



**INTRODUCTION TO INDUSTRIAL
DEVELOPMENT FINANCING
IN CALIFORNIA**

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I. [Introduction - What is Industrial Development Financing?](#)

A. [General Introduction](#)

Industrial Development Financing is a technique for using tax-exempt bonds or notes¹ issued by a state or local government entity to provide the funds for various capital costs for private businesses. This technique results in passing through to the private user the lower interest costs found in the “municipal” tax-exempt financial market. Any tax benefits of the capital investment remain with the private user, and from the user's standpoint its obligations are very similar to a commercial loan or an issuance of corporate debt.

Industrial development financing is not available, however, to every business or for every project. There are three major limitations, each of which must be successfully handled:

(a) [State law authorization](#) -- Since IDBs are issued by governmental agencies, they can only be used to the extent and following the procedures allowed by the laws of the state of use. While all states now permit some IDBs, rules vary widely. California laws, discussed in this paper, are more restrictive than some other states.

(b) [Federal tax laws](#) -- IDB financing “works” only if the interest on the bonds (as certified by an unqualified opinion of a recognized bond counsel law firm) is excludable from gross income of bondholders for federal income tax purposes. The Internal Revenue Code, and implementing I.R.S. regulations and rulings, are very restrictive in what facilities can qualify for IDBs. Even within the limited eligible category of manufacturing facilities, only a small part of capital costs incurred by American businesses are financeable.

(c) [Source of financing](#) -- Even if a project is eligible for IDBs under state and federal laws, there may not be any investors willing to buy the bonds. The bond market looks for very safe investments, and many projects are not suitable for this market unless they have strong, third-party guarantees. This is a matter unique to each company or project, which should be explored early.

The remainder of this paper will give an introduction to items (a) and (b) listed above, which are the province of bond counsel. Item (c) is the province of bankers -- investment and commercial -- and financial advisers. To give some background to the rest of the paper, I will describe in general terms the structure of an IDB financing. This now assumes that all the hurdles listed above have been passed.

¹ These bonds or notes used to be called “industrial developmental bonds.” All three terms were interchangeable and referred to the same thing. This article will continue to refer to such bonds or notes by the common abbreviation “IDB,” although the Tax Reform Act of 1986 officially uses new terms such as “private activity bond” and “qualified small issue bond.”

B. [Structure of an IDB Financing](#)

In the typical IDB structure, the governmental agency (the “Issuer”) acts as a conduit, or intermediary, between the company or developer seeking financing (hereafter referred to as the “User”) and the bondholders (the investors, or source of capital). The transaction is structured around two major legal documents. The first is a Trust Indenture or equivalent instrument which defines the terms of the bonds, provides for their issuance, payment and redemption, and which governs all of the flows of funds to and from the bondholders. The parties to the Indenture are the Issuer and a Trustee (normally a commercial bank). The Bond proceeds will be deposited by the Issuer into a Construction Fund held by the Trustee, and the User will draw down these funds as needed to pay for its project.

Simultaneously with the issuance of the bonds, the Issuer and the User will enter into a financing contract. Most often this will be a loan agreement, but may also be an installment sale agreement or a “full-payout” lease. (For convenience, the financing contract will be referred to as a “Loan.”) The loan agreement will cover, among other things, the following areas:

1. the loan of bond proceeds by the Issuer to the User;
2. an unconditional promise (without allowance for any offsets or defenses) by the User to repay the loan by making payments sufficient to pay the principal of, premium, if any, and interest on the Issuer's bonds, as they become due;
3. provisions to pay fees or costs of the Trustee and the Issuer, and to maintain any required reserves;
4. the promise of the User to build the project as planned and approved, and to maintain and use it;
5. any financial covenants, security agreements or other terms desired by the lender or underwriter to secure the bonds (the security may include a deed of trust, a guaranty, or other security arrangements outside the terms of the loan agreement itself); and
6. remedies on default.

It has become very common for the User to obtain a third party “credit enhancement” to make the bond issue marketable. This will typically be a letter of credit from a highly-rated bank, or an insurance policy. With this arrangement, the investors need not look to the credit of the User; this is usually mandatory for smaller or start-up businesses, especially since commercial banks no longer actively buy tax-exempt bonds. (See Part III(H) below.)

At the bond closing, the Issuer will assign to the Trustee all of its rights and interest in the loan agreement and in any deed of trust or other security instruments. The User



will make its loan repayments directly to the Trustee, which will remit them to the bondholders. In the event of a default, the Trustee will act on behalf of the bondholders to enforce all rights available under all of the financing documents. The Issuer's role is purely to act as a conduit to provide the tax exemption on the bonds, and after bond delivery, the Issuer will have virtually no involvement with the bonds, the project, or the User. Thus the bonds are limited, special obligations of the Issuer, payable solely from the payments made by the User under the loan agreement, and from enforcement of any security interests or credit enhancements. Neither the Issuer nor any entity of government is required to make any payment on the bonds from any taxes, other revenues or other funds. The issuance of these bonds will not affect, or be affected by, the credit rating of the Issuer.

II. [California State Laws Authorizing IDB Financing.](#)

California was one of the last states to authorize use of IDBs to finance typical industrial or commercial projects. Such bonds have only become common since 1981. Unlike most states, which have authorized municipalities to issue bonds essentially for any projects permitted by federal tax laws, the authorization in California has been fragmented. Various types of government entities are authorized to finance specific kinds of projects, and some projects, in some locations, cannot be financed at all. Therefore, early consultation with qualified bond counsel is advisable.

The following is a brief summary of the authorizations for major categories of projects under California law:

- | | | |
|-----------------------------|---|---|
| <u>Industrial</u> | - | Anywhere in the state, through a local Industrial Development Authority (see Part A below) or the California Economic Development Financing Authority (see Part B below). |
| <u>Retail, Commercial</u> | - | No tax-exempt financing allowable. |
| <u>Multi-family Housing</u> | - | Anywhere in the state, through local agencies or the California Housing Finance Agency in Sacramento (not discussed further in this paper). |

The next sections of this article provide some more detail on the state law authorizations and procedures for industrial, retail and commercial projects.

A. [The California Industrial Development Financing Act.](#)²

1. [The Issuing Body](#)

The California Industrial Development Financing Act (the “Act”) creates within each city, county and city and county in California a new public body called an Industrial Development Authority (“Authority”). An Authority can be activated by ordinance of the city council/board of supervisors (the “governing body”). The sole function of an Authority is to issue bonds to assist financing of eligible projects. The jurisdiction of an Authority is coextensive with the area of the local government unit which activated the Authority. Thus, if a prospective User finds that the city in which its project is located has not formed an Authority, the financing can still be undertaken through the county. Indeed, most of the larger counties in the state have Authorities, and many cities have therefore chosen not to form an Authority. In addition, a “joint powers authority” consisting of several jurisdictions may issue IDBs, exercising the powers of an Authority. One such agency, which has numerous city and county members, is the California Statewide Communities Development Authority (telephone 510-933-9229 for information).

Under the Act, the bonds are issued by the Authority, but must be approved by (a) the governing body, and (b) a statewide Commission created to oversee IDB activity under the Act. The Commission consists of five ex-officio members, chaired by the State Treasurer; the others are the State Controller, the Director of Finance, the Secretary of the Trade and Commerce Agency, and the Commissioner of Corporations. The Commission has several professional staff members, located in Sacramento (telephone 916-653-3843). The Commission plays a very important role in the procedures created by the Act.

2. [Eligibility for Financing](#)

The Act authorizes issuance of bonds only to assist projects falling within the following categories:

- 1) Industrial projects, including, without limitation, assembling, fabricating, manufacturing, processing or warehousing, with respect to any products of agriculture, forestry, mining, or manufacture;
- 2) Projects for energy development, production collection or conversion; or
- 3) Research and development facilities.

² California Government Code §§ 91500-91574.



Furthermore, the Act is pre-emptive, meaning that cities, counties and redevelopment agencies are prohibited from IDB financing of any of these facilities except through the procedures in the Act.

By reason of exclusion from the above categories, many types of projects are not eligible for financing under this Act, including (without being comprehensive): commercial facilities, shopping centers, retail stores, rental office buildings, medical facilities, hotels, restaurants, transportation facilities, truck terminals, pollution control facilities (unless part of a larger, eligible industrial plant or energy project) and industrial park land development.

In addition to being in the qualified category, a project must demonstrate some public benefits to justify the governmental involvement. The Act requires the Authority and the Commission to make a finding that the project will either (a) secure or increase employment or local payrolls, (b) reduce prices or increase quality of products to consumers, or (c) result in savings or better utilization of energy or materials. Another limitation is that the project to be financed cannot be used to relocate jobs from one area of the state to another unless there is a strong justification.

The Commission has developed guidelines which place primary emphasis on the number of jobs to be created or saved by the project. The Commission will normally insist on at least one job for each \$50,000 of bonds. With respect to relocations, the Commission will consider the justifications on a case-by-case basis, but will usually insist that the User give timely notice to the city or county where it is presently located of its plan to move, and make an effort to find suitable space in the same vicinity.

The Act allows use of bond proceeds to pay for virtually all costs incurred by the User for the project, including: land and any interests in property; buildings; fixtures; machinery, equipment, and furnishings; landscaping; all costs for architects, engineers, surveyors, attorneys, permits, and other incidental costs; and all costs of the financing and issuance of the bonds. An eligible project can be for construction of a new plant, expansion of an existing plant, or rehabilitation or replacement of part or all of an existing plant or its equipment. Although acquisition of existing facilities is authorized, because of the need to demonstrate a public purpose, such transactions are unlikely to be approved unless there is a “distress” sale to prevent closure of a plant and loss of jobs. Moreover, federal tax laws also largely eliminate use of IDBs to acquire existing facilities (see Part III(E) below).

The Act can be used to accomplish either tax-exempt or taxable financings.

3. [Procedures and Terms of Financing](#)

The Act sets forth a rather detailed series of steps to be followed in order to issue bonds. A very brief summary of these steps follows. Typically, these steps can take 2-4 months to complete, but many transactions take a longer time because of the need to arrange workable financing.

- 1) Filing of application.
- 2) Initial approval of project by the Industrial Development Authority, with findings of public purpose.
- 3) Approval of Authority's actions by local governing body.
- 4) Filing of information package with State Commission.
- 5) Approval by State Commission that (a) project has adequate public purposes, (b) project does not result in a prohibited relocation, and (c) issuance of bonds is "fair, just and equitable." These approvals are often done separately, at different times.
- 6) Final approval of terms of bond issue by the Authority.

The actual terms of the bonds (including business covenants and security arrangements) will be negotiated between the User and the underwriter or bond purchaser, subject to a few limits set by the Act. The maximum interest rate on tax-exempt bonds is 12% (interest can be at a fixed rate or at variable rates, but not to exceed the ceiling). There is a maximum discount of 5% on sale of bonds (to limit the yield) and maximum term of the bonds of 40 years. The Act authorizes refunding of outstanding bonds. The Act allows the bonds to be sold at private (negotiated) sale.

The Act authorizes issuance of \$350 million of tax-exempt bonds per year (plus another \$350 million of taxable bonds). 10% of these funds are to be reserved for projects in enterprise zones at least until October 1 of each year. This appears to be adequate for the volume of financing in the state, particularly in light of volume cap restrictions on tax-exempt bonds (see Part III, (F) below).

An amendment to the Act in 1982 requires that all construction workers on IDB-financed projects be paid prevailing wages. The Act provides that bonds are exempt from property taxation, and interest on bonds is exempt from all state or local taxes on income. Property and facilities financed with bonds are not exempt from property taxation, assessments or other applicable charges.

B. [California Infrastructure and Economic Development Bank](#)

Starting January 1, 1995, there was created a new State agency which was given the power to issue IDBs. From 1995 through 1998, this agency was called the California Economic Development Financing Authority. However, as of January 1, 1999, this agency was terminated and all of its functions were consolidated into the California Infrastructure and Economic Development Bank ("CIEDB"). CIEDB has a three-member Board consisting of the Secretary of the Trade and Commerce Agency (as Chair), the State Treasurer and the Director of



Finance. CIEDB has fairly broad authority to issue revenue bonds (IDBs) for industrial or commercial projects, on a tax-exempt or taxable basis, so long as various public benefit findings relating to economic development in the State are made.

CIEDB's procedures (which will be largely the same as its predecessor) are somewhat simpler than for bonds issued under the Act, described in Part A above. There is only one application, and one body to review the bonds, namely CIEDB itself. After making an application, CIEDB will adopt an inducement resolution, and then later adopt a final bond resolution when the project is ready to obtain volume cap. CIEDB bonds are not subject to approval by CIDFAC; however, the same general standards (i.e., adequate credit enhancement, adequate job creation, etc.) will be applied at the level of obtaining volume cap. Also, of some significance in some cases, projects financed with CIEDB bonds do not have to pay prevailing wages for construction work. However, because CIEDB is a state agency (unlike IDA's, which are local agencies), CIEDB bonds must be issued through the office of the State Treasurer, which by law acts as "agent of sale" for all State bonds. Generally, the structure, terms and conditions of CIEDB bonds would be the same as for bonds issued under the Act.

For further information and application materials, contact the staff at the California Trade and Commerce Agency, (916) 324-1299.

III. [Synopsis of Federal Tax Law Affecting IDB Issuance.](#)

A. [Introduction](#)

The financial incentive for use of industrial development bonds is the exclusion from gross income for federal income tax purposes of the interest on the bonds. Therefore, as a practical matter, bonds must be issued in compliance with the Internal Revenue Code of 1986 ("Code") and its implementing regulations, principally Treasury Regulations Sections 1.103-7, 1.103-10, and 1.103-11.

It is first helpful to understand the "structure" of Section 103 of the Code. Section 103(a) provides that interest on any obligations issued by or on behalf of any state or political subdivision is excluded from gross income. Section 103(b) limits this broad exemption by providing that interest on municipal bonds is taxable if the bonds are "private activity bonds." A private activity bond (or "PAB") can be generally described as any bond whose proceeds will be used by, and the debt service of which will be paid by, a private User. Finally, several sections of the Code describe certain PABs whose interest will be exempt from taxation, despite the general prohibition, if the bonds meet prescribed tests.

Section 142 lists a variety of "exempt facilities" which can be financed with exempt PABs, without any dollar limitation, such as residential rental housing, docks, wharves, airports and certain mass transportation facilities, sewage and solid waste disposal facilities, hazardous waste facilities and water furnishing facilities. The Act was drafted so that California



Industrial Development Authorities cannot issue bonds to finance any of these “exempt facilities.”

The other category of exempt PABs is described in Section 144(a), and consists of bonds issued to provide for the acquisition of any land or depreciable property, but subject to strict size limits of either \$1 million or \$10 million. Hence, these bonds are called “small issue bonds” (but will be referred to here by their old acronym, “IDB”). The laws discussed in Part II of this paper generally are aimed at small issue bonds. The remainder of this Part will describe in a summary and simplified manner the applicable federal tax regulations.

B. [Use of Proceeds](#)

1. [Generally](#)

To qualify as an exempt small issue, “substantially all” (which is defined to mean 95%) of the proceeds of the bond issue must be used to acquire, improve, construct, or reconstruct land or depreciable property. The latter generally includes buildings, fixtures, machinery, and equipment, although recent laws have limited the ability to use bond proceeds for some specific types of depreciable property discussed below. Under the Treasury's regulations, the remaining 5% of bond proceeds can be used to provide working capital for the User (i.e., to pay non-capitalizable costs). The 1986 Tax Act further provides that costs of issuance of the bonds cannot exceed 2% of the face amount of the issue, and this 2% is charged against the 5% “bad money,” so for practical purposes only 3% is available for non-qualifying costs. (Any costs of issuance above 2% must be paid by the User from its own funds.)

The most important consequence of this rule is that not more than 5% of bond proceeds can be used to refinance the cost of acquisition or construction of any capital facilities that were originally acquired by the User (or any “related person” of the User) prior to the initial steps in the bond transaction. Any prohibited refinancing is considered by the Internal Revenue Service as the provision of working capital to the User. This restriction is discussed in more detail below in part D.

2. [Manufacturing](#)

The other very important restriction on use of proceeds is that IDBs may only be used to acquire “manufacturing facilities.” While the exact scope of the phrase is not fully clear, at the most, facilities will have to relate to some fabrication or processing of goods. One useful starting point is the Standard Industrial Classification or “SIC” Code assigned to the company; codes in the 2000-3999 range are identified by the Department of Commerce as “manufacturing.”³

³ In 1997, a new classification system called the North American Industrial Classification System (NAICS) replaced the old SIC codes.

An amendment to the tax law made in 1988 provides that ancillary facilities, such as offices, warehouse space, parking, etc., can be financed only if they are directly related to the manufacturing operation function, and then only to a maximum of 25% of the costs used to build or acquire the “core manufacturing” facilities. This can be a very difficult matter to define. corporate headquarters offices will not qualify to the extent they exceed what is needed to supervise the particular manufacturing facility being financed (and subject to the 25% limit noted above). Tax counsel will very carefully review architectural plans to ascertain the usage of all parts of a manufacturing building.

(As part of the 1993 Budget Reconciliation Act, Congress enacted provisions for the designation of almost 100 “empowerment zones” or “enterprise communities” around the nation, which are areas of economic distress. Among the incentives involving these zones, limited authority will be granted to issue IDB-like bonds for commercial, as well as manufacturing purposes, but subject to many detailed restrictions. It is very uncertain whether this new authority can be used in a practical way. Enterprise community areas have been designated in South-Central Los Angeles, San Diego, Oakland, San Francisco (Hunter's Point district), Watsonville, and in Imperial County.)

C. [Size Limits](#)

The second important test for an exempt small issue relates to the maximum size of the bond issue. Section 144(a)(4) of the Code limits the size of an exempt small issue to \$1 million, or, upon the making of an election by the Issuer, \$10 million. These two size limits are discussed below.

In either case, the applicable size limit is measured only with respect to the political jurisdiction where the facility being financed is to be located, which is either an incorporated municipality, or, if the facility is not located within an incorporated municipality, the unincorporated areas of the county. If the facility will be located on or near a city or county boundary line, however, the size limits will also take into account any “integrated” facilities located on the other side of the boundary. Finally, the size limits will be measured, within the relevant political jurisdiction, with respect to both the User whose facility will be financed with bonds and any “related person” of the User. For a corporation, “related person” may include (i) corporate parents, subsidiaries or companies under common control, and (ii) individuals or companies who are “related persons” of any individual who controls the corporation (e.g., majority shareholder). With respect to individuals, “related persons” may include both blood relatives and business partners. The full definition of “related person” is quite broad, and is beyond the scope of this summary.

1. \$1 million limit - For a bond issue to qualify, the “aggregate face amount” of bonds cannot exceed \$1 million. To calculate this amount, it is necessary to combine (i) the face amount of the bonds to be issued and (ii) the remaining outstanding principal amount of any prior exempt small issue bonds previously issued to finance facilities within the same political



jurisdiction for the User or any of its “related persons.” This provision essentially makes available at least \$1 million in tax-exempt bonds to finance industrial facilities for any User in each city or county where that User has ongoing or new capital requirements, subject to the \$40 million limit (discussed below).

2. \$10 million limit - If a proper election is made prior to the issuance of bonds, the permissible “aggregate face amount” of bonds can be increased to \$10 million. For this type of bond, however, the \$10 million limit applies to the sum of:

- (i) the face amount of the bonds to be issued;
- (ii) the remaining principal amount of all prior small issue bonds (see \$1 million limit above); and
- (iii) all capital expenditures (A) made by the User or any “related person” for any facilities located within the political jurisdiction; (B) made by any other “principal user” of the facility being financed (such as a landlord or tenant); or (C) made by any person (whether or not a “principal user”) to benefit the bond-financed facility. These capital expenditures are measured over a six-year period which begins three years before the bonds to be qualified are issued and ends three years after the date of issuance. (To avoid double-counting, the capital expenditures which will be paid or reimbursed by the bonds are excluded.)

Thus, the \$10 million small issue is truly limited to smaller projects; bonds will not be tax-exempt if the total capital expenditures of the User at a plant site, and elsewhere throughout the relevant political jurisdiction, including the bond issue, will exceed \$10 million over the six-year period. There is one noteworthy exception to this limitation; the total allowable capital expenditures can be increased to \$20 million if the local government has received a UDAG grant to assist the project. A \$10 million bond issue is also subject to the new \$40 million limit discussed below.

A great deal of attention obviously must be paid to determining exactly what expenditures the User has made or plans to make, and to determining who are the “principal users” whose expenditures have to be counted. (Generally, any private user of more than 10% of a bond-financed facility is a “principal user”.) It is not the purpose of this brief summary to review the mass of detailed tax law on this subject, other than to note that the questions can be rather complex, and the rules generally turn out to be more restrictive than one first thinks. A careful review of capital expenditures by qualified bond or tax counsel at an early stage in the financing is strongly recommended to determine whether the bond issue is feasible.

It should also be noted that, because the \$10 million capital expenditure limit carries three years past the date of bond issuance, it is possible for the User to exceed the limitation after bonds are issued. In such a case, the interest on the bonds becomes taxable, but only as of the date the capital expenditure limit was breached (not retroactively to the date of issuance). The bonds normally contain provisions for mandatory redemption in such an event.

D. [Timing Requirements](#)

As stated in part B above, the use of bond proceeds to refinance costs which had been previously incurred is treated for federal tax purposes as provision of working capital. A procedure has been developed to provide a relatively clear test for what costs can be paid from the proceeds of bonds.

The procedure requires that the issuer of bonds adopt an “inducement resolution” stating its general approval of the project to be financed and indicating its then present intent to issue bonds at some future time. Once an inducement resolution has been adopted, the User can use bond proceeds to reimburse itself for all project costs paid or incurred after a date which is 60 days prior to the date of the inducement resolution (the “inducement date”) but prior to bond issuance (together, of course, with all costs to be paid after bond issuance). On the contrary, costs for acquisition or construction of capital facilities paid or incurred prior to the inducement date cannot be paid from bond proceeds except to the extent of the 5% “insubstantial portion.”

Recent amendments to federal tax regulations have made two changes to the prior rules governing “inducement resolutions.” First, certain “preliminary costs”, such as design, engineering, permitting, soil sample, etc. can be financed or refinanced from bond proceeds regardless of when they were first paid, provided such preliminary costs cannot exceed 20% of the bond issue. Land acquisition, or any site preparation or construction cannot count as a “preliminary cost.” Second, in order to qualify as good costs, reimbursements of “hard costs” made after the inducement date (i.e., other than preliminary costs) must occur not later than the latest of 18 months after (i) the expenditure was made, or (ii) the project has been placed in service or abandoned, but in no case more than 3 years after the expenditure has been made. This latter rule requires diligence from project developers if they must incur some hard costs (i.e. land acquisition) from internal funds early in the process, but permitting or other delays may prevent bonds from being issued for some time.

There can be some difficult legal questions regarding whether costs have or have not been “paid or incurred” as of a particular date. It is therefore highly desirable for the User as much as possible to avoid ordering, contracting for or acquiring land, equipment or materials, or causing physical construction work to be done, more than 60 days prior to the adoption of an inducement resolution by the issuer. Failure to comply with this “timing rule” is one of the most frequent causes of disqualification of substantial project costs from being financed with tax-exempt bonds.

E. [Eligibility Limits](#)

Over the years, Congress has enacted a series of limitations on use of IDBs, of both a procedural and a substantive nature. These are outlined below.

1. [Useful Life](#). The weighted average life of the bond issue cannot exceed 120% of the weighted average estimated useful life of the assets being financed.

2. Prohibited Uses. Bonds are prohibited if:

(a) more than 25% of the proceeds are used for automobile sales or service, retail food or beverage facilities (which does not include grocery stores), or provision of recreation or entertainment, or

(b) any proceeds are used for commercial golf course, country club, massage parlor, tennis club, skating facility, racquet sports facility, hot tub or suntan facility, racetrack, airplane, sky box, health club, gambling facility or retail liquor store.

3. Combination of Projects. A single User cannot simultaneously issue a “package” of several IDBs for different locations, relying on a separate \$10 million cap for each issue. Furthermore, a single project exceeding \$10 million in cost cannot be divided into condominium units and financed with separate IDBs for several unrelated Users.

4. Public Approval. Before issuance of bonds, there must be a noticed public hearing, and some elected official or elected body responsible for the bond issue, and with jurisdiction over the project site, must give its approval. This process is commonly referred to as the “TEFRA hearing” after the title of the tax legislation which enacted it.

5. Limit on Land Cost. Not more than 25% of net bond proceeds can be used to pay for land costs. If land costs exceed 25%, the User can contribute equity toward the cost of the land without violating the rule. Valuation can be a problem, since the law does not have any good faith rule. It will usually be safest to stay well within the actual 25% limit.

6. Acquisition of Existing Facilities. Prior law allowed IDBs to be used for acquiring new or used facilities or equipment, but the Code now limits IDBs to new facilities with one exception. A used building (and its existing equipment) can be acquired with IDBs if the User spends an amount equal to at least 15% of the amount of bond proceeds to be used to acquire the facility on rehabilitation expenditures within two years. Again, valuation can be a problem, as may be determining what expenditures qualify as rehabilitation. Also, an equity contribution can pay for used property without violating the rule.

7. \$40 Million Overall Limit. Under prior law, subject to the \$10 million capital expenditure limit in each locality, any company could benefit from an unlimited number of IDBs. Many large companies and chains used this technique. Now, no company can use or benefit from either a \$1 million or \$10 million “small-issue” IDB if upon issuance the company's total outstanding IDBs of all kinds will exceed \$40 million nationwide. This rule does not affect issuance of “exempt facility” bonds, such as for solid waste disposal, but “exempt facility” bonds are counted in measuring the \$40 million. The rule is very complex, and requires a separate \$40 million inquiry to be made for every principal user of a facility over a 3-year period after bond issuance or project completion. As a result, compliance may become very difficult for multi-user projects.

8. Federal Guarantees. The Code prohibits any direct or indirect “federal guarantee” of a bond issue (including IDBs). This cuts out use of federal deposit insurance to back up bonds, and also may cause problems if there are any federal agency users of an IDB facility. Generally, investment of normal trustee funds in government obligations is permitted.

F. State Volume Limit

The most controversial provision of the 1984 tax law imposed for each state an annual ceiling of \$150 per capita (or \$200 million, whichever is larger) for all industrial development bonds and student loan bonds, with certain exceptions. The 1986 Tax Act broadened and tightened this volume cap.

Under current law, all Private Activity Bonds -- which includes exempt facilities, small issue bonds, single family and multifamily housing bonds, student loan bonds, mortgage credit certificates and certain other categories -- are subject to a single, statewide annual cap. From 1987 to 2000, this cap was \$50 per capita (but with a minimum of \$150 million per state). In late 2000, Congress increased this cap to \$62.50 per capita (\$187.5 million minimum) in 2001, and \$75 per capita (\$225 million minimum) in 2002. Starting 2003, this amount will be indexed for inflation. Each state must set up a system to “allocate” this annual state cap to individual bond issues. Excluded from the cap are bonds for certain airport, dock and wharf or publicly-owned solid waste facilities, certain veterans housing bonds, bonds for 501(c)(3) hospitals or schools, and bonds which refund an outstanding private activity bond, subject to meeting certain tests.

The cap in California for 2003 was \$2.633 billion. Pursuant to State law, the state cap is controlled and distributed by a 3-member agency called the California Debt Limit Allocation Committee (CDLAC), consisting of the State Treasurer, as chairman, the State Controller and the Director of Finance. Any issuer desiring to sell a private activity bond must apply to CDLAC.

Competition for allocation has gone up and down over the years based on factors such as overall economic activity, the level of interest rates, and willingness of banks to support bond issues. In the late 1990’s, with economic activity in the State rebounding, competition for volume cap was very strong, with the demand for allocations 2 to 3 times the available cap. The combination of weaker economic activity and the 25% increase in the statewide cap since 2001 have eased pressure somewhat. In 2002 and 2003, IDB financings did not use up their set-aside of allocation, which was at a level under \$100 million.

In 2000, CDLAC introduced new guidelines which use a point-ranking system to determine which IDB projects will receive cap. Priority is given to projects in redevelopment or enterprise zones or in communities with higher than average unemployment. Higher points are also given for projects conforming with “Smart Growth” guidelines, and which leverage the bond funds. A minimum of 1 job must be created for each \$50,000 of bonds, and a higher ratio gets more points. In 2003, CDLAC had three allocation rounds (the last of which has already



passed its application deadline) and it is likely to stay with that process. The application deadlines for 2004 are not yet set, but past practice indicates the first deadline will be in January and the final deadline will be in mid-summer, making early action necessary. For more information, contact CDLAC at 916-653-3255 or visit their Website at “www.treasurer.ca.gov” and click on “Boards and Commissions.”

G. [Arbitrage](#)

Section 146 of the Code and its implementing regulations limit the practice of “arbitrage,” which is the investment of proceeds of a municipal bond in taxable obligations which produce a higher rate of return. Under the old law, IDBs of the type described in this paper presented little difficulty in compliance with arbitrage regulations, so long as the bonds did not represent a greater dollar amount than was reasonably needed for the project and the project could be constructed and completed with diligence within three years.

Previous law permitted investment of the proceeds of IDBs, pending disbursement on construction costs, at market yield, which often produced additional funds to pay for project costs. However, the 1984 law has almost completely eliminated the ability of a User to gain any arbitrage profit, and may in some cases cost the User money.

Two new rules were enacted, which apply to all IDBs in addition to all the existing arbitrage regulations. The first rule limits the amount of bond proceeds which can be invested at a yield higher than the yield on the bonds to 150% of annual debt service for the current year. However, existing “temporary periods” for unlimited investments continue to apply. This rule will mostly impact the size of reserve funds or “sinking funds.”

The second rule says that, regardless of any “temporary periods” or other rules which allow investments to be made at a yield higher than the bond yield, any arbitrage profit which is actually earned has to be rebated to the Treasury. There are exceptions to this rule if all bond proceeds are spent on the project within six or eighteen months. Rebate of excess earnings on bond proceeds can also be used to comply with any “yield restriction” requirements. The rebates are due every five years, and 60 days after final maturity or payment of the bonds.

The implementation of the arbitrage rebate rules is quite complex. Orrick, Herrington has formed a Financial Services Group located in our Los Angeles office which has extensive experience in making rebate calculations. The Group has recently become an independent company called Bondlogistix. For further information, contact Craig Underwood at 213-629-2463.

H. [Changes in Demand for IDBs](#)



The 1986 Tax Act made major changes not only in eligibility of various bonds, but also affected the market, or demand, for tax-exempt bonds. One factor that has apparently not made an impact is the lowering of marginal rates. The tendency of such a change to “narrow” the spread between tax exempt and taxable rates seems to have been offset by strong demand for bonds as one of the last remaining tax shelters, tied to reduced supply. Some other changes in the law have, however, had an effect on the market for IDBs:

1. Interest on almost all private activity bonds (including small issue bonds) is includable as an item of tax preference for both corporate and individual alternate minimum tax calculations. This factor is apparently adding up to 50 basis points (1/2 of 1%) to the yield on such bonds.

2. Bond interest is treated as an offset to certain deductions for property and casualty insurance companies.

3. Commercial banks -- once voracious purchasers of IDBs and other tax-exempt bonds -- lost their ability to deduct 80% of the interest cost for carrying bonds in their portfolio. This change significantly increased the cost of owning bonds to banks, and very few of them have been willing to buy IDBs at attractive rates in the initial years of the Tax Reform Act. Lately, however, some banks have been purchasing IDBs rather than writing letters of credit.

4. A somewhat different “demand” issue is a change in depreciation rules allowed to a company which uses an IDB to finance depreciable property. The new law requires the property to be depreciated on a straight-line basis, over its “class life” rather than a shorter period which would otherwise apply. This change marginally reduces the attractiveness of IDB financing to the User.

I. [Caveat](#)

Readers should be mindful that this paper has provided only a brief summary of the major issue areas under Section 103; the full scope of the rules is more complex than has been suggested in this paper and the rules are subject at all times to changes arising from new statutes or revisions in Internal Revenue Service regulations or interpretations. Early consultation with bond counsel would be a good practice -- even before the filing of an application with an issuer -- to allow a full investigation of all relevant facts, and to provide appropriate advice on steps to avoid jeopardizing the tax-exempt financing.

