Tax-Exempt Bonds:
A Quick Guide to Industrial Development Bonds

Industrial Development Bonds ("IDBs," also referred to as qualified small issue bonds or small issue manufacturing bonds) are a type of qualified private activity bond under the Internal Revenue Code of 1986, as amended (the "Code"). For an explanation of the financing structure and restrictions common to all qualified private activity bonds, see "Tax-Exempt Bonds: A Quick Guide to Qualified Private Activity Bonds."

IDBs are available to help private parties finance the construction, expansion, or renovation of privately-owned manufacturing and other types of facilities that are designated as eligible for tax-exempt financing under the Code. A type of "conduit" bond, IDBs may be issued by certain governmental units, with the bond proceeds then loaned to the private borrower entity. Various types of issuers may have the authority to issue IDBs pursuant to state and local law; in Washington, IDBs will often be issued through the Washington Economic Development Finance Authority ("WEDFA"). More information about WEDFA and its application process is available at its website, wedfa.org.

Manufacturing Facilities

Under Section 144(a) of the Code, IDBs may be issued to finance or refinance the acquisition, construction, reconstruction, or improvement of manufacturing facilities.[1] The Code requires that 95% or more of the net proceeds of the bonds be used to finance a "manufacturing facility," which is defined as "any facility which is used in the manufacturing or production of tangible personal property (including the processing resulting in a change in the condition of such property)," as well as facilities that are "directly related and ancillary to a manufacturing facility," *if* they are located on the same site as the core manufacturing facility *and* are not financed with more than 25% of the net bond proceeds.[2]

Formal guidance on what constitutes manufacturing for purposes of Section 144(a) is scarce; however, the IRS has provided some private letter rulings ("PLRs") on the matter. PLRs cannot be relied upon by anyone other than the taxpayer requesting the ruling, but they can provide insight for certain fact patterns. In general, the available guidance suggests a requirement that facilities transform a product or material into a different, usable product. Thus, a facility that converted rolls of papers into paper bags, an integrated printing facility that transformed paper and ink into printed products, and an ocean-going

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[1] Prior to 1986, IDBs were available to finance a wider range of projects. Today, qualified small issue bonds are limited to financing manufacturing facilities or the purchase of land or property by first-time farmers. If you have questions relating to the use of qualified small issue bonds to finance projects by first-time farmers, please reach out to any of the members of Pacifica's Public Finance team listed at the end of this publication.

[2] *See* 26 U.S.C. § 144(a)(12)(C). Those considering refinancing prior small issue bonds should be aware that this definition differed slightly for small issue bonds issued in 2009 and 2010.

vessel that harvested and transformed scallops into a processed product ready for commercial consumption and use were each held to be manufacturing facilities in separate PLRs. In contrast, the IRS has opined that a facility that bred, grew, harvested and packaged fish was not a manufacturing facility but was more in the nature of an agricultural facility. Likewise, "reverse vending machines"—machines situated in grocery stores that accepted used beverage containers, crushed and sorted the glass or aluminum according to color, and dispensed a monetary deposit—were not manufacturing facilities because they did not form an intermediate product, but rather simply facilitated storage of used recyclable containers until they were collected and taken to a recycling facility.[3]

Some examples of directly related and ancillary facilities include short-term warehousing space for raw materials or temporary warehousing space for finished products; on-site testing facilities; loading docks for unloading raw materials or loading finished projects; and forklifts or similar equipment. Any facilities for distinct and separate economic activities are generally not considered directly related and ancillary to the manufacturing facility.

Sizing Limitations

The Code limits the size of an IDB issue to $1 million, with the option for an issuer to elect to issue an aggregate face amount of up to $10 million under certain circumstances.[4] The limit is calculated by adding: (1) the face amount of the current bond issue; and (2) the face amount of any IDBs previously issued and outstanding that relate to facilities that are (i) located in the same incorporated municipality or unincorporated area of the county, and (ii) whose principal user is or will be the same person or two or more related persons. If the $10 million limit is elected, the aggregate amount also takes into account capital expenditures of the principal user or related persons paid or incurred during a six-year period spanning three years prior to and three years after the issue date, for all facilities of the principal user or related persons located in the same incorporated municipality or unincorporated area of the county. Capital expenditures of a state or local government in the same jurisdiction as the facility and principally benefitting a principal user's facility—e.g., roads or drainage pipes provided by a city that principally benefit the financed facility—will also be counted as capital expenditures. On the other hand, capital expenditures relating to certain unforeseeable circumstances—e.g., replacement of property destroyed or damaged by fire or storm, or expenditures required due to a post-issuance change in law—are not taken into account for purposes of calculating the aggregated amount.

For bonds issued after December 31, 2006, the IRS will disregard up to $10 million of capital expenditures during the six-year period, thereby effectively bringing the aggregate limit up to $20 million (assuming $10 million of capital expenditures).[5] Thus, for IDBs issued after December 31, 2006, a

[3] *See* PLR 8815033, PLR 8934063, PLR 9014014, PLR 8819026, and PLR 8829048.
[4] *See* 26 U.S.C. § 144(a). The issuer must affirmatively make this election prior to or at the time of issuance of the bonds; the election should be reflected on the issuer's Form 8038, which will be filed after the bond issue closes.
[5] *See* 26 U.S.C. § 144(a)(4)(G).

borrower / principal user of facilities within a particular jurisdiction may benefit from up to $10 million of outstanding bond proceeds plus $10 million of capital expenditures within the six-year period straddling the issue date. However, the principal amount of the current bond issue remains limited to $10 million.

In addition, the aggregate authorized face amount of any issue allocated to any "test-period beneficiary" of the bond-financed facility may not exceed $40 million, calculated by taking into account other outstanding IDBs, exempt facility bonds, or qualified redevelopment bonds allocable to such beneficiary. A test-period beneficiary is any owner or principal user (including all related persons) of the bond-financed facility at any time during the three-year period beginning on the later of (i) the date such facilities were placed in service, or (ii) the date of the IDB issue.

Depreciation Deductions

Under Section 168(g) of the Code, property financed with tax-exempt bonds is depreciable only under the straight-line method of the alternative depreciation system rather than an accelerated method. Borrowers should take this limitation into account when calculating the benefits of tax-exempt bond financing.

Further Information

If you are considering whether a project may qualify as an IDB, whether a particular financing structure will meet the criteria for tax-exempt financing, or have any other questions relating to IDBs, please contact any of our public finance attorneys listed below.

Alison Benge	Alison.Benge@pacificalawgroup.com	206.602.1210
Deanna Gregory	Deanna.Gregory@pacificalawgroup.com	206.245.1716
Faith Li Pettis	Faith.Pettis@pacificalawgroup.com	206.245.1715
Stacey Lewis	Stacey.Lewis@pacificalawgroup.com	206.245.1714
Jon Jurich	Jon.Jurich@pacificalawgroup.com	206.245.1717
Tobias Tobler	Tobias.Tobler@pacificalawgroup.com	206.602.1215
Katherine Van Gunst	Katherine.VanGunst@pacificalawgroup.com	206.602.1213