

## INTRODUCTION TO “TAXABLE FLOATERS”

- Finance Any Project or Asset
- Obtain Lower Interest Rates than Conventional Loans
- Obtain Longer Terms than Conventional Loans
- Raise Any Amount of Capital

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## INTRODUCTION TO “TAXABLE FLOATERS”

To understand “taxable floaters,” think about the interest that these bonds bear. The interest is not exempt from federal income taxation. Another characteristic is that the interest floats, or varies, periodically. In fact, lower floaters are formally known as “variable rate demand bonds.”

Even though the interest is not federally tax exempt<sup>1</sup>, it is lower than a standard term loan, for example. The lower interest rate stems from the structure of this type of financing. The bonds are secured by a bank letter of credit that is investment grade<sup>2</sup>. The interest rate adjusts to reflect market rates periodically, usually weekly. The bondholder may tender the bonds and get back the principal and interest on 7 days notice. All of these factors result in a very low interest rate.<sup>3</sup>

The borrower may redeem (prepay) the bonds at any time, without penalty.

The bonds are sold into the capital markets for short-term taxable obligations, such as a taxable money market fund. The bonds are marketed, or placed, by an underwriter, or placement agent.

The interest rate on the bonds is generally priced at a spread to 30-day LIBOR. “LIBOR” is the London Interbank Offered Rate, quoted daily in the Wall Street Journal.

The borrower in Georgia and many states cannot obtain property tax<sup>4</sup>, cash or in-kind incentives for a project unless a public body like a development authority issues bonds for the borrower in a sale-leaseback structure; *i.e.*, the public body holds title to the project and leases it back to the borrower. Taxable floaters, issued by a public body like a development authority, can fill this need.

On the other hand, the borrower itself, or a special purpose entity owned by the borrower, can issue the bonds, rather than a development authority or other public body. If a development authority issues the bonds, they are industrial development revenue bonds. If the borrower (or its SPE) issues the bonds, they are corporate or company bonds.

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<sup>1</sup> The interest on bonds that are issued through a development authority is exempt from state income taxation. Federal income taxation always applies to the interest on taxable floaters.

<sup>2</sup> Ratings are assigned by nationally recognized organizations such as S&P and Moody’s.

<sup>3</sup> The interest rates on tax-exempt bonds is usually even lower, of course. The focus of this White Paper is on financing through taxable bonds. For more information on tax-exempt financing, please refer to our White Paper, “Bond FAQ’s.”

<sup>4</sup> There are limited exceptions, not of general interest.

The schedule for the financing is faster, and transaction costs are lower, if the issuer is the borrower (or its SPE). On the other hand, issuance through a public body, such as a development authority, may be necessary in order for the borrower to obtain the incentives mentioned above.

Taxable floaters can be issued to finance any type of fixed asset, as well as certain current assets.

For example, suppose a company wishes to finance a distribution center with related capital expenditures comprised of \$17.5 million for the building, \$1.95 million for the land, and \$40 million for the machinery and equipment. All of these capital costs qualify for taxable floater financing, either through corporate or company bonds issued by the company, or through industrial development revenue bonds issued by a development authority.

If a borrower wished to finance a project that the local development authority was not authorized to finance (such as certain recreational projects), then corporate or company bonds could always be used. For example, a creditworthy Georgia resort company recently issued \$100 million in corporate taxable floaters, secured by an investment grade bank letter of credit, to finance or refinance a variety of corporate projects, including a resort.

Although it would qualify for financing through a development authority, a distribution center is an example of a type of project that would not qualify for financing that is tax-exempt. This is because of the limited types of projects that can satisfy the applicable federal income tax rules. For example, in the distribution center example above, not only is the project not a manufacturing project (that might be qualified for financing through tax-exempt “small issue” industrial development revenue bonds), but the project’s capital expenditures exceed the \$20 million limit (of which up to \$10 million could be represented by tax-exempt bonds) applicable to “small issue” manufacturing IDBs. Nevertheless, the project is financeable through taxable floaters, at rates which presently are quite comparable to tax-exempt rates.

Suppose the same distribution company wished to convert its revolving line of credit, secured by its inventory and receivables, into a term loan. Taxable floaters are an alternative means of financing the same need, on terms that are usually better. This illustrates the flexibility of taxable floaters as to the types of corporate needs that may be financed using this technique.

The one indispensable requirement for taxable floater financing is the letter of credit needed to secure the bonds. This is a “direct pay” letter of credit, which is expected to be, and will be, drawn on to pay interest and principal on the bonds. The market for these bonds requires that the letter of credit must be investment grade. Unless the bonds are privately placed, for securities law reasons the letter of credit must be issued by a commercial bank.

Any bank can issue a letter of credit. Suppose, however, that the borrower’s existing bank relationship is with a smaller bank whose letters of credit are not investment grade, such as a community bank. In that case, the borrower may continue to use its existing bank, while obtaining the necessary investment grade rating for the letter of credit.

From a larger, rated bank, the borrower can obtain either a confirmation of the smaller bank's letter of credit, or alternatively a "wrap" letter of credit, either of which supports the bonds with the larger bank's credit. The borrower and the unrated bank will be obligated, under a reimbursement agreement with the larger bank, to repay any amounts paid by the larger bank under its confirmation or letter of credit, plus (when applicable) interest. The larger bank will, however, add its own fees. These will affect the all-in pricing, or cost to the borrower of the financing.

The unrated bank, if it is a member of the Federal Home Loan Bank, may have its letter of credit enhanced by the FHLB's confirming it or providing a letter of credit.<sup>5</sup> Bonds secured by an FHLB confirmation or letter of credit qualify for rating at the FHLB's credit rating, which is typically the highest investment grade rating, Aaa/AAA. The FHLB's annual fee for providing the confirmation or letter of credit is small. Moreover, the Aaa/AAA rating favorably impacts the interest rate on the bonds.

A project's owner, such as a real estate developer, can sell the project to a buyer who could continue the taxable floater financing structure. This is because the bond documents for taxable floaters can provide for the substitution of a qualified letter of credit from another bank while the bonds are outstanding. The buyer would simply provide an acceptable letter of credit, resulting in the release of the seller from its obligations related to its own letter of credit.

As a final note on this structure, some borrowers are interested in fixing the interest rate on these variable rate financings. It is possible, of course, to issue fixed-rate taxable bonds secured by a bank letter of credit. A better interest rate is usually obtained if the bonds are issued as taxable floaters, and the borrower synthetically "fixes" the interest rate through an interest rate "swap." A "swap" is a type of derivative security<sup>6</sup>. With a "floating to fixed" swap, the borrower pays a fixed rate of interest to a counterparty, who in turn pays a floating rate of interest to the borrower. Private companies, as well as public sector borrowers, are increasingly entering into swaps. Prudent borrowers will carefully analyze the issues connected with using swaps.

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<sup>5</sup> Because of the IRS' position on certain issues, this credit enhancement technique should only be used when the bonds are taxable bonds, as opposed to tax-exempt bonds.

<sup>6</sup> Other types of derivatives, such as caps, are available and can often be more cost-effective than swaps. When tax-exempt bonds are used for financing, bond counsel should be consulted before the borrower enters into a derivative product such as an interest rate swap, because of related issues under the federal income tax rules.

This paper is a quick-reference guide for company executives and managers, economic developers, participants in the real estate and financial industries, and their advisors. The information in this White Paper is general in nature. Various points, which could be important in a particular case, have been condensed or omitted in the interest of readability. Specific professional advice should be obtained before this information is applied to any particular case. Any tax information or written tax advice contained herein (including any attachments) is not intended to be and cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer. (The foregoing legend has been affixed pursuant to U.S. Treasury Regulations governing tax practice.)

Additional information concerning this topic, as well as White Papers and references on other topics, can be found at <http://danmcrae.info/>.

If you have any questions or comments, we would be pleased to provide more information. Please contact:

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