

TIME IS RIGHT, BUT FEW BANKS PUSHING TAX-EXEMPT BONDS

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With interest rates down and the market for conventional loan customers more competitive than ever, commercial banks and lenders need a sound investment strategy to stay afloat. One such strategy is tax-exempt bond financing, which some enterprising banks and lenders have aggressively marketed to community businesses and nonprofits, earning major tax exemptions and other benefits in the process.

When properly structured, tax-exempt bonds can constitute a significant subsidy, enabling financing to be issued at materially lower interest rates. Lenders, the ultimate purchasers of the bond, can receive triple-tax-exempt interest income, depending on locale, as well as achieve community prestige and professional satisfaction. Borrowers, on the other hand - usually small manufacturers or nonprofits with limited funds - reap reductions and exemptions on a variety of taxes and municipal services, and much lower down-payment requirements on the loan acquisition.

Tax-exempt bond financing, which has been around in one form or another on a municipal level since the 1930s, is available in two types: civic facility bonds and industrial revenue bonds. Civic facility bonds are issued by municipalities to provide funding to nonprofits for acquisition and renovation of facilities, in order to generate jobs, services, and economic stimulus in communities suffering from downturns and adverse demographic trends. Industrial revenue bonds are used to provide financing to manufacturers for acquisition and renovation of facilities.

Use of both these types of bonds became more widespread in the 1960s. This led Congress to pass legislation, beginning with the Revenue and Expenditure Control Act of 1968, which limited the tax exemption to bonds that met specific requirements.

Today the interest income on otherwise tax-exempt industrial revenue bonds is generally subject to the alternative minimum tax, and banks that earn tax-exempt interest income on such bonds may find that a portion of their own tax deduction for interest expense is disallowed. These issues require careful scrutiny in each case to ensure that the lender is not accepting a lower tax-exempt yield, only to find itself with a tax burden that was not taken into account in the pricing of the transaction.

Here's how the process for project funding would work in a typical scenario:

A bank would counsel its customer to apply to the local tax-exempt bond issuing authority with help from attorneys experienced in government incentives, taxes, and real estate transactional law. The customer would be required to meet certain terms related to credit, solvency, and use of proceeds. Upon approval of the application, the bank would buy the bond at closing.

In New York City, for example, a customer who acquires property with financing through the New York

Industrial Development Agency takes title to the property and leases it back to the IDA, which leases it back to the customer. As bond issuer, the IDA keeps ownership in name only, with a lien on the property granted to the bond trustee.

The bank customer has no direct financial relationship with its bank in this case. Instead, the customer makes payments to the trustee appointed by the bond issuer according to the lease terms. The customer pays a significantly lower interest rate, as much as 2 or 3 percentage points (depending on market conditions), and receives the following additional benefits in New York:

- Ability to borrow 90 percent to 100 percent of the cost of the property and improvements.
- Exemption from the mortgage recording tax (in New York City, 2.75 percent of the amount of the secured loan).
- Exemption from increases in real estate tax as the result of improvements (a benefit that may also be available to certain not-for-profit entities outside of the IDA process).
- Reduction in real estate tax on the land of up to \$500 per employee on the job site per year for 20 years, followed by a gradual reduction in the abatement (also a benefit that may be available to certain qualified not-for-profit entities outside of the IDA process).
- Exemption on sales tax for equipment and building materials.
- Qualification for an approximate 15 percent reduction in the cost of energy use.

The bondholder bank, on the other hand, receives interest income that, while lower than what it would receive on a conventional loan, is more than offset by as much as a triple tax exemption. This is especially advantageous in the current period of closer spreads between conventional rates and those of tax-exempt bonds - for example, 6 percent compared with 4.5 percent. The bank also has a happy customer, with the potential for more business and the reputation of being a contributing member of the community.

So why aren't more banks jumping on the tax-exempt-bond bandwagon?

The answer may lie more in mind-set of the banks than in reality. Banks are comfortable making loans secured by first mortgages on buildings and land. The idea of a loan based on a bond issued by another entity does not sit well with an experienced lender who considers conventional mortgages risky enough.

The truth is the lender actually has as much control in the bond transaction. While the bank has no direct financial relationship with the customer, it does have a relationship with the trustee appointed by the issuer.

The trustee administers the bond and holds a lien on the property to secure repayment. The bank bondholder is able to direct enforcement of the mortgage and dictate the exercise of remedies in the event of default. As a result, the bank is as secure as it would be under a conventional mortgage agreement, with the added benefits of being a bondholder instead of a mortgagee.