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## Tax-Exempt Financing for Local Infrastructure Projects

*Bond Basics and Beyond*

October 2016  
IACC Annual Conference

## Tax-Exempt Bond Financing

**Session overview:**  
Your community may be able to use tax-exempt bond financing for infrastructure and other projects.

Today we will:

1. Learn the basics of issuing bonds
2. Explore tax-exempt private activity bonds and the Bond Cap Allocation Program
3. Get an update on the possible impacts of federal tax reform proposals






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## Where do Bonds fit in financing infrastructure?

**Tax-exempt bonds**

- Public purpose
- Private activity benefiting the public (affordable housing, infra., etc.)

**Other options:**

- Taxable Bonds –private activity
- Loans from government
- Loans from banks
- Grants
- State's LOCAL program ([www.tre.wa.gov/LOCAL](http://www.tre.wa.gov/LOCAL))
- Private/innovative funding (P3s, etc.)



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## Financing Options

**Are bonds better than bank loans?**

- Bonds have lower interest rates but higher up-front costs
- Bonds work better for larger amounts of money and longer periods of time
- Loans from banks work well for interim, variable-rate financing
- Most banks will not go longer than 10 years
- Banks often work better for less robust credits



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## What is a Municipal Bond?

**Debt** issued by a city, county, local, or other government entity used to fund expenditures such as the construction of highways, bridges or schools.

- Government (issuer) sells the bond to the investor(s)
- Investor(s) provides the capital for the project
- Government promises to re-pay the face-value of the debt **with interest**



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## Tax-Exempt Bonds

**Municipal bonds can be taxable or tax-exempt**

- Tax-exempt bond interest is exempt from Federal income tax
- Therefore the investor is willing to take a lower interest rate
- Lower interest rate = lower financing costs

**Tax-exempt bonds have many strings attached**

**– We will talk about these in a little bit**

- Governmental purpose
- IRS !!!
- Limits on private activity
- Reasonable expectation for spending proceeds
- Arbitrage restrictions



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### Municipal Bonds: Four Main Types

- *General Obligation (GO) Bonds*
- *Revenue Bonds*
- *Special Assessment Bonds (often LIDs)*
- *Certificates of Participation*

• *We are going to skip talking about taxable bonds today*



### Municipal Bonds: GO Bonds

*General Obligation (GO) Bonds*

- Public purposes
- Voted or non-voted
- Payable from property taxes and other revenues
- Debt is secured by full faith and credit of the issuer
- Limited or unlimited taxing authority
- Amount limited by state statute



### Municipal Bonds: Revenue Bonds

*Revenue Bonds*

- Water, sewer, electric, other enterprise systems
- Payable from specific system/project revenues
- No dollar limit, system revenues create a practical limit
- Certain covenants or conditions: debt service coverage, reserve fund, etc.



### More Municipal Bonds

*Special Assessment Bonds*

- Finance improvements (e.g. roads, sewers) in specific area
- Payable through assessments of properties benefiting from the improvement
- Typically a set up as a Local Improvement District (LID)
- Do not count against statutory debt limitations

*Certificates of Participation (COPs)*

- Issued by the Office of the State Treasurer
- LOCAL program, [www.tre.wa.gov/LOCAL](http://www.tre.wa.gov/LOCAL)
- Aggregates many local jurisdictions' smaller debt issues
- Payable from jurisdictions' general funds
- Counts against statutory debt limitations



### Limitations on Municipal Debt

*General Obligation debt is limited by state statute and constitution*

Per state statutes: debt is limited to a **percent of assessed valuation** of the taxable properties in the jurisdiction

	Non-Voted	Total		Non-Voted	Total
Counties	1.5%	2.5%	Port GO Bonds *	3/8%	1.25%
Cities	1.5%	7.5%	Water/Sewer	0.5%	2.5%

See: Bond Users Clearinghouse, WA State Department of Commerce  
<http://www.commerce.wa.gov/Documents/Limitations-on-Municipal-Debt.pdf>

\*Port district debt limitations are influenced by taxable property values, or Pro-rating revenues, and other factors .



### Tax-Exempt Bond Financing





*Bond Cap Allocation Program*  
 WA State Department of Commerce



### Private Activity

What if the bond has more than a little bit of benefit to a private business or individual?

**Private Activity = Taxable Bond** (with a few exceptions)

**Private Loan Test:**

- >5% used for loans to individuals or non-governmental entities

**Private Business Test:**

- 10% for private business purpose, AND
- >10% of payments secured by property used



### Annual Bond Cap Allocation

**Tax-Exempt Private Activity Bonds**

- Bond Cap Allocation Program, WA State Department of Commerce
- Authorizes the issuance of tax-exempt private activity bonds
- Ensures statewide issuances are within federal limits
- Businesses or developers work with public authorities to develop projects and issue the bonds for financing



### Annual Bond Cap Allocation

**\$717 million in 2016**

Projects are eligible if they provide significant public benefit – and fit into one of four categories:

- Housing (affordable)**
  - 42% initial allocation
  - this is a change from 32% last year
- Small-issue manufacturing**
  - 25% initial allocation
- Exempt (capital) facilities**
  - 20% initial allocation
- Student loans**
  - 5% initial allocation
  - this is a change from 15% last year



### Exempt Facilities funds most infra. Related projects

**Exempt Facilities (20%)**

- Issuers: WEDFA, ports, PUDs, EDCs, IDCs
- Water or sewer (that would be considered a private activity)
- Recycling
- Solid waste
- Electrical generation (that would be considered a private activity)
- Certain other kinds of environmental projects




### Categories Defined

**Housing (32%)**

**Multi-family**

- Issuers: HFC, LHA
- New construction and rehab

**Single Family**

- Issuer: HFC
- Homeownership, such as down-payment assistance
- Low and moderate income first-time homebuyers




### Categories Defined

**Small-Issue Manufacturing (25%)**

- Industrial development/ manufacturing
- First-time farmer/rancher
- Issuers: WEDFA, Ports, EDCs, IDCs, WSHFC
- \$20 million capital expenditure limit
- \$10 million bond limit



SCAFCO CORPORATION  
Grain Systems Division  
Spokane, WA



## Conduit Issuers

**Local Conduit Issuers**

- Economic Development Corporations
- Industrial Development Corporations
- Local Housing Authorities
- Certain types of special purpose districts

**State Conduit Issuers**

- Washington State Housing Finance Commission [www.wshfc.org](http://www.wshfc.org)  
Housing, Energy, 501c3
- Washington Economic Development Finance Authority (WEDFA) [www.wedfa.wa.gov](http://www.wedfa.wa.gov)  
Small Issues, Exempt Facilities, QECBs



## Benefits of Tax-Exempt Private Activity Bonds

**Tax-Exempt Private Activity Bonds**

- Leverage public/private partnerships
- Create jobs
- Support community businesses

Conduit issuer can reduce risk and eliminate debt capacity impacts to the local jurisdiction



## Changes to state law

**SSB 6342**

- Changes initial allocation percentages
  - 10% from student loans to housing
- Allows earlier redirection of student loan funds
  - Feb. 1 instead of July 1st



## Federal Tax Reform

**Uncertain Future of Tax-Exempt Bond Financing**

Various Federal proposals to *expand, limit or eliminate the tax-exemption*

**Current System**  
Tax Exemption = Lower Interest Rates = Lower Project Costs

**Limiting or Elimination of the tax-exemption**  
More Federal Income Tax Burden (Investors) = Higher Interest Rates = Higher Project Cost



## New competitive and economic environment

- Economy improved and affordable housing need has surged
  - As a result, all past carryforward authority has been used
- Almost no carryforward anticipated this year
- Probably more bond demand than authority next year
- Fed. will probably keep interest rates low

= competitive environment for bond allocations

- especially in the housing sector

= small manufacturing and exempt facilities may not find enough financial advantage in tax exempt option to offset issuance and administrative costs and requirements



## Tax-Exempt Bond Financing

**Following the Rules**




## Creating a Finance Team

### Your team

- You (Issuer)
- Bond Counsel
- Financial Advisor (Municipal Advisor)
- Underwriting Firm or Bank
- Underwriter counsel or bank counsel
- Rating Agency
- Bond Insurer

### Be sure you understand and are comfortable with the process

- Your team of consultants may use a lot of jargon or make assumptions about your level of knowledge of the bond issuance process
- Ask a lot of questions!



## Bond Counsel

### Legal opinion

- Makes sure you are following all the rules
- Prepares/reviews resolutions and official statements
- Ensures proper authorization and enforceability
- Reviews Federal tax law impacts and regulations
- Provides legal opinion that the bonds
  - Have been duly authorized and are valid and enforceable obligations
  - Exempt (or not) from Federal income tax



## Municipal Advisor

### Fiduciary responsibility to the issuer

- Works with an issuer to develop and review a plan of finance and coordinate the overall financing
- Bond structuring and financial analysis
  - Bank vs. underwriting firm
  - Sale Method: Competitive vs. negotiated
- Provide current market-based expertise
- Coordination with rating agencies, bond insurers, underwriters
- Represents the issuer in negotiations with the underwriter
- Facilitates a competitive sale



## Underwriting Firm (Bank)

### Fiduciary responsibility to the investor

- Underwriter: financial institution that sells your bonds to investors
- Bank: purchases your bond to hold as an investment



## Paperwork

### Bond resolution / ordinance

- Provides all the details of the bonds as approved by the governing body (e.g. City Council, Port Commission)
- Approved on the date of sale or ahead of time on a delegated basis

### Official statements

- Disclosure document provided to investors prior to the sale
- Contains information about the project being financed; structure; call provisions; security for the bonds; and details about the issuer, local economy, etc.
- Updated with the pricing details after the sale (Final Official Statement)



## More Paperwork – for the life of the bond

### Continuing Disclosure

- Obligated to provide certain **annual financial information** and material event notices to the municipal securities market under the SEC's Rule 15c2-12.
- Obligated to report **events that may impact the ability of an issuer to pay** the amounts owed on their bonds
- 15 disclosable events include:
  - Delinquent payments and defaults.
  - Adverse tax opinions, Internal Revenue Service (IRS) determinations, or other material events affecting the tax status of the security.
  - Ratings changes.
  - Bankruptcy, insolvency, receivership, or similar event.



### In Conclusion

*Before you decide to use bond, understand the trade-offs and obligations*

- **Bonds:**
  - Lots of work
  - More disclosure
  - Higher issuance costs
  - Rating requirements
  - More oversight & regulations
  - Continuing disclosure for the life of the bond (long term obligations)
  - 6-12 weeks (more if requiring a ballot measure)
- **Remember to consider other options:**
  - Grants
  - State and Federal Loans
  - Direct lending from a bank
  - State's LOCAL program ([www.tre.wa.gov/LOCAL](http://www.tre.wa.gov/LOCAL) )
  - Private/innovative funding (P3s, etc.)



## Questions




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