

Questions & Answers on Recovery Zone Facility Bonds

What is tax-exempt financing?

A tax-exempt bond is a debt instrument issued by a State or local government that is either sold in the public market or placed with investors by an investment banking firm or purchased directly by a bank. Bond purchasers do not have to pay Federal income tax on the interest income received from a tax-exempt bond if certain tax rules are met. Interest on the bond may also be exempt from State and local income taxes.

Who can issue a tax-exempt Recovery Zone Facility Bond?

Only a State or local governmental unit—or an economic or industrial development authority authorized by a State or local government unit to issue bonds—can issue a tax-exempt Recovery Zone Facility Bond. Neither a bank nor a borrower can issue debt on its own and qualify it as tax-exempt debt.

Who purchases tax-exempt bonds?

At present, the majority of tax-exempt bonds are purchased by individuals, but corporations, mutual funds, and insurance companies also purchase a large portion of tax-exempt bonds. Technically, the investment banking firm serving as the underwriter of the bonds will purchase the bonds from the State or local governmental issuer, then re-offer the bonds for sale to the public. A bank or investment banking firm may also place the bonds with a small group of purchasers or hold the bonds for their own account.

How will businesses in the Zone benefit from tax-exempt financing?

The primary benefit of tax-exempt financing is a lower interest rate than the rate on a conventional loan. Bond purchasers are willing to take a lower interest rate because they will not have to pay tax on the interest income that they receive from the bond. The governmental issuer loans the proceeds of the bonds to a business, passing on the lower interest rate. Lower interest rates mean a better cash flow for Recovery Zone Businesses. Another benefit is the time period of the debt. Tax-exempt bonds may be issued for 120 percent of the average useful life of the capital investment. It is also possible—depending on many financial circumstances—to issue tax-exempt bonds to finance 100 percent, or nearly 100 percent, of the transaction. Additionally, up to 2 percent of the issuance can be used to pay for the costs of issuance, thus allowing the borrower to finance those expenses instead of paying them out of pocket.

At what point in the process should a business contact the governmental issuer?

Tax-exempt financing typically takes longer to complete than a standard conventional loan. To expedite the process, a business should contact the governmental issuer in the very early planning stages. The issuer will select attorneys (bond counsel) who specialize in tax-exempt bonds to work with the borrower on understanding the tax, securities, and other rules associated with the financing. Once the borrowing and repayment details are determined, the bond counsel will give an opinion stating that interest on the bonds is excludable from Federal income taxes. In addition, a business will need an official declaration or resolution from the issuer indicating its intent to finance costs with tax-exempt bonds if the business expects to use tax-exempt bond proceeds to reimburse itself for any costs paid before tax-exempt bonds are issued. Businesses using tax-exempt bonds must typically pay an administrative fee to the issuer authorized by Federal tax code to confer tax-exempt status on the bond issuance.

What types of businesses can take advantage of bond financing?

Most business will qualify - retail, commercial, industrial, manufacturing and agricultural. Certain business activities are not qualified to use Recovery Zone Facility Bond financing, including businesses that rent residential rental property (defined as a project where 80% or more of the gross rental income is derived from the rental of dwelling units), country clubs; massage parlors; hot tub facilities; suntan facilities; golf courses; racetracks; or gambling facilities.

What types of projects can be financed with Recovery Zone Facility Bonds?

Bond proceeds can be used only to construct a building; renovate an existing building or equipment; acquire new equipment or a new building not yet placed in service by another taxpayer; and acquire used equipment not previously used in the Zone. However, bond proceeds can be used to acquire an existing building only if an amount equal to 100 percent of the adjusted basis of the property or \$5,000, whichever is greater, is spent to recondition or rehabilitate the building within a 2-year period. Until further guidance from the Internal Revenue Service, proceeds cannot be used to acquire land.

Can a business use bond proceeds for working capital purposes?

At least 95 percent of the bond proceeds (including any investment earnings) must be used to pay costs that are capitalized for Federal tax purposes. Any amounts available for working capital would be minimal.

Are there any limits on the amount that can be borrowed on a tax-exempt basis?

The County has a limit on the principal amount of tax-exempt Recovery Zone Facility Bonds that can be issued prior to January 1, 2011. Beyond this overall limit, there is no tax law limit on the size of borrowing for any one borrower. The size of any borrowing will also, of course, be limited by the ability of the business to repay the loan.

What costs are involved in tax-exempt financing?

There are certain costs involved in tax-exempt financing that may be higher than those involved in a conventional loan. A business may need to consider the costs of tax-exempt borrowing compared with interest savings over the term of the bond. These costs include fees to the issuer, fees to a bond counsel who reviews the transaction and delivers an opinion that interest on the bonds is tax-exempt, fees to the underwriter who markets the bond, and fees of a trustee who disburses bond proceeds and collects loan payments from the business. The tax laws allow up to 2 percent of the bond proceeds to be used to pay costs of issuance of the bond. Additional amounts must come from the equity of the business or from taxable financing.

What information must a business make available to the public?

The tax laws require a public notice and hearing regarding the bond issuance, including the amount to be borrowed, the name of the borrower, and the nature and location of the financed property. Following the hearing, the bond issue must be approved by an elected executive or the legislative body of the issuer. Other proceedings of the issuer and documents submitted to the issuer may be subject to public disclosure requirements. The financial condition of the borrower will also be included in offering materials made available to prospective purchasers of a bond.

Will tax-exempt financing affect any other tax rules of a business?

A business will not be able to take advantage of accelerated depreciation for any depreciable property purchased with proceeds of the bonds. Bond-financed property must be depreciated over the class life of the property using the straight line method.

What forms would a business have to file with the IRS for tax-exempt financing?

The business would not file any specific forms with the IRS beyond forms usually filed with a tax return. When bonds are issued, the issuer files an information return on the bonds with the IRS, and there may be certain other informational filings. However, all will be made by the issuer based on information supplied by the borrower. For example, any investment income earned on bond proceeds above the yield on the bonds must be paid to the IRS every 5 years, but the filing itself would be signed by issuer. If the bond transaction is audited by the IRS, the business likely would be called on to submit documentation.