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Tax-Exempt Bonds:
A Quick Guide to Qualified Private Activity Bonds

Most people have some familiarity with municipal bonds, but may assume that tax-exempt municipal bonds are issued only to finance government-owned infrastructure projects like roads, schools, and parks. In fact, tax-exempt bonds may be issued to finance the acquisition, construction, development, or renovation of certain privately-owned facilities. These bonds are called qualified private activity bonds ("PABs"), and they can be a powerful tool in a facility owner's financing toolbox. This publication describes PABs, how they are issued, and what types of projects and developers may take advantage of them.

Advantages of Financing with Tax-Exempt Bonds

A bond is a debt instrument that represents a promise to repay the principal amount of a debt plus interest. In the governmental context, a state or local governmental unit issues and sells bonds to one or more bond purchasers and uses the proceeds of the sale to finance infrastructure or another governmental project. The issuer is then required to make debt service payments to bond purchasers from a source such as tax revenues or revenues derived from the project. Except in limited circumstances, tax-exempt municipal bonds cannot be issued for the benefit of private parties.

A key feature of municipal bonds is their ability to be issued as tax-exempt obligations under the Internal Revenue Code of 1986, as amended (the "Code"), meaning that bond purchasers do not pay federal (and, in some circumstances, state) income tax on the interest income they earn. Because of this feature, bond purchasers are generally willing to accept a lower interest rate than if the bonds were taxable. A lower interest rate translates to savings for the party responsible for paying debt service on the bonds, thereby lowering the cost of borrowing money. In exchange for these benefits, the Code imposes restrictions on the use and investment of the proceeds of tax-exempt obligations. Borrowers may also finance their projects in whole or in part using taxable bonds that are not subject to the same requirements.

Financing Privately Owned or Operated Projects Using Private Activity Bonds

Many PABs are issued as "conduit" bonds by certain governmental units, who then loan the bond proceeds to the private borrower entity. Various types of governmental issuers have the authority to issue PABs pursuant to state, local and federal law, with the Code dictating the types of borrowers or projects that are eligible for tax-exempt financing.

Types of Private Activity Bonds. There are several types of qualified PABs, each with differing characteristics and restrictions, including exempt facility bonds, qualified 501(c)(3) bonds, and qualified small issue manufacturing bonds. Exempt facility bonds, which are available pursuant to Section 142 of

the Code, may be used to finance a variety of privately-owned facilities, including but not limited to airports, docks and wharves, facilities for the furnishing of water and energy, sewage and solid waste facilities, affordable housing and green/sustainable design projects, and facilities relating to certain types of transportation. Qualified broadband and carbon capture facilities were recently added to the list of Section 142 exempt facilities. Qualified 501(c)(3) bonds, available under Section 145 of the Code, may be issued to finance property owned by a 501(c)(3) nonprofit organization or governmental unit. Common uses of qualified 501(c)(3) bonds include financing educational, cultural or charitable facilities (such as affordable housing) to be owned and operated by nonprofit organizations. Qualified small issue bonds, also known as industrial development bonds, are available under Section 144 of the Code to finance privately-owned manufacturing and related types of facilities.

Financing Structure. In a PAB transaction, the governmental issuer serves as a conduit for the flow of bond proceeds from the bond purchaser to the private borrower, and for the flow of principal and interest payments from the borrower to the bond purchaser. The issuer sells the bonds to one or more bond purchasers and loans the proceeds of the bond sale to the borrower. The borrower uses the proceeds to finance a capital project and is then obligated to make loan or lease payments from its general revenues or revenues of the financed facility to the issuer. In turn, the issuer will use the payments received from the borrower to pay principal and interest on the bonds to the bond purchaser. In many PAB transactions, the bond is sold privately to a bank, and the bond transaction operates much like a private bank loan, with the project to be financed frequently serving as additional security for repayment of the debt.

Capital Expenditures. With some limited exceptions, proceeds of tax-exempt bonds must be used to finance or refinance "capital expenditures." A capital expenditure is any cost of a type that is properly chargeable to a capital account (or would be so chargeable with a proper election) under general federal income tax principles.

2% Costs of Issuance Limitation. The costs associated with a bond financing are known as "issuance costs" and may include fees and costs owing to lending institutions, underwriters, financial advisors, trustees, legal counsel, and other parties involved with the bond issuance. Section 147(g) of the Code limits the amount of issuance costs that may be paid using PAB proceeds. The costs of issuance financed by the issue of a PAB may not exceed 2% of the proceeds of the issue.

Reimbursing Pre-Issuance Expenditures. An issuer may use tax-exempt bond proceeds to reimburse capital expenditures made prior to the issue date if two main criteria are satisfied: (1) the issuer must have adopted a declaration of official intent to reimburse no more than 60 days after the expenditure was paid; and (2) the reimbursement allocation must be made not later than 18 months after the later of (a) the date the original expenditure was paid, or (b) the date the project is placed in service or abandoned. In either case, the allocation must be made not more than three years after the original expenditure is paid. There are exceptions for preliminary expenditures such as architectural, engineering, surveying, soil testing, and similar costs incurred prior to acquisition, construction, or

rehabilitation of a project not exceeding 20% of the issue price of the bonds and for *de minimis* expenditures—*i.e.*, costs of issuance of any bond or an amount not in excess of the lesser of $100,000 or 5% of the proceeds of the issue. Preliminary expenditures do not include land acquisition, site preparation, and similar costs incident to commencement of construction.

Prohibited Facilities. Even if a bond falls within one of the Code's enumerated categories for qualified PABs, the Code prohibits *any* amount of PAB bond proceeds from being used to finance the following types of property: airplanes; skyboxes or other private luxury boxes; health club facilities; facilities used primarily for gambling; and stores the principal business of which is the sale of alcoholic beverages for consumption off premises. The prohibition against health club facilities does not apply to qualified 501(c)(3) bonds.

Maturity Limitation. With certain limited exceptions, the weighted average maturity of the bonds in an issuance may not exceed 120% of the reasonably expected economic life of the facilities being financed. The weighted average maturity of an issue is determined by taking into account the respective issue prices of the bonds issued as part of the entire issue. In general, a first step is to determine the types of facilities or property being financed—e.g., building, furniture and fixtures, other equipment—and assign an appropriate economic life (in years) to each. The economic life may be determined based on all of the facts and circumstances or a safe harbor (generally, the midpoint lives under the Asset Depreciation Range system) may be used. Then, the individual economic lives are weighted according to the amount of bond proceeds being spent on each asset. Land is not taken into account when calculating an expected economic life unless 25% or more of the net proceeds of the issue are used to finance the land.

Public Approval Requirement. Before an issuer may issue a qualified PAB, it must meet the public approval requirements of Section 147(f) of the Code, including receiving host approval and issuer approval. For issuer approval, either the governmental unit that issues the bond or the governmental unit on behalf of which the bond is issued must approve the issue. For host approval, the governmental unit the geographic jurisdiction of which contains the site of a project to be financed by the bond must approve the issue.[1]

Public approval must be from (a) an applicable elected representative of the approving governmental unit following a public hearing for which there was reasonable public notice, or (b) a voter referendum of the approving governmental unit. Approval under clause (a) requires a public hearing that provides a reasonable opportunity for interested individuals to express their views on the proposed issue and the location and nature of the project. Public notice of the hearing describing the proposed project must be provided no fewer than seven calendar days before the public hearing. This procedure is known as the

[1] Each governmental unit the geographic jurisdiction of which contains the site of a project to be financed by the issue must approve the issue. However, if the entire site of the bond-financed project is within the geographic jurisdiction of more than one governmental unit with in a State (counting the State as a governmental unit within such State), then any one of those governmental units may provide host approval.

TEFRA notice and hearing. It is important to be aware of and take the timing of these required steps into account.

Investment Restrictions. Under Section 148 of the Code, in order for the interest on municipal bonds to be exempt from federal income taxes, the bonds must not be "arbitrage bonds." Bonds will be arbitrage bonds if either (a) any proceeds of the bonds are reasonably expected to be used, or are intentionally used, directly or indirectly, to acquire investments that have a materially higher yield than the yield on the bonds ("higher yielding investments"), or to replace funds that are used to acquire higher-yielding investments, or (b) any applicable arbitrage rebate amounts are not paid when due to the United States, all except as permitted by the Code and related Treasury Regulations.

Subject to certain exceptions, investment earnings allocable to gross proceeds must be rebated to the United States in an amount equal to the difference between the amount actually earned and the amount that would have been earned if those investments had a yield equal to the yield on the issue.

For more information on arbitrage and rebate, see "Tax-Exempt Bonds: A Quick Guide to Yield Restriction and Rebate Exceptions," available here.

Additional Rules for Exempt Facility and Qualified Small Issue Bonds

Exempt facility bonds and qualified small issue bonds are subject to several requirements that do not apply to qualified 501(c)(3) bonds.

95% Requirement. At least 95% of the net proceeds of the bonds must be used to finance or refinance capital expenditures of an exempt facility described in Section 142(a) for exempt facility bonds or a manufacturing facility described in Section 144(a)(12)(C) for qualified small issue bonds. This rule accordingly allows for up to 5% of net proceeds to be used to finance so-called "bad costs," including costs of issuance. "Net proceeds" includes certain investment earnings and excludes up to 10% of bond proceeds that are deposited in a reasonably required reserve or replacement fund.

Restrictions Relating to the Acquisition of Property. Although costs of land acquisition are generally considered capital expenditures (and thus help meet the 95% capital expenditure requirement), for most types of qualified PABs, the Code nonetheless limits the amount of net bond proceeds that may be used to acquire land or an interest in land to less than 25%.[2] Further, bond proceeds may not be spent to acquire an existing facility, unless the borrower intends to spend at least 15% of the bond-financed acquisition price (or, in the case of a structure other than a building, 100% of the bond-financed acquisition price) on rehabilitating the facility.

Volume Cap. Finally, the Code limits the total amount of PABs that may be issued within a state during a calendar year. This limitation is known as "volume cap" and it applies to qualified small issue bonds and

[2] The Code contains an exception pertaining to the acquisition of land by first-time farmers or ranchers.

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most exempt facility bonds.[3] The Code provides a formula for allocating volume cap among state issuers, but a state may elect to adopt a different allocation formula. Volume cap is a limited resource and may be scarce in some states (including in Washington). If volume cap is required, it is important to know the deadlines to get a volume cap allocation and to make sure volume cap is secured before moving forward with the bond issuance.

Substantial User Limitations. Interest on a qualified small issue or exempt facility bond will not be tax-exempt for any period that that bond is held by a substantial user of the bond-financed project (such as the conduit borrower) or a related person. The tax exemption is restored once the bond is transferred to a party that is not a substantial user or related person.

In addition, for exempt facility bonds issued to finance acquisition costs, there are limitations on the involvement of the same substantial user before and after the acquisition. Proceeds allocated to the acquisition may not constitute “good costs” of the exempt facility if any person that was a substantial user of the facility at any time during the five-year period before the issue date or any related person to that user receives (directly or indirectly) 5% or more of the bond proceeds for the user’s interest in the facility and then continues to be a substantial user of the facility at any time during the five-year period after the issue date. In general, a substantial user of a facility is a non-exempt person that uses a part of the facility in its trade or business, including a person that (a) derives gross revenues from the financed facility in excess of 5% of the total revenues derived by all users of the facility, or (b) occupies more than 5% of the entire usable area of the financed facility.

Further Information

If you are considering whether a project may qualify as a qualified private activity bond, whether a particular financing structure will meet the criteria for tax-exempt financing, or have any other questions relating to PABs or conduit bond issuances, please contact any of our public finance attorneys listed below.

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[3] Airports, docks and wharves, environmental enhancements of hydro-electric generating facilities, qualified public educational facilities, qualified green building and sustainable design projects, qualified highway or surface freight transfer facilities are types of exempt facilities that do not require volume cap.

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