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Industrial Development Bonds in a Post-Stimulus Bill World

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Both the American Recovery and Reinvestment Act of 2009 (ARRA) and the Housing and Economic Recovery Act of 2008 (HERA) contain provisions that together expand and make more appealing the use of Industrial Development Bonds (IDBs).

IDBs are authorized under Section 144 of the Internal Revenue Code and provide manufacturing and processing companies with low-interest financing for capital expenditures. A governmental agency issues these tax-exempt bonds, and the bond proceeds are loaned to the manufacturing company to finance capital expenditures. Eligible capital expenditures include the acquisition of land, building construction, building renovation and the purchase of machinery and equipment. An issuance of IDBs to finance a borrower's capital expenditures cannot exceed $10 million.

Impact of ARRA

ARRA modifies IDBs by expanding the possible uses for IDBs to include financing the capital costs of businesses that produce intangible property, defined as "any patent, copyright, formula, process, designs, pattern, knowhow, format, or other similar item." Previously, IDBs could be used only to finance capital costs incurred by manufacturers producing tangible products. This expansion could benefit a wide range of businesses, including software developers, biotech and pharmaceutical companies and entertainment industry firms, by providing them with a low-cost financing vehicle.

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While the expansion of the use of IDBs to businesses that produce intangible property is the most significant change, ARRA also temporarily eliminated the ancillary facilities limitation. This means that IDBs can be used to finance any facility that is functionally related and subordinate to a manufacturing facility. Prior to this change, only 25% of the net proceeds from IDBs could be used to finance these ancillary facilities, such as offices and warehouses. In connection with the expansion of IDBs to producers of intangible property, this change makes sense since it is difficult to determine whether an office or meeting room at a software company or entertainment firm is the manufacturing facility itself or only an ancillary facility. However, this change could also benefit traditional manufacturers by providing them with flexibility in designing and financing their facilities.

In addition, the provision contained in ARRA that exempts private activity bonds from the alternative minimum tax (meaning the interest paid on the bonds is tax-exempt even to holders that are subject to the alternative minimum tax) also benefits borrowers who use IDBs. This provision should allow borrowers to obtain lower interest rates on their bond issuances since the bonds are appealing to a larger pool of potential buyers.

Impact of HERA

HERA provides that bonds guaranteed by a Federal Home Loan Bank in connection with their original issuance are no longer ineligible for tax-exempt status. This means that a Federal Home Loan Bank letter of credit can be used to support a tax-exempt bond issuance through the provision of a AAA-rated “wrap” around a direct-pay letter of credit issued by one of the Federal Home Loan Bank’s member banks. The effect of this is that manufacturers are potentially able to obtain lower interest rates on IDBs.

IDBs are primarily structured either as (1) a direct purchase by commercial banks or finance companies without any credit enhancement or (2) variable rate demand obligations (VRDOs) supported by a direct pay letter of credit. Traditionally, VRDOs would result in a cheaper rate payable by the manufacturer/borrower (even after taking into account fees to a letter of credit bank and remarketing agent, which fees are not necessary in the direct purchase scenario) since the holders of the bonds rely on the rated credit of the letter of credit provider rather than just the credit of the manufacturer and the holders are able to “put” their bonds for par plus accrued interest typically with only 7-30 days’ notice. In order to ensure that the bondholders putting their bonds would be paid in full, the letter of credit would include a liquidity feature whereby the letter of credit bank buys the bonds if other remarketing proceeds are not available. However, the credit crisis has made direct pay letters of credit with liquidity features required to support the VRDO structure difficult to obtain and expensive when available. The entry of the Federal Home Loan Banks into this arena as permitted by HERA changes this. In fact, the first issuance of IDBs supported by a Federal Home Loan Bank guarantee in California closed on November 19, 2008, with the Federal Home Loan Bank of San Francisco wrapping a letter of credit provided by City National Bank in order to finance a project for Pocino Foods Co.

Timing

ARRA provides that relief from the ancillary facilities limitation, exemption from the alternative minimum tax for investors who purchase IDBs and the ability to use IDBs to finance a facility used in the creation or production of intangible property applies only to bonds issued before January 1, 2011, unless such time period is extended by the federal government.

HERA provides that a Federal Home Loan Bank’s guarantee will not impact the tax-exempt status of the underlying obligations so long as the bonds are issued and the guarantee is made (or is the extension or renewal of a guarantee made) prior to December 31, 2010. So, this enhancement to the IDB program is available only until December 31, 2010, unless such time period is extended by the federal government.

IDBs in California

In California, potential borrowers work with the California Industrial Development Finance Advisory Commission (CIDFAC) in order to obtain IDB financing. In 2008, California streamlined the IDB approval process by transferring the state’s IDB allocation to CIDFAC so a borrower no longer needs to obtain tax-exempt allocation from the California Debt Limit Allocation Commission after obtaining CIDFAC approval with respect to its project by demonstrating that the project meets certain eligibility requirements, including that the project provides some public benefit. Now borrowers can just obtain approval and tax-exempt allocation from CIDFAC. According to the state treasurer's website, in calendar year 2008, CIDFAC approved 18 projects for a total of $118.34 million in IDB proceeds which created 713 jobs.

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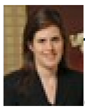

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