A Lower Cost Way of Financing Capital Projects

Private projects—from hospitals and schools to recycling and energy plants—can qualify for tax-exempt bonds

BY EMILIE R. NINAN

ALTHOUGH TAX-EXEMPT BONDS are more commonly associated with financing governmental projects, the federal tax code actually allows certain private institutions ranging from 501(c)(3) nonprofit organizations (e.g., hospitals, colleges and universities, private and charter schools, affordable housing developments, museums, and other cultural institutions) to bioenergy and other manufacturers to finance capital projects with tax-exempt bonds, which have a lower interest rate than conventional taxable loans.

Tax-exempt bonds are required to be issued by a government entity. The entity can issue bonds for its own projects or serve as a conduit and lend the proceeds to a qualifying borrower such as the private institutions discussed above. In Delaware, there are only a handful of conduit bond issuers, including state agencies such as the Delaware Economic Development Authority, the state's three counties—New Castle, Kent, and Sussex—as well as certain municipalities, such as the City of Wilmington.

Typically, a financial institution (e.g., investment bank or a commercial bank) purchases the bonds and pays the purchase price to the issuer. The governmental issuer in turn lends the bond proceeds received to a qualified borrower. Because bond purchasers do not have to pay tax on the interest earned on the bonds, the purchasers are willing to accept a lower interest rate. Those savings are passed along to the borrower, resulting in a lower cost of debt service.

The interest rate on tax-exempt bonds is based on the borrower's credit, and the governmental entity has no repayment or other obligations with respect to the bonds. Once the government issuer loans the purchase price to a qualified borrower, it steps out of the deal. With respect to bonds directly purchased by commercial banks, the issuer assigns the repayment rights to the bond purchaser, resulting in a relationship between the bond purchaser and the borrower that is akin to a traditional conventional loan.[1]

What Kind of Projects May Tax-exempt Bonds Be Used to Finance?

In addition to projects for 501(c)(3) organizations, tax-exempt bonds also may be used to finance certain types of manufacturing facilities and utility projects—work that involves sewage, solid waste, electricity, or gas, for example.

Tax-exempt bonds may be used to finance capital projects that involve, among other activities:

- Acquiring land (with certain restrictions)
- Building a new facility
- Acquiring an existing building at no more than fair market value
- Rehabilitating or expanding an existing facility

1 By comparison, Bonds purchased by investment banks are sold to the public and have a trustee representing the bond holders.

- Customizing a rental property to satisfy a particular tenant's needs
- Acquiring new or used equipment
- Refinancing conventional debt or other tax-exempt debt used to finance capital expenditures.

Tax-exempt bonds are typically long-term debt instruments with 30-year maturity dates, depending on the useful life of the assets being financing. In addition to the design and hard costs of the project, proceeds of the bonds can also be used to pay for a portion of the costs of issuance and any required reserve funds or credit enhancement. ■

For more information, contact public finance attorney **Emilie Ninan**, co-chair of the Finance Department at Ballard Spahr LLP, at ninane@ballardspahr.com. Ballard Spahr's nationally recognized Public Finance Group has participated in the issuance of more than $1 trillion in tax-exempt bonds in every U.S. state and territory. The firm advises nonprofit and for-profit organizations across industries in determining whether tax-exempt bonds are an option for financing their projects.

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