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"INTRODUCTION TO TAX-EXEMPT BONDS"

Questions and Answers
About
Tax-Exempt Bonds

January 1, 2011

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"INTRODUCTION TO TAX-EXEMPT BONDS"

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Introduction

This White Paper deals with bonds. Its focus is revenue bonds issued to finance private projects. I think there is a need for a "Plain English" introduction to the basics about these bonds. The goal of this White Paper is to provide you with just such an explanation.

This White Paper discusses bonds informally, in a "Question and Answer" format. If you have other questions, please let me know.

What Is A Bond?

A bond is an obligation to repay borrowed money. In Georgia, industrial development revenue bonds are generally issued by development authorities, but may also be issued by counties, municipalities and authorities of other types. The governmental body that issues a bond is referred to as the "**issuer**" of that bond. A business entity (the "**company**") should not confuse an issuer's agreeing to issue industrial development revenue bonds, with the issuer's promising to sell bonds backed by its own credit to raise money for the company. On the contrary, in a bond issue, the issuer is just a conduit (i.e., a "**conduit issuer**") for issuing bonds representing a financing by the company (i.e., the company is a "**conduit borrower**")." The issuer's name is on the bonds, but the issuer is not liable for the repayment of the bonds, except from funds received from the company and any other "pledged security."

Who Has To Repay The Bonds?

The bonds are revenue bonds that are repayable from revenues derived from the company and other bond security (such as the project itself) that are pledged by the issuer and from any other security provided by the company, such as a letter of credit. Neither the general credit of the issuer nor the credit of the county or city is pledged as security for the bonds.[1] Some incentives structures involve credit enhancement by the city or county, or both (the "c**ommunity**"). This still doesn't make the community liable on the bonds themselves; all that's happening is that additional security (such as payments from the community to the issuer under an intergovernmental agreement) is being provided as additional security for the bonds. These incentives structures are outside the scope of this White Paper.

What Bonds Can A Development Authority Issue?

A development authority can issue bonds for any purpose permitted by the Georgia Constitution and the governing law (the Development Authorities Law, for "statutory" development authorities, and their respective local Constitutional amendments and related local legislation, in the case of Constitutional development authorities). However, the bonds may be issued as federally tax-exempt bonds only if the financing qualifies under the Internal Revenue

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[1] In rare cases, the Constitutional amendment for a particular community's "Constitutional" development authority can affect this rule.

Code of 1986, as amended (the "**Code**"). Federally tax-exempt bonds include, most commonly, bonds for certain "**exempt facilities**", "**qualified 501(c)(3) bonds**" issued for the benefit of federally-recognized 501(c)(3) organizations, and "**exempt small issue**" bonds for certain manufacturing facilities.

What Projects Can Exempt Facility Bonds Finance?

On and subject to the federal tax rules respectively applicable to each type of them, exempt facility bonds can be issued to finance-

1) airports,

2) docks and wharves,

3) mass commuting facilities,

4) facilities for the furnishing of water,

5) sewage facilities,

6) solid waste disposal facilities,

7) qualified residential rental projects,

8) facilities for the local furnishing of electric energy or gas,

9) local district heating or cooling facilities,

10) qualified hazardous waste facilities,

11) high-speed intercity rail facilities,

12) environmental enhancements of hydroelectric generating facilities,

13) qualified public educational facilities,

14) qualified green building and sustainable design projects, or

15) qualified highway or surface freight transfer facilities.

The particulars of the tax rules applicable to exempt facility bonds are outside the scope of this White Paper.

What Projects Can Nonprofits Finance With "Qualified 501(c)(3) Bonds"

On and subject to the federal tax rules applicable to them, "qualified 501(c)(3) bonds" can be issued to finance property owned by a federally recognized "501(c)(3) organization or a governmental unit. The requirements to qualify as a "501(c)(3) organization are beyond the scope of this White Paper, as are the particulars of the applicable tax rules.

The following is a non-exclusive list of some types of projects that might be financeable with this type of tax-exempt bond-

1) Private Schools,
2) Colleges and Universities, and R&D Facilities,
3) Arts and Cultural Facilities,
4) Hospitals, and Health Care Facilities, and
5) Senior Living Facilities.

How Much Of A Manufacturing Project Can "Exempt Small Issue" Bonds Finance?

Under the tax rules for exempt small issue bonds of manufacturing facilities: (i) the amount of the tax-exempt bonds (and certain outstanding prior issues of tax exempt bonds) may not exceed $10 million, (ii) the amount of the tax-exempt bonds, plus such prior issues plus the amount of certain other capital expenditures incurred during a six-year period (commencing three years before and ending three years after the issue date of the bonds) within the same city or county with respect to facilities used by the conduit borrower or certain related persons cannot exceed $20 million and (iii) the amount of tax-exempt bonds applicable to each conduit borrower and certain related persons are limited to $40 million nationwide (for purposes of this test only bond balances, not capital expenditures are material). Thus,

- Expenditures on more than just a single manufacturing project in a single location may be counted against the capital expenditure limitation. Capital expenditures by the company as the "**principal user**" of the project and certain of its related parties are counted, and these expenditures would be counted if they were made, for example, on a sister plant located in the same city or unincorporated portion of the same county.

- Bond issues closed before 2007 remain subject to more restrictive capital expenditure rules that applied when the bonds were issued. This means, for example, that proceeds of a tax-exempt bond issue for a manufacturing project that closed in 2007 would be included in the capital expenditures counted against an earlier tax-exempt bond issue that closed within three years prior to the 2007 bond issue (as would non-bond financed capital expenditures for the earlier project).

At least 95% of the net proceeds of qualified small issue bonds must be spent on land or depreciable property, or, if permitted, to redeem bonds. At least 70% of the net proceeds of an exempt small issue have to be expended for core manufacturing facilities, not more than 25% can be expended for "directly related and ancillary" property, and not more than 5% can be expended for other purposes.

These bonds are subject to the volume cap under Section 146 of the Internal Revenue Code ("**Code**").

Why Use Tax-Exempt Bonds?

Tax-exempt bonds are the best way to borrow money, if just the interest rate is considered (other considerations are overall cash flow requirements, balance sheet treatment, etc- bonds often have to compete with other financing structures in order to be selected by the company as the one to be used). The lower interest rate results from the interest being tax-exempt to the bond buyer (the buyer can afford to accept a lower rate of interest, if the buyer doesn't have to pay federal income tax on the interest). There are other reasons, too (see below).

If Tax-Exempt Financing Isn't Available, What Options Do I Have?

Bonds which are not federally tax-exempt, called "taxable" bonds, are the most flexible way to finance with bonds, although the interest rates are not as low as would be the interest rates on tax-exempt bonds.

What Are the Advantages of Taxable Bonds?

Taxable bonds can be used for any type of project that the development authority is authorized to finance[2], without any kind of capital expenditure limitation, and without the need for TEFRA approval or an allocation of the State's "volume cap" from the Georgia Department of Community Affairs ("**DCA**").[3] Even though the interest is not federally tax-exempt, the interest on taxable bonds is exempt from Georgia income tax, which can provide a limited

[2] Alternatively, taxable bonds structured as "taxable floaters" can be issued by the conduit borrower or its SPE without using the development authority as the issuer and therefore without being constrained by the purposes for which development authorities are authorized to issue revenue bonds. That structure would not, however, support the development authority's providing most types of discretionary incentives to the conduit borrower for its project.

[3] An "allocation" is a federal requirement that is a normal part of the process of issuing "small issue" manufacturing bonds. An allocation is not required for qualified 501(c)(3) bonds).

interest rate benefit. Good examples of how to use taxable bonds include financing distribution projects (or other non-manufacturing projects that don't qualify for tax-exempt financing), manufacturing projects that are disqualified for tax-exempt financing because their capital expenditures are too high, and projects that would qualify for tax-exempt financing except that the way that the financing is structured violates one of the tax rules.

How Are The Bonds Sold?

In order to be marketable, the bonds must be backed by a good enough credit. The company will sign a lease or a note, promising to pay basic rent or note payments to the development authority. The basic rent or note payments match the debt service on the bonds. However, public investors usually aren't willing to just look to the basic rent or note payments for repayment of the bonds; they want to be able to look up a credit rating for the bonds, find that it is investment grade, and know that they will be paid through a bank letter of credit (that has been issued to secure the bonds), without having to worry about defaults by the company.

What Does "Investment Grade" Mean?

In the terminology used by S&P and Fitch, for example, investment grade is a rating of BBB- through AAA (Moody's is the other major rating agency, and has its own terminology). If the bonds are secured by a bank letter of credit, the bank's letters of credit must be rated investment grade. On the strength of the letter of credit, the rating agency will assign a rating (the same rating as the letter of credit) to the bonds. Frequently, the bonds themselves are not rated, but still sell on the basis of the rating of the bank that issues the letter of credit.

What Type Of Letter Of Credit Is Needed?

The letter of credit for a bond deal is issued by a commercial bank. A letter of credit is a separate document, in which the bank itself undertakes to make stipulated payments on the conditions specified in the letter of credit itself. This means that the bank's own credit[4] is passed through to the bonds. In bond financings, the type of letter of credit that is involved is called a "direct pay" letter of credit (as opposed to a "stand-by" letter of credit). Instead of the company making basic rent or note payments directly, the bank, under the letter of credit, pays the amount thereof to the trustee for the bondholders (and is reimbursed by the company), rather than "standing by" in case the company defaults on its basic rent payments or note payments. This is done to avoid problems under the Bankruptcy Code if the company goes bankrupt.

[4] In cross-border transactions, it should be possible for a company's bank abroad to issue a standby letter of credit and for the company then to use that to back a "direct pay" letter of credit issued in the U.S. by a U.S. bank (that would have a banking relationship with the company's bank abroad). This is called a "back to back" letter of credit structure. Of course if the bank abroad is investment grade rated and has a regulated U.S. branch, it could provide the direct pay letter of credit, without the need for a second bank to be involved.

Can Bonds Be Issued Without A Letter Of Credit?

In some cases, a company with good, but unrated, credit may be able to privately place the bonds with a bank or financial institution with which it regularly deals, without a letter of credit. Sometimes community banks will buy the bonds on the same basis. The process can be simplified in either case if the bonds are drawdown bonds (funds are drawn down as needed and there is no trustee for the bondholders).

Regardless of whether a bank issues a letter of credit to support the bonds, or buys the bonds directly into its portfolio, the transaction is an extension of credit[5] by the bank to its customer. The bank will underwrite the extension of credit in accordance with its normal policies. If the company has strong credit of its own, perhaps the extension of credit will not be collateralized. Otherwise, the bank would require collateral, perhaps including personal guaranties from the company's principals, and could be expected to impose such requirements as a debt-to-equity ratio for the project being financed. More stringent underwriting requirements can be expected for start-up projects.

Companies whose own credit is investment-grade or near investment-grade are often able to use tax-exempt bond financing via a public offering, limited offering, or private placement.

Privately placed bonds can be sold through a placement agent or underwriter to investors that do not have a pre-existing relationship with the company (often a letter of credit is required, even if the bonds are being privately placed). If the bonds are publicly sold, they are sold to (or through) an underwriter, who sells or resells them publicly to such investors as tax-exempt money market funds, bank trust departments, and profitable corporations.

What's The List Of Participants In A Bond Issue?

In the case of a typical private placement of bonds, there would be the conduit borrower (the prospect/company), the conduit borrower's counsel, the issuer (the development authority),

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[5] If the bank is buying the bonds directly into its portfolio, the loan documents between the bank and its customer (the company) that are being collateralized will include, for example, a "Credit Agreement" or a "Bond Purchase Loan Agreement". If the bank is providing a letter of credit, the comparable agreement might be termed a "Reimbursement Agreement" or "Credit Agreement". An example of the collateral typically required is a first priority security deed or mortgage on the project and a pledge of inventory. In the case of tax-exempt bonds, the federal income tax rules usually make it impractical (by restricting yield or requiring yield reduction payments) to directly or indirectly use as collateral "replacement proceeds" (including cash, bank deposits, securities and other types of investment property). If "back to back" letters of credit are used, the bank issuing the direct pay letter of credit to secure the bonds would not normally need more collateral than the stand-by letter of credit from the other bank, but the other bank might require collateral, and providing this collateral would also be subject to the "replacement proceeds" rules.

the issuer's counsel, the bond counsel, the bond purchaser and perhaps a bond purchaser's counsel, and, perhaps guarantors that are stockholders or affiliates of the company.

In the case of a public offering of lower floaters, there would be the conduit borrower, the conduit borrower's counsel, the issuer, the issuer's counsel, the bond counsel, the underwriter, an underwriter's counsel, the bond trustee, the trustee's counsel, the remarketing agent, the letter of credit bank, the letter of credit bank's counsel and there may be guarantors that are stockholders or affiliates of the company that would guarantee the obligation of the company to reimburse the letter of credit bank for amounts drawn under the letter of credit.

What are all of the steps in a bond issue?

All (tax-exempt or taxable) bond issues in Georgia follow these steps-

- The company files a request with the development authority for bond financing. This is not a legal requirement, but is typical. Some development authorities have formal application procedures and forms. Please contact me if you are interested in obtaining a specimen "Application for industrial development revenue bond financing."

- The development authority adopts an inducement resolution, and the development authority and the company execute a letter of intent and inducement agreement. Please contact me if you are interested in obtaining a specimen inducement resolution.

- The company finds[6] a purchaser for the bonds (a bank, financial institution or underwriter). If a letter of credit is needed, the company finds a letter of credit bank. The company will obtain written commitments from these participants. The commitment(s) will dictate the terms of the bonds.

- Once the financing commitments have been received, bond counsel can begin drafting documents, which are then distributed to all of the participants for review and comment.

- When these documents are finalized, the development authority then adopts a bond resolution approving the bonds and the final bond documents. (If the bonds are subject to SEC disclosure requirements, underwriter's counsel around this time will be preparing the disclosure document: the Official Statement or Offering Memorandum).

- The parties involved in the judicial validation (district attorney, clerk of court, etc) are then brought into the process, and the impending validation is advertised in the local newspaper two weeks in a row.

- The bonds are then judicially validated.

- After the parties sign closing documents and the required documents are recorded, the

[6] We can assist the company with this, particularly in assembling the financing team.

bond issue is closed.

In the case of tax-exempt bonds and tax-credit bonds, the following additional steps are involved-

- As bond counsel, we try to get the company to fill out a tax questionnaire we provide as soon as possible. We discuss this questionnaire with the company, and determine if the bonds can be issued as tax-exempt bonds.

- Notice (called a "TEFRA Notice") of a public hearing is published in the local newspaper at least 14 days in advance of the hearing at which members of the public may appear and comment on the bonds, on the nature and location of the project and on the plan of financing. This advertisement is in addition to the advertisements of the validation. The TEFRA Notice generally runs prior to the validation advertisements.

- The hearing (called a "TEFRA Hearing") is held before the development authority (or its hearing officer) or the Board of Commissioners of the County (or Mayor and City Council, in the case of a city development authority or its hearing officer). The TEFRA Hearing may be held before or after the adoption of the bond resolution.

- The bonds are then approved (called "TEFRA Approval") by the appropriate elected official, which will generally be the Board of Commissioners of the County (or Mayor and City Council, in the case of a city development authority), or a designated elected official, such as the Chairman of the Board of Commissioners or Mayor. The schedule for this Approval is usually dictated by the meeting schedule of the County or City.

- An application is filed with the Department of Community Affairs[7] for an allocation of a part of the State of Georgia's private activity bond volume cap (an allocation is not needed for qualified 501(c)(3) bonds). The development authority and the company will sign the application, which usually will be filed by bond counsel. We try to file the application as soon as all the requirements have been met (obtaining financing commitment and TEFRA approval, etc).

- DCA issues the private activity bond volume cap allocation.

- At the closing, the development authority and the company execute a tax compliance certificate and certain other tax-related documents are executed in addition to the other bond documents.

- After the closing, an IRS Form 8038 is filed.

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[7] The Department of Community Affairs administers the state's general volume cap for private activity bonds under IRC § 146. However, there are certain types of bonds that are exempt from the volume limitations of IRC § 146 and have their own volume cap that is not administered by The Department of Community Affairs

The company is responsible for the costs of issuing the bonds to the extent not paid from bond proceeds (only 2% of the proceeds of tax-exempt private activity bonds may be applied to costs of issuance). The development authority should be sure that this obligation is set forth in the inducement agreement that the company signs early in the process.

The bond issuance process generally takes 60-90 days from receipt of the financing commitment from the letter of credit bank or bond purchaser. If the company needs funds for the project prior to closing, once the inducement resolution has been adopted, it could either use its own funds or obtain a "bridge loan" from a bank, either of which could be repaid out of bond proceeds

More Information

This paper is a quick-reference guide for company executives and managers, elected and appointed officials, economic developers, participants in the real estate and financial industries, and their advisors. The information in this paper is general in nature. Various points which could be important in a particular case have been condensed or omitted in the interest of readability. Specific professional advice should be obtained before this information is applied to any particular case. Any tax information or written tax advice contained herein (including any attachments) is not intended to be and cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer. (The foregoing legend has been affixed pursuant to U.S. Treasury Regulations governing tax practice.)

Additional information concerning this topic, as well as White Papers and references on other topics, can be found at http://danmcrae.info/.

If you have any questions or comments, we would be pleased to provide more information. Please contact:

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