

## **MAJOR TAX RESTRICTIONS ON THE ISSUANCE OF MANUFACTURING PRIVATE ACTIVITY BONDS**

The following is a summary of major restrictions imposed by the Internal Revenue Code on qualified small issue private activity bonds. This summary does not, however, identify all Internal Revenue Code limitations and other requirements that may apply to a determination regarding bond eligibility. Final assessment of all the requirements of the Code is made by bond counsel and the Attorney General of Michigan.

### 1. Manufacturing Facilities Only

Only manufacturing facilities are eligible. For the purposes of federal tax law, manufacturing facilities are those used in the manufacturing or production of tangible personal property. Some industrial service processes and facilities are not eligible under the current definition. (For example, non-manufacturing expansion of manufacturing facilities is ineligible.) Related on-site office, short-term warehousing, product test laboratories, and other facilities may or may not be eligible depending upon circumstances.

### 2. Term

The maturity of a bond issue cannot exceed 120% of the average reasonable expected economic life of the assets being financed with bond proceeds. In general, the economic life of an asset is determined on a case-by-case basis. However, the administrative guidelines established for the midpoint lives under the ADR System where applicable and the guideline lives under Rev. Proc 62-21 in the case of structures may be used to establish lives of assets. The conduit borrower can, however, issue bonds with maturities longer than these administrative guidelines would allow where the conduit borrower can show, on the basis of facts and circumstances, that the economic life to the borrower or principal user is longer than the lives established under the administrative guidelines. In general, land is not taken into account in determining average economic life.

### 3. Inducement

Signing of a binding purchase contract or initiation of construction more than 60 days prior to receipt of a bond issuer's action declare its official intent for federal tax purposes may nullify eligibility of those expenditures for tax-exempt financing.

### 4. Depreciation

In stages, TEFRA (the Tax Equity and Fiscal Responsibility Act of 1982), DEFRA (The Deficit Reduction Act of 1984), and the Tax Reform Act of 1986 have eliminated the dual subsidy of allowing tax exempt bond financed facilities to use an accelerated cost recovery form of depreciation deduction. Therefore, property financed with the proceeds of an industrial revenue bond must be depreciated under the Alternative Depreciation System of Section 168 (g) of the Internal Revenue Code. Generally, this requires using the straight line method over a recovery period equal to the property's Class Life Asset Depreciation Range mid-point life. In most cases, the recovery periods for the Alternative Depreciation System are longer than the generally applied recovery periods under other accelerated depreciation systems. Personal property with no class life is to be recovered over 12 years, and real property is to be recovered over 40 years.

5. Use of Bond Proceeds

At least 95% of the net proceeds of the bonds must be spent for land or depreciable property.

At least 95% of the net proceeds of the bonds must be spent for manufacturing facilities. In addition, at least 70% of the net bond proceeds must be spent for “core manufacturing” facilities (e.g. property used in the production of the product).

No more than 25% of the net bond proceeds may be used for purposes related and ancillary to “core manufacturing,” (e.g. on-site short-term storage facilities, test labs, parking lots, office space related to the plant, plant employee areas, loading docks, forklifts and rail spurs).

Proceeds of the bonds used for the acquisition of land must be less than 25% of the bond proceeds.

No proceeds of the bonds may be used to purchase existing facilities (and in certain cases, the equipment within the building), without rehabilitation expenditures equaling at least 15% of the cost of the facility financed with the bond proceeds. In general, the cost of used equipment alone may not be financed with bond proceeds; however, a minimal level of used components may be allowed, if included in otherwise “new” terms.

No more than 3% (5% if issuance costs are self-funded) of the bond proceeds may be used to fund costs, which were paid or incurred prior to the inducement of the project by the issuer of the tax-exempt bonds.

6. \$20,000,000 Capital Expenditure Limit

If the bond issue is over \$1,000,000, the capital expenditure of the borrower, including any principal users (e.g., lessees) of the bond-financed facility, and any related parties thereto which are made in the jurisdiction in which the bond proceeds are spent, may not exceed \$20,000,000 during the 72 month period beginning 36 months before the date of the issuance and ending 36 months thereafter.

7. Tooling

Tooling, purchased by the borrower’s customers and retained and used by the borrower, may result in capital expenditures, which count towards the borrower’s \$20,000,000 limit.

8. The \$40 Million Company Limit

The Internal Revenue Code imposes nationally a \$40,000,000 limit on the aggregate principal amount of outstanding private activity bonds for a firm, its parents, subsidiaries, substantial users of the facility, or any related parties thereto. Additionally, in determining the \$40,000,000 national limit, consideration must be given to the amount of bonds outstanding on any facility where the firm is using more than 10% of the space.

9. Cost of Issuance Limitation

The issuance costs financed by the bond issue may not exceed 2% of the proceeds of the issue. Costs of issuance subject to the 2% limitation include, but are not limited to:

- »Underwriter’s discount
- »Bond counsel fees
- »Financial advisor fees
- »Rating agency fees
- »Trustee fees
- »Printing fees
- »Michigan Strategic Fund fees
- »Paying agent fees
- »Legal Advertisement Charges
- »Accountant fees, feasibility and engineering studies related to the issuance bonds

10. Unified Volume Cap

Congress has empowered the State of Michigan to develop a system for the allocation of the annual unified volume limitation authorized for the issuance of private activity bonds. The Internal Revenue Code limits an issuing authority to a maximum amount of tax-exempt bonds that can be issued to finance a particular qualified purpose during a calendar year. If the volume cap is reached, the Fund may be unable to issue any bonds subject to the volume cap until the next calendar year.

11. Arbitrage Restrictions

Except where the full amount of bond proceeds are expended for the project within six months of the closing of the bond issue, federal law restricts arbitrage yield to no more than 1/8<sup>th</sup> of 1% over the yield of the bonds. Any amounts in excess of this limit must be “rebated” to the federal government at least every five years, subject to a \$100,000 per year debt service fund exemption. Investment must be arm’s length transactions.

Non-purpose Obligations

At no time may amounts invested in non-purpose obligations with a yield higher than the yield on the issue exceed 150% of debt service on the issue for such bond year. The aggregate amount invested at a higher yield must be promptly and appropriately reduced as bonds are retired. An exception is provided for proceeds invested for an initial temporary period and for any amount held in a bona fide debt service fund.

12. Refunding

Current refunding of outstanding bond issues is permitted. Advance refunding (where the outstanding bonds are not paid off within 90 days of the issuance of the refunding bonds) are prohibited for private activity bonds, except for non-profit corporations.

13. Change in Use of Bond Financed Property

A change in use of property financed with a tax-exempt financing to a non-qualified use will generally result in loss of income tax deductions for rent; interest or equivalent amounts paid by the person making the non-qualified use of the property and may result in loss of tax-exemption on bond interest provided under present law.

14. Alternative Minimum Tax

Affects marketability and cost of small issue private activity bonds (and other tax-exempt bonds) by subjecting some holders of tax-exempt obligations to alternative minimum tax.

Prepared by: Michigan Strategic Fund  
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