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“USING BONDS TO BUY BUSINESS ASSETS”

**Use This Legal Product,
Tax-Exempt Industrial Development Revenue Bonds,
To Finance Asset Acquisitions
At the Lowest Interest Rates Possible**

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USING BONDS TO BUY BUSINESS ASSETS

Introduction

Federally tax-exempt “small issue” industrial development bonds (“IDBs”) can be used to purchase an existing manufacturing facility under certain circumstances. Tax-exempt financing can provide interest cost savings of 25% to 35% over comparable conventional financing.

Structuring the Transaction

There are certain limitations which apply to the use of tax-exempt “small issue” financing for used facilities. The transaction must be structured as an asset acquisition (or be treated as such for federal income tax purposes) and seller and purchaser cannot be related persons or entities. Thus the property involved cannot be property that the company or a related person or entity already owns, because that would not be viewed as an acquisition. Further, the property involved cannot be property that the company is leasing under a capital lease, because under the federal tax law, the company would be deemed to be the tax-owner of the leased property. In a case where a company is leasing a facility under a true lease (an operating lease) and wants to do a bond financing to purchase the property, tax-exempt bonds could be used to purchase the property, provided that (1) the company or a related person or entity does not receive 5% or more of the bond proceeds for its prior interest in the property (such as a payment with bond proceeds in termination of its leasehold interest or a payment with bond proceeds to reimburse it for leasehold improvements that it may have made to the property) or (2) if more than 5% is received, the exceptions in the following rule must apply. The rule states that the bonds will not be tax-exempt in a case where the original use of the facility begins before the issue date of the bonds, if any person that was a substantial user (a 5% user) of the facility at anytime during the 5-year period before the issue date or any related person to that user receives (directly or indirectly) 5% or more of the proceeds of the bond issue for the user’s interest in the facility and is a substantial user of the facility at any time during the 5-year period after the issue date, unless: (a) an official intent (i.e., an “inducement resolution”) for the facility is adopted within the 60 days after the date on which acquisition, construction, or reconstruction of that facility commenced; and (b) for an acquisition, no person that was a substantial user or related person after the acquisition date was also a substantial user more than 60 days before the date on which the official intent was adopted.

The IDB’s must comply with the requirements of the Internal Revenue Code relating to “exempt small issue” private activity bonds. The bond issue must meet the following tests: at least 70% of proceeds must be allocated to core manufacturing facilities; not more than 25% may be allocated to directly related and ancillary facilities; and not more than 5% may be allocated to other purposes and only 2% (which is a part of the 5%) can be used to pay issuance costs. Not more than 25% of the proceeds can be expended on land and not more than 10% can be placed in a debt service reserve. For IDB’s exceeding \$1 million in amount, the amount of the IDB’s may not exceed \$10 million and the total amount of such IDB’s plus other relevant capital

expenditures within the applicable jurisdiction over the six-year test period (3 years prior to and 3 years after the issue date of the IDB's) must not exceed \$20 million. There are other requirements, as well.

The "Rehabilitation" Requirements

The most notable requirement with respect to the acquisition of an existing facility is the "rehabilitation" requirement. In the case of purchased buildings (and equipment therein) an amount equal to at least 15% of the amount of the proceeds of bonds that are used to purchase the building (and equipment therein) must be spent on rehabilitation expenditures. A similar rule applies for structures other than buildings, substituting 100% for 15%. Used equipment which is not acquired with a related building may not be financed with proceeds of tax-exempt IDB's. Rehabilitation expenditures consist of any additions (but not to enlargements to) or improvements to an acquired building which are chargeable to the borrower's capital account and also include the acquisition of new fixtures. With respect to equipment which is acquired with the building, rehabilitation expenditures include the rehabilitation of existing equipment or the replacement of existing equipment with equipment performing similar functions. The rehabilitation expenditures have to be made within two years after the facility is acquired, or, if later, two years following the date the IDB's are issued. It is not required that the costs of rehabilitation be paid with bond proceeds; the proceeds of the bonds can all be used towards the acquisition of the facility and do not have to be, but may be, applied towards the rehabilitation costs.

If the percentage of rehabilitation expenditures is expected to be less than 15% of the total purchase price of the existing facilities, the amount of the IDB's can be reduced in order to achieve compliance. For example, assume a company wishes to purchase a \$9.9 million facility with \$1 million being allocable to land and \$8 million being allocable to the building and equipment, and plans to spend \$900,000 for qualifying rehabilitation expenditures. The company could issue \$7.9 million in tax-exempt IDB's and apply \$1 million to land and \$6 million to the building and equipment therein and \$900,000 (15% of \$6 million) to rehabilitation expenses. The remaining \$2 million could be paid for with equity, financed on a conventional basis or financed with an issue of taxable IDB's (which can be issued simultaneously with the tax-exempt IDB's under the same bond documents).

Interim Financing

As soon as the decision is made to proceed with the project, the company should arrange for the adoption by the development authority, of an "inducement resolution" (which would include an "expression of intent" providing for the use of bond proceeds to reimburse project costs incurred and paid prior to the issue date of the IDB's). After that, the company could immediately purchase the project with its own funds or with proceeds of an interim loan. When the tax-exempt IDB's are subsequently issued, the proceeds of the bonds can be applied to reimburse the company or "take-out" the temporary financing. With certain exceptions, bond proceeds cannot be used to reimburse original expenditures made earlier than 60 day prior to the expression of official intent. Under the *de minimis* exception an amount not in excess of the

lesser of \$100,000 or 5% of the proceeds can be used for earlier expenditures. In addition, an amount not in excess of 20% of the issue price of the bonds may be used to reimburse certain preliminary expenditures, such as architectural, engineering, surveying, soil testing, and issuance costs that are incurred prior to the commencement of the acquisition, construction and rehabilitation of the project, other than land acquisition, site preparation, and similar costs incident to commencement of construction. In general the reimbursement must be made not later than 18 months after the later: of: (a) the date the original expenditure is paid; or (b) the date the project is placed in service or abandoned, but in no event more than 3 years after the original expenditure is paid.

Conclusion

Because it is quite common to make capital improvements and to replace equipment in due course following an acquisition of a manufacturing operation, which would tend to satisfy the “rehabilitation” requirement anyway, the use of tax-exempt financing to acquire an existing manufacturing facility should always at least be considered.

More Information

This White 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://danmcræe.info/>.

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

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