



# Private Activity Bonds & Industrial Revenue Bonds

PRIMER

## INTRODUCTION TO PRIVATE ACTIVITY & INDUSTRIAL REVENUE BONDS

Tax exempt bonds typically carry a lower interest rate than a rate on commercial corporate bonds. Corporations and nonprofits can borrow money by issuing taxable bonds on their own in the commercial marketplace or they can work with public entities to issue bonds where those bonds can potentially become tax-exempt. These bonds are known as private activity bonds.

A private activity bond is one that primarily benefits or is used by a private entity. The federal tax code classifies state and local government bonds as either governmental bonds or private activity bonds. Governmental bonds have a tax-exempt status. Private Activity Bonds are any bonds where: (i) more than 10 percent of the proceeds is to be used in a trade or business of a person or persons other than a government entity; and (ii) which can be directly or indirectly repaid from, or secured by, revenues from a private trade or business. If a bond “fails” these two tests, it is a governmental bond and the interest on the bond is tax exempt. If a bond “meets” these two tests, it is a private activity bond and interest on the bond is taxable. Taxable bonds typically carry a higher interest rate.

However, if a bond meets these two tests, there are still provisions in the tax code that could qualify them for tax-exempt financing. There are currently 27 activities in the tax code that would allow a project to attain tax exempt status.

Private activity bonds are known as pass through bonds or conduit bonds because the obligation to repay the principal and interest payments rest with the private entity. There are many forms of these bonds such as exempt facility bonds, qualified 501(c)(3) bonds, mortgage bonds, small issue bonds, student loan bonds, and veterans’ mortgage bonds. One of the most well-known forms of private activity bonds are industrial revenue bonds (IRBs), also known as industrial development bonds.

## USE OF INDUSTRIAL REVENUE BONDS/PRIVATE ACTIVITY BONDS

IRBs are among the most popular and cost-effective economic development tools used to incentivize growing businesses to acquire land, buildings and equipment. Typically, IRBs are issued by cities or counties who work with a state authority. Depending on the type of IRB project, the property owners of the bonds can receive subsidies through one of the following: (i) a property tax exemption; (ii) gross receipts tax deduction; (iii) exemption from bond interest on state income taxation; (iv) exemptions of bond interest from federal taxation; or (v) sales tax exemptions for labor and materials purchased on new facilities. Subsidies for IRBs vary state to state and municipalities should work with their municipal advisor and bond counsel to determine what options are available.

There are two permissible types of tax-exempt IRBs used for corporations:

1. Small Issue IRBs are restricted to the construction, expansion, or renovation of manufacturing facilities. They are generally limited to \$1 million, but under certain circumstances can increase to \$10 million.
2. Qualified facility IRBs have no size limits, but they can only be utilized for the 27 activities that are allowable per the tax code.



Some states also utilize taxable IRBs to work around federal government limits on the amount of tax exempt bonds that can be issued. Taxable IRBs are not designed to provide low-cost financing due to lower interest rates; instead, incentives are utilized to offset property, sales, or income taxes for the company.

Municipalities have no backstop or tax guarantee in an IRB issue; the issuer is not considered responsible for repayment of the debt. In IRB financing, the bond issuer acquires ownership of the property financed and leases it back to the business. The lease rentals are then used to repay the bonds. The tax exempt status of the bonds is maintained by the recipient of the bonds.

IRBs are an important tool for municipalities to consider utilizing to achieve positive outcomes for the community. They can help to assist developers with community revitalization or promote economic growth in certain geographic areas of the community.

## QUESTIONS THE FINANCE OFFICER SHOULD ASK ABOUT IRBS/ PRIVATE ACTIVITY BONDS

The finance officer should be prepared to answer the following questions about a proposed IRB:

- » How will the project have a positive economic impact to the community?
- » What is the anticipated method and terms of the borrowing?
- » What impact will the proposed expansion have on the company?
- » Has a cost benefit analysis of the project been conducted?
- » Has a “but for” analysis been completed to determine the financial need of the corporation and whether tax subsidies are needed?
- » What is the stability and viability of the corporation and their commitment to the community?
- » What type of clawback provisions should be included in the contract to ensure the company/property owner meets expectations in job creation?
- » How does an entity maintain its tax exempt status if there is qualified private activity?

## OUTSIDE RESOURCES FOR IRBS/PRIVATE ACTIVITY BONDS

- » Community Development Finance Agencies (CDFA): [www.cdfa.net](http://www.cdfa.net)
- » City of Albuquerque, New Mexico: <https://www.cabq.gov/economicdevelopment/business-owners/services-programs/bonds>
- » City of Olathe, Kansas: <https://www.olatheks.org/government/economic-development/economic-incentive-programs/industrial-revenue-bonds-tax-abatements>
- » City of Springfield, Missouri: <https://www.springfieldmo.gov/657/Industrial-Development-Bonds>

## About GFOA

The Government Finance Officers Association (GFOA) represents approximately 20,000 public finance officers throughout the United States and Canada. GFOA's mission is to promote excellence in state and local government financial management. GFOA views its role as a resource, educator, facilitator, and advocate for both its members and the governments they serve and provides best practice guidance, leadership, professional development, resources and tools, networking opportunities, award programs, and advisory services.