsel, who represents the trustee in negotiating the bond documents; and (v) rating agencies and bond insurers.

III. WHAT QUALIFIES FOR TAX-EXEMPT FINANCING?

A. General

Whether a particular project qualifies for tax-exempt financing depends primarily on (i) the identity of the issuer of the bonds or other obligations; (ii) what is being financed with the proceeds of the obligation; and (ii) who will be using the bond-financed facilities. In order for an obligation to be tax-exempt, it must be issued by a state or political subdivision of a state, such as a county, city, town, industrial development authority, economic development authority, community development authority, water and sewer authority or other similar entity. Even if issued by such an entity, however, the obligation will not be tax-exempt unless the proceeds of the obligation are used for facilities that qualify for tax-exempt financing under the applicable provisions of the Internal Revenue Code and State law. There are two main types of tax-exempt bonds: governmental bonds and private activity bonds.

B. Governmental Bonds

In order to qualify as a governmental bond, no more than 10% of the proceeds of the bonds may be used directly or indirectly in any trade or business by any person other than a state or governmental unit, and the payment of no more than 10% of the bonds may be secured by or derived from property or borrowed money used for private business. The test is 5% for "unrelated" private business use. Any bond that fails to qualify as a governmental bond (by failing to meet both tests described above) is a "private activity bond." For example, bonds issued to finance county offices where 25% of the space is leased to private businesses and the rent paid in connection with those leases equals 15% of total debt service are "private activity bonds" (unless the bond issue is sized so that it only finances the governmental use portion). Private activity bonds are exempt from federal income taxation only if they qualify under one of the special provisions applicable to private activity bonds described below. Governmental bonds are typically issued by states, counties, cities and towns for traditional governmentally owned and operated projects such as schools, courthouses, governmental office buildings, jails, libraries, roads, water and sewer systems and solid waste disposal facilities. Generally, the procedural and tax requirements applicable to governmental bonds are less onerous than those applicable to private activity bonds.

C. Private Activity Bonds

Private activity bonds are usually issued by industrial development authorities or other agencies or instrumentalities of the state, county, city or town for projects that are owned, operated or leased by non-governmental entities. Interest on private activity bonds is exempt from federal income taxation only if the bonds and the projects which they are used to finance satisfy several complex requirements. In general, in order for interest on a private activity bond to be exempt from taxation, it must fit within one of seven categories of qualified bonds described below.

1. Exempt Facility Bonds

Exempt facility bonds may be issued to finance certain types of facilities without limitation as to amount, including, among others: airports; docks and wharves; mass commuting facilities; facilities for the furnishing of water; sewage facilities; solid waste disposal facilities and qualified multi-family residential projects.

2. Qualified Small Issue Bonds (Manufacturing Facility Bonds)

In 1986, because of the extraordinary volume of qualified small issue bonds being issued, and because of adverse publicity regarding the types of facilities that were being financed, Congress limited the use of qualified small issue bonds to manufacturing facilities. The term "manufacturing facility" means any facility used in the manufacturing or production of tangible personal property, including the processing resulting in a change in the condition of such property. The manufacturing facility may include on-site offices, but office space may not exceed that directly related to the day-to-day operations of the manufacturing facility. Qualified small issue bonds may be issued in an aggregate principal amount of up to $10,000,000, but if the issue exceeds $1,000,000, additional restrictions will be imposed on the owner and principal users of the facility. In particular, during the applicable six-year period, the capital expenditures of the owner and all principal users in the jurisdiction where the bond-financed facility is located plus the amount of bonds issued may not exceed $20,000,000. The small issue exemption is not available for a bond issue if the amount of the issue allocated to any beneficiary of the facility being financed with the bonds plus the outstanding amount of other tax-exempt bonds allocated to the beneficiary exceeds $40,000,000.

3. Qualified 501(c)(3) Bonds

Qualified 501(c)(3) bonds may be issued for the benefit of organizations described in Section 501(c)(3) of the federal tax code if the property which is to be provided by the net proceeds of the issue is owned by that organization or by a governmental entity. The most common use of qualified 501(c)(3) bonds is for the acquisition, construction, renovation and equipping of hospitals, other health care facilities such as nursing homes and retirement communities, and educational institutions.

4. Others

IV. OTHER FEDERAL TAX LAW REQUIREMENTS

In addition to the basic qualification issues described above, there are also a number of other federal tax law requirements that affect tax-exempt bonds. Some of these requirements apply to all tax-exempt bonds, while others apply only to private activity bonds.

A. Requirements Applicable to All Tax-Exempt Bonds

1. Reimbursement Regulations.

Federal tax law restricts the ability of an issuer to issue tax-exempt bonds for the purpose of reimbursing previously paid project costs. In order to be able to reimburse project expenditures with tax-exempt bond proceeds the issuer is required to have in place a declaration of its intent to reimburse itself for such expenditures (a "reimbursement resolution") not later than 60 days after the expenditure to be reimbursed is paid. There is an exception for certain preliminary expenditures such as architectural and legal fees.

2. Arbitrage

In the early 1970's, investment bankers devised financing schemes whereby an issuer would issue tax-exempt bonds and invest the proceeds of those bonds in taxable obligations bearing interest at a much higher rate than the tax-exempt bonds, thereby generating "arbitrage" profits for the issuer. Treasury regulations implemented in the 1970's put a halt to this type of financing by eliminating the federal tax-exemption for any bonds that were classified as arbitrage bonds. The current version of the arbitrage regulations also places limitations on the yield at which bond proceeds may be invested, imposes restrictions on reserve and replacement funds, and, unless an exception applies, requires the rebate of arbitrage profit to the United States.

3. Registration Requirement

In order for the Internal Revenue Service to keep better track of the ownership of tax-exempt bonds, the federal tax laws were changed in 1983 to require that all tax-exempt bonds with maturities of one year or more be issued in registered form. Prior to that time, most tax-exempt bonds were issued in bearer form, where the identity of the owner was much more difficult to ascertain.

4. Federal Guarantee Prohibition

Interest on obligations of state or local governments is not exempt from federal income taxation if those obligations are federally guaranteed. Such obligations are considered to be federally guaranteed if they are directly or indirectly guaranteed, in whole or in part, by the United States or any of its agencies or instrumentalities.

5. Information Reports

In order for interest on bonds to qualify for the federal income tax-exemption, the issuer must file an information return (Form 8038 or 8038-G) with the Internal Revenue Service Center in Philadelphia, Pennsylvania. The report is required to contain information regarding the issuer, the bond issue, the property financed and other matters. Failure to file the information return can result in interest on the bonds becoming taxable retroactive to the date of issue.

B. Requirements Applicable to Private Activity Bonds

Because private activity bonds are generally considered to further less important public purposes than governmental bonds, the federal tax laws contain significant additional restrictions applicable only to private activity bonds. Most of these restrictions were implemented in an effort to decrease the exploding volume of private activity bonds in the early 1980's, or to make public officials more accountable for the types of projects being financed with those bonds.

1. Volume Cap

Most private activity bonds are subject to an annual volume limitation. The total aggregate principal amount of private activity bonds which may be issued in a state during any calendar year may not exceed a per capital dollar amount Generally,qualified 501(c)(3) bonds, any exempt facility bonds issued to finance airports, docks or wharves, any exempt facility bonds issued for a governmentally owned solid waste disposal facility and any refunding bonds are not included within the volume cap.

2. Public Hearing Requirements

Under current law, in order for any issue of private activity bonds to qualify for federal income tax-exemption, a public hearing must be held on the proposed issue not less than 14 days after the public notice, and the issue must thereafter be approved by the highest elected officials of the local government.

3. Use of Proceeds

Generally, at least 95% of the proceeds of a private activity bond must be used for the public purpose for which the private activity bond is being issued. In addition, no more than 2% of bond proceeds may be used to pay issuance costs. Federal tax law prohibits the use of 25% or more of the proceeds of any private activity bond to acquire land.

4. Average Maturity Limitation

In order to make sure that private activity bonds are not outstanding for significantly longer than the expected useful life of the facilities being financed, federal tax law provides that the average maturity of any private activity bond may not exceed 120% of the average reasonably expected economic life of the facilities being financed with the bonds.

5. Restriction on Acquiring Used Property

Tax-exempt private activity bonds may be used to finance the acquisition of existing, previously used property only if rehabilitation expenditures will equal at least 15% of the portion of the cost of the facility financed with bond proceeds (100% for structures other than buildings).

6. Straight Line Depreciation

Federal tax law requires that property financed with tax-exempt bonds (other than residential rental projects) be depreciated under an alternative method (straight line over 40 years for buildings or class life (or 12 years if no class life) for equipment.

V. FEDERAL SECURITIES LAW CONSIDERATIONS

Section 5 of the Securities Act of 1933 prohibits the offering or sale of securities through any means of interstate commerce or by use of the mails unless a registration statement is in effect with the Securities and Exchange Commission or an exemption from the registration requirement is available.

A. Exemption from registration

Section 3(a)(2) of the 1933 Act exempts from registration "any security issued or guaranteed by any state of the United States, or by any political subdivision of a state."

Consequently, bonds of local governments which are offered to the public are not required to be registered. In the case of private activity bonds, however, the exemption from registration under Section 3(a)(2) of the 1933 Act is only available if interest on the bonds is exempt from taxation under the Internal Revenue Code. Although bonds issued by local governments are generally exempt from registration, the entire financing must be scrutinized to determine if some part of the transaction involves a separate security which must be registered. Examples of separate securities include third party guarantees, letters of credit, participation certificates and insurance. Most of these separate securities have their own exemptions under the 1933 Act, with certain exceptions.

B. Anti-fraud Provisions

Although most tax-exempt bonds are exempt from the registration requirements of the 1933 Act, they are not exempt from the anti-fraud provisions of that Act or of the Securities and Exchange Act of 1934, both of which prohibit the making of false or misleading statements in connection with the sale of a security.

C. Disclosure

Because tax-exempt bonds are subject to the anti-fraud provisions of the securities laws, it is always necessary in a public offering of tax-exempt bonds for the issuer to prepare a disclosure document (usually called an official statement) for delivery to potential investors. At a minimum, official statements include a description of the securities being offered, a description of the project being financed with the proceeds of the issue, detailed facts concerning the issuer, a discussion of the tax-exemption of interest on the bonds, and financial statements of the issuer or conduit borrower, as appropriate.

D. Rule 15c2-12

Primarily in response to the highly publicized defaults by the Washington Public Power Supply System, the Securities and Exchange Commission (the "SEC") adopted Rule 15c2-12 (the "Rule") on June 30, 1989. The rule generally governs the procedures underwriters must follow in making official statements available to potential investors. On November 10, 1994, the SEC approved an amendment to the Rule. Effective July 3, 1995, an underwriter may not enter into a contract to provide underwriting services unless there is in place an undertaking by a party to the offering to make continuing disclosure of certain financial and other information. The undertaking must state that one party to the offering will provide (i) "annual financial information" for certain parties to the offering, and (ii) notices of certain material "events" about the offering itself. The required annual financial information and notices of the certain material events must be submitted to each nationally recognized municipal securities information repository ("NRMSIR") and the state information depository ("SID"), if one exists, in the issuer's state. The following are exempted from the new Rule: (a) securities with authorized denominations of $100,000 or more; (b) small issuers with no more than $10,000,000 outstanding in aggregate principal amount of publicly offered securities; (c) securities with principal amounts of less than $1,000,000; (d) securities with maturities of 18 months or less; and (e) underwriters exempted by the SEC.

Michael F Dow
McGuireWoods LLP
7 Saint Paul Street
Baltimore, Maryland 21202
410.659-4428
mdow@mcguirewoods.com