IRB SUMMARY

CITY OF ALBUQUERQUE
INDUSTRIAL REVENUE BONDS (IRBs)

Benefits of IRBs

Industrial revenue bonds (sometimes called industrial development bonds, IDBs or IRBs) have three principal benefits for companies: property tax exemptions, gross receipts or compensating tax exemptions and (in very limited number of cases) an exemption from federal income taxation on the interest paid to bondholders, resulting in lower interest rates for a borrower than other types of commercial borrowings. Property and gross receipts or compensating tax exemptions are almost always available to New Mexico projects with significant capital development. The third benefit depends on whether the specific IRBs being considered are deemed "tax exempt" under the federal income tax code.

What Are IRBs?

In economic effect, an IRB is a loan by a lender/bond purchaser to a company, where the loan proceeds and the loan repayments flow through a government issuer. The tax benefits of IRBs result from the form of the loan and the involvement of a government issuer, with the government issuer taking title to the facility and/or equipment. In its simplest form, an IRB structure involves a company (typically a corporation, a limited partnership or limited liability company) that wants to purchase and/or construct and/or equip a facility. Instead of purchasing, constructing or equipping directly, the company enters into an agreement (usually a lease) with a government issuer. The agreement provides that the company will lease the facility from the government issuer, construct and equip the facility and, at the end of the lease term, purchase the facility from the issuer at a nominal price. Importantly, the company constructs and equips the facility as the agent of the issuer. In order to obtain the funds to purchase, construct and equip the facility, the issuer issues bonds, which are sold to the company's lender or an affiliate of the company. Please note that the City does not finance bonds; nor does the City provide any credit enhancement. The City is merely a conduit issuer. The proceeds of the bond sale are used to pay the expenses of the facility. The bonds are paid off solely with the payments made by the company to the issuer under the lease.

Issuers

IRBs can be issued by any New Mexico county or municipality or the New Mexico Finance Authority. Municipalities, such as the City of Albuquerque (the "City"), can issue IRBs for projects within their limits or within the unincorporated portion of a county within 15 miles of their limits. Most counties can issue IRBs for projects only within their unincorporated territory. Bernalillo County, however, can issue industrial revenue bonds for projects within Albuquerque City limits.

Projects

Only "projects" as defined in the IRB statute can be financed with IRBs. Projects can include land, buildings, furniture, fixtures and equipment. Municipal projects (as opposed to county projects) do not include facilities used primarily for the sale of goods or commodities at retail and certain regulated utility projects. Projects do not need to include land; they can be for equipment only. Also, any land included in a project need not be owned in fee. The costs of projects that can be financed are limited to capital costs and transaction costs. Working capital generally cannot be financed with IRBs, nor is there any benefit associated with doing so.

More specifically, New Mexico municipal IRB legislation specifically identifies "projects" as land, buildings, equipment and improvements which are suitable for use by any of the following:

1. any industry for the manufacturing, processing or assembling of any agricultural or manufactured products;
2. any commercial enterprise in storing, warehousing, distributing or selling products of agriculture, mining or industry but does not include facilities designed for the sale of goods or commodities at retail or distribution to the public of electricity, gas, water or telephone or other services commonly classified as public utilities;
3. any business in which all or part of the activities of the business involve the supplying of services to the general public or to governmental agencies or to a specific industry or customer but does not include establishments primarily engaged in the sale of goods or commodities at retail;
4. any water distribution or irrigation system, including without limitation, pumps, distribution lines, transmission lines, towers, dams and similar facilities and equipment, designed to provide water to any vineyard or winery;
5. any electric generation facility other than one for which both location approval and a certificate of convenience and necessity are required prior to commending construction or operation of the facility, pursuant to the Public Utility Act [62-13-1 NMSA] and Electric Utility Industry Restructuring Act of 1999 [62-3A-1 NMSA 1978]; and
6. any 501(c)(3) corporation.

<u>Taxable IRBs</u>
Through the use of IRBs certain state tax incentives are available, and it is not necessary for the issuer to structure IRBs as tax exempt under federal income tax laws. (As described below, tax exempt bonds are available for manufacturing projects of a limited size, 501-c-3 corporations, and certain other specified projects.) Indeed, most of the recent transactions authorized by various cities in the state as industrial revenue bonds have been "taxable" bonds. The primary purpose of issuing taxable bonds is to provide to the company using the facility a property tax exemption for the facility being financed and a gross receipts or compensating tax exemption for the equipment and other personal property purchased for the facility.

<u>Property Tax Exemption</u>
While real and personal property included in a project financed with municipal IRBs is exempt from property tax for as long as the bonds are outstanding, up to a maximum of

30 years by State statute, the period for bonds issued by the City is limited to 20 years by City policy. The property tax exemption results from the fact that title to the project property is held by the City. Property of a county or municipality is exempted from taxation under the New Mexico constitution. The lessee's interest in an industrial revenue bond lease is exempt from property tax pursuant to 7-36-3 NMSA 1978 as amended. Issuers may require "payments in lieu of taxes," as the City does, or may shorten the bond term, thereby decreasing the benefit of the property tax exemption.

Gross Receipts or Compensating Tax Exemption

Personal property, including furniture, fixtures, equipment and certain other disposable assets purchased with IRB proceeds for a project are exempt from gross receipts taxes if purchased in the state, and compensating taxes, if purchased out of state, with the proceeds of IRBs. The exemption results from title to the property being held by the City and the company acting as agent for the City in the development of the project. A special nontaxable transaction certificate ("NTTC") is required for the gross receipts tax exemption. Building materials (bricks and mortar) incorporated in a project and becoming a part of the real property are not exempt from gross receipts and compensating taxes. An additional investment tax credit may be available for manufacturing equipment, depending on the number of new employees related to the project. If an IRB structure is not used, that tax credit merely offsets the compensating tax or a portion of the gross receipts tax imposed on the equipment; if an IRB structure is used, the gross receipts or compensating tax can be avoided and the credit can be applied to other taxes, such as payroll withholding taxes. Other special tax credits offered by the State may be limited by the use of IRBs.

Tax Exempt IRBs

The interest on all New Mexico IRBs is exempt from New Mexico income tax. In order for interest on IRBs to be excludable from gross income for federal tax purposes (i.e., "tax exempt"), numerous other conditions apply. Most commonly, the project must be a manufacturing facility. The principal amount of the bonds cannot exceed $10 million. Also, no "substantial user" of a manufacturing project (including the company) may make more than $20 million in capital expenditures (whether or not from proceeds of the IRB) within the boundaries of an issuer in the six year period beginning three years before the date the bonds are issued and ending three years after the issuance of the bonds. State of New Mexico "cap allocation" for such projects must be obtained from the State Board of Finance. Certain other "exempt facilities" enumerated in the tax code also may qualify; however, the issuance of bonds for these purposes in New Mexico is extremely limited. In general, tax exempt IRBs will carry a lower interest rate than similar taxable IRBs, often about 30% lower. However, because of tax provisions that do not allow banks to deduct their "costs of carry" with respect to IRBs, there is generally no interest rate differential between similar "taxable" and "tax exempt" IRBs sold to banks. Interested banks should be consulted for any possible variance from this result. Tax exemption is lost if the IRBs are held by an affiliate of the company. Certain changes to the tax law with respect to tax-exempt bonds were made for bonds issued in 2009 and 2010, but to date most of these provisions have not been renewed. Interested companies should consult bond counsel.

Credit Considerations

An IRB does not put the issuer's credit on the line, only the company's. This is because the issuer is only a conduit, agreeing to pay the bondholders only what it receives from the company. Therefore, if a lender would not be willing to make a loan to a company, the lender generally will not purchase IRBs issued for that company. IRBs can be backed by "credit enhancement" such as a guaranty, a letter of credit or an insurance policy. But, if a "credit enhancer" is not willing to make a loan to a company, that credit enhancer will not be willing to issue a letter of credit, guaranty or insurance policy backing that company's IRBs. If a lender is willing to make a commercial loan to a company for capital development purposes, that loan can generally be structured as an IRB. Many "taxable" IRBs are structured to be purchased by an affiliate of the company (often called "self purchases").

Timing

From start to finish, the issuance of IRBs by the City generally takes approximately 90 days.

This schedule applies to "self purchases." If a third-party lender or a credit enhancer is involved, or if the IRB is to be tax exempt for federal income tax purposes, several more weeks should be added. For an overview of the primary steps involved in the IRB process, see APPENDIX A "Typical Basic Steps in a City of Albuquerque Taxable IRB."

Public Process

The issuance of IRBs is a public process. Generally, there are three public hearings on the proposed bonds. City of Albuquerque IRBs must be approved by both the City Council and the Mayor, unless the Mayor is overridden by a two-thirds majority of City Council. The officials involved will weigh the costs and benefits of the IRBs. The primary cost to local government is foregoing property and gross receipts tax revenues, though in some cases it can be argued that the project would not be undertaken without the IRBs, so there is little tax loss. The primary benefit is usually job creation, or retention. However, it is often difficult to get IRBs issued for an existing facility without a showing of job creation, unless a good faith argument can be made that the facility would close without the IRBs. IRBs are unlikely to be issued for facilities that compete with existing local businesses. Officials are sensitive to environmental issues surrounding the project and to the concerns of neighbors. They are also interested in the creditworthiness of the company because, even though an issuer's credit is not on the line, a default could have a general negative impact in the community.

Clawbacks and Springing PILOTS

Increasingly, local governments are adding provisions to IRB documents to protect against early closure of facilities or the failure to achieve predicted job growth goals. These provisions can take the form of "clawbacks", i.e, provisions that require a repayment of the taxes avoided by the use of IRBs in the event of early closure of a facility, or so called "springing" payments in lieu of taxes ("PILOTS") which require that payments be made in future years if job creation estimates (or other promises) are not met or maintained by the company. In a recent example, Philips Semiconductors agreed to pay back to the City of Albuquerque more than $13,000,000 of taxes avoided upon the closing of its plant within three years of the issuance of the IRBs by the City.

Company Health Coverage Requirements

Companies interested in financing a project with IRBs issued by certain larger municipalities and counties may also be required to meet certain health coverage requirements. In particular, IRBs may not be issued by a city having a population of more than forty thousand (such as the City of Albuquerque) or by a "Class A" county (such as Bernalillo County) to finance a project that is valued at $8,000,000 or more unless an employer of the project (i) offers its employees and their dependants health insurance coverage that is in compliance with the New Mexico Insurance Code or a comparable health benefits plan pursuant to the federal Employee Retirement Income Security Act of 1974; and (ii) contributes not less than fifty percent of the premium for health insurance coverage for those employees who choose to enroll; provided that the fifty percent employer contribution shall not be a requirement for the dependent coverage that is offered.

Savings and Costs

On a $25 million project consisting of $10 million in land and buildings, $15 million in equipment, the nominal value of the property tax savings over 20 years is about $3.2 million. (This assumes a 2010 property tax rate of 0.046632, a 7-year life for equipment, with straight-line depreciation.) The compensating tax savings on the equipment is $769,000. (This assumes all equipment will be purchased out of state; if purchased in state, the gross receipts tax savings are slightly higher.) On the cost side, the transaction costs for a simple "self purchase," which include the fees of lawyers for the company and the issuer, are in the neighborhood of $40,000-$50,000. If the issuer is one such as the City of Albuquerque that requires staff and board or commission review, add $5-10,000. For credit enhancement (which would likely apply only to tax-exempt bonds), add another $10-15,000 in transaction costs and 1-1.5% of the principal amount in annual expenses. A significant amount of fees should be expected in connection with the issuance of tax-exempt bonds. All of these expenses are in addition to those that would be involved if an IRB structure were not used, such as title insurance premiums, legal fees associated with the purchase or long term lease of real estate, and legal fees related to the negotiation of loan documents. As a rule of thumb, "self purchase" IRBs generally are not cost effective for projects of less than $3,000,000.

Information provided courtesy of Brownstein, Hyatt Farber and Schreck, LLP; Albuquerque, NM