

# **FINANCING WITH PRIVATE ACTIVITY BONDS**

## **INTRODUCTION**

As Arizona's oldest law firm practicing municipal finance law, Gust Rosenfeld P.L.C. has served as bond counsel, issuer's counsel, underwriter's counsel and trustee's counsel for the issuance of private activity bonds since such bonds were first issued in Arizona. Because of the firm's hallmark reputation in municipal finance, the firm served as the principal drafter of the Arizona legislation creating industrial development authorities and pollution control corporations and the legislation concerning volume cap allocation that now regulates private activity bonds in Arizona.

Private activity bonds are securities issued by or on behalf of a local government to provide debt financing for projects used most often by a private user. Private activity bond financing normally results in reduced financing costs since interest on the bonds is not subject to federal income taxes. The state or local government does not generally pledge its credit for payment of the bonded debt. Private activity bonds are normally payable solely from payments made by the private user of the property financed.

Financing with tax-exempt bonds requires strict compliance with a series of requirements and limitations established by the Internal Revenue Code. Additionally, recent changes to federal securities rules provide that in most instances the entity obligated to pay debt service on the bonds must annually provide operational and financial data to all national information repositories sanctioned by the S.E.C. Finally, state laws governing the conduct of the issuers and pertaining to the issuance of bonds must also be satisfied. Gust Rosenfeld provides services that guide a client effectively and efficiently through the complexities of a tax-exempt financing.

## **PROJECT ELIGIBILITY**

Projects to be financed on a tax-exempt basis with private activity bonds must comply with the Internal Revenue Code and its regulations and various state statutes. The federal tax rules are usually more restrictive and complex than the applicable state laws. This letter does not attempt to describe all limitations and requirements imposed by the Internal Revenue Code in order to finance projects on a tax-exempt basis but will serve as only a brief description of certain major points. This letter does not explore tax-exempt financing available to counties, cities and towns for facilities directly owned and financed by the governmental unit.

Federal Law.

The Internal Revenue Code provides that only the following private activity bonds may bear tax exempt interest:

1. Exempt facility bonds.
  - a. Airports, docks and wharves, mass commuting facilities and high speed intercity rail facilities.
  - b. Facilities for the furnishing of water.
  - c. Sewage facilities and solid waste disposal facilities.
  - d. Residential rental projects.
  - e. Local furnishing of electric energy or gas.
  - f. Local district heating or cooling facilities.
  - g. Qualified hazardous waste facilities.
  - h. Environmental enhancements to hydroelectric generating facilities.
2. Mortgage revenue bonds.
3. Qualified small issue bonds. Such bonds are limited to \$20 million dollars which limit includes the amount of both bonds and capital expenditures during 6 year period beginning 3 years before and ending 3 years after bonds are issued. Small issue bonds are available only for manufacturing facilities.
4. Student loan bonds.
5. Qualified development bonds.
6. Qualified 501(c)(3) bonds.

It should first be noted that to have tax-exempt bonds 95% or more of the bonds' net proceeds must be used for the exempt facilities or purposes. Other requirements specifically relating to private activity bonds include the requirements for: an allocation of the state private activity bond volume cap; a TEFRA hearing; and a 2% limit on the amount of the costs of issuance paid from tax exempt bond proceeds. However, with respect to qualified 501(c)(3) bonds, the federal law among other matters, does not require such bonds to receive an allocation of the state volume cap and does not limit the type of facility financed by a 501(c)(3) entity provided such facility is owned by the 501(c)(3) entity and used for its nonprofit purpose.

State Law.

Generally, in Arizona the issuer of private activity bonds is an industrial development authority ("IDA") formed under Arizona's Industrial Development Financing Act (the "Act"). An IDA is sponsored by any county, city or town. If one does not exist where a project is proposed to be located, it is not difficult to form one with local government cooperation.

Under Arizona law IDAs may issue bonds to finance various types of facilities, but as previously noted not all such financings would be tax-exempt because of the more restrictive eligibility standards found in federal law. The types of facilities eligible to be financed by an IDA under the Act include the following:

1. Any enterprise for the manufacturing, processing or assembling of any agricultural or manufactured products (tax-exempt financing only if a manufacturing facility).
2. Any commercial enterprise for the storing, warehousing, distributing or selling of products of agriculture, mining or industry, or of processes related thereto, and including research and development therefor (tax-exempt financing only if a manufacturing facility).
3. Office building or buildings for use as corporate or company headquarters or regional offices or the adaptive use for offices of any building within this state that is on the national register of historic places or rehabilitation of residential buildings located in registered historic neighborhoods (tax-exempt financing only if a manufacturing facility).
4. A health care institution as defined in Section 36-401 (tax-exempt financing only if owned by a 501(c)(3) entity).
5. Residential real property for dwelling units located within the municipality or county approving the formation of the corporation and, in the case of a county, whether or not also within a municipality which is within the county.
6. Repairing or rehabilitating single-family dwelling units or constructing or repairing residential fences and walls.
7. Convention and trade show facilities (tax-exempt financing only if owned by a 501(c)(3) entity).
8. Airports, docks, wharves, mass commuting facilities, parking facilities, or storage or training facilities directly related to any as provided in this item (tax-exempt financing only if owned by a governmental unit or, in the case of a parking facility, by a 501(c)(3) if used by and for the purpose of such entity).
9. Sewage or solid waste disposal facilities or facilities for the furnishing of electric energy, gas or water.

10. Industrial park facilities (tax-exempt financing is not available).
11. Air or water pollution control facilities (tax-exempt financing is not available).
12. Any educational institution operated by a nonprofit educational organization that is exempt from taxation under Section 501(c)(3) of the United States Internal Revenue Code not otherwise funded by state monies or any educational institution or organization established under the provisions of Title 15, Chapter 1, Article 8 and owned by a nonprofit organization.
13. Research and development facilities (tax-exempt financing only if owned by a 501(c)(3) entity).
14. Commercial enterprises, including facilities for office, recreational, hotel, motel and service uses if the facilities authorized by this subdivision are to be located in a designated area (tax-exempt financing only if owned by a 501(c)(3) entity).
15. A child welfare agency, as defined in Section 8-501 owned and operated by a nonprofit organization.
16. A transportation facility constructed or operated pursuant to Title 28, Chapter 26, Article 1 or 2 (tax-exempt financing only if owned by a 501(c)(3) entity).
17. A museum operated by a nonprofit corporation.
18. Facilities owned by a nonprofit corporation engaged in delivering the community services listed in the statute.
19. Correctional facilities for Arizona Department of Corrections or the Arizona Department of Juvenile Corrections.

### **VOLUME CAP**

Many types of projects that are eligible for tax-exempt financing are subject to the federally required annual volume cap which restricts the amount of certain tax-exempt private activity bonds that can be sold in any one state. Volume cap is not usually required for tax-exempt financings relating to 501(c)(3) entities. Beginning in 2002, each state received \$75.00 per capita per year; this amount is adjusted for inflation each year and is now \$95.00 per capita. Historically, in Arizona the demand for volume cap far exceeds the supply. Fortunately, each state's volume cap is replenished each January 1st.

Arizona's allocation of the volume cap is administered by the Arizona Commerce Authority (Commerce). Beginning January 1 of each year and prior to July 1st of each year, Arizona's volume cap is allocated as follows:

1. 10% for the discretion of the Director of Commerce.
2. 35% for mortgage revenue bonds and/or mortgage credit certificates.
3. 10% for qualified residential rental projects, 30% of which shall be set aside for 180 days for rural projects.
4. 20% for student loan bonds.
5. 15% for manufacturing projects.
6. 10% for all other projects which may be financed through private activity bonds other than mortgage revenue bonds, mortgage credit certificates and manufacturing projects.

For all of the categories other than the amount pertaining to mortgage revenue bonds and the amount allocated for the discretion of the Director, the allocations are available on a first drawn-first served basis as determined by a drawing held by Commerce each year at 8:00 a.m. on the first business day in January. For most of the year, allocations of volume cap are valid for ninety days, thereafter they expire unless bonds have been issued or the allocation is extended. Until December 17 of each year, no project may receive an allocation of more than \$20 million, except for allocations of Director's discretion, mortgage revenue and/or mortgage credit certificates and student loan bonds.

Allocations which have not been used, and any other portion of the volume cap, except for the Director's discretionary amount, are pooled on July 1st and reallocated on a first come-first served basis as established by another drawing conducted on July 1st.

Although risk is attached, a borrower may anticipate a volume cap allocation and, if proper procedures are taken, may incur taxable debt which can be funded at a later date from a volume cap allocation.

For further assistance, please feel free to call any of the partners of Gust Rosenfeld who specialize in municipal finance: Scott Ruby, 602.257.7432.