What Are Tax-Exempt Bonds

By Richard Harmon

MANY ORGANIZATIONS SEEKING TO borrow money for a major project are familiar with conventional bank debt or other forms of taxable debt that are based on taxable interest rates such as the prime rate or the London Interbank Offered Rate (LIBOR), which is established daily by the British Bankers Association. However, nonprofit entities – specifically 501(c)(3) organizations such as K-12 schools and church-sponsored schools – can utilize tax-exempt bonds to finance eligible construction, acquisition, renovation, expansion and equipment projects. Further, tax-exempt bonds can be utilized to refinance existing construction loans or mortgages associated with eligible projects.

Tax-Exempt Bond Basics

Tax-exempt bonds are securities issued by a school to fund the cost of a project. They generally bear interest rates that are 20 percent to 40 percent lower than other sources of capital such as a conventional bank loan. Why is there such an interest rate advantage for the borrower? Investors in tax-exempt bonds generally have significant income which is subject to income tax, and these investors are seeking ways to lower their tax bills. They are willing to accept lower interest rates on tax-exempt bonds as, in most cases, federal income tax is not paid on the interest received, and, in many states, tax-exempt bonds are free from state and municipal income taxes as well. As a result, investors pass-on these savings in the form of lower bond coupon rates to the borrower.

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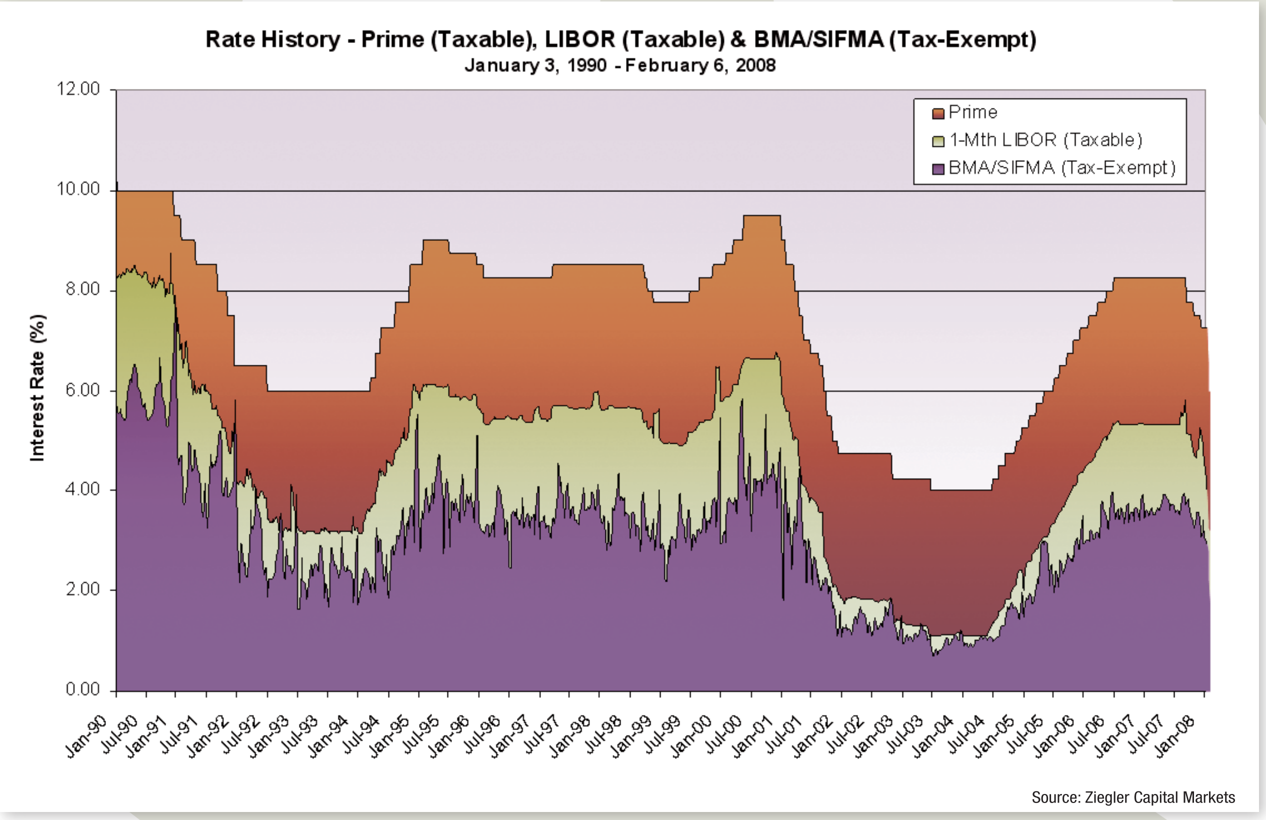

While tax-exempt bonds are not a fit to fund every type of project, borrowing costs that can be 20 percent to 40 percent lower than conventional financing provide a great incentive for private schools to explore borrowing on a tax-exempt basis.

To illustrate the various historic interest rates and their relationships, the chart at top compares three different rates, each reflecting interest rates that are used for conventional bank loans, and taxable and tax-exempt bond issues during an 18-year period from January 1990 through February 2008. During this period, the prime rate averaged 7.28 percent, while one-month LIBOR averaged 4.54 percent – both taxable rates. Comparatively, the SIFMA index, which represents a weekly (seven day) high-grade market index comprised of approximately 650 active tax-exempt variable rate demand bonds in any given week, has averaged 3.10 percent.

From a relational standpoint, the tax-exempt SIFMA rate (in blue) has been on average 42.61 percent and 68.31 percent of the prime and LIBOR average rates during this period, representing significant interest expense savings for 501(c)(3) organizations seeking to finance and refinance eligible projects.

The lower interest cost with tax-exempt-based borrowing provides obvious benefits. A lower interest rate allows most borrowers to qualify for a higher loan size, which allows for projects to be fully funded, and closes potential funding and timing gaps associated with construction projects and capital campaigns. Further, tax-exempt financings allow for 501(c)(3) organizations to expand their missions by allowing projects to be completed more quickly and cost effectively, creating the opportunity for interest savings to be redeployed for mission and program enhancement, and expansion.

Borrow tax-exempt and taxable if needed, pay off the taxable debt first

Mike Melliere's article, "Can our school project qualify for tax-exempt finance?" discusses what type of church-school projects qualify for tax-exempt financing. To summarize, some faith-based schools may have components of their projects that are not eligible for tax-exempt bonds. In that case, a taxable series of bonds can be issued to specifically fund the non-eligible projects (i.e. dedicated worship space). In such cases, the taxable bonds can be structured to be paid either along the same terms as the tax-exempt bonds or on an accelerated basis; whereby, the higher interest rate taxable bonds are paid first, and repayment of the tax-exempt bonds is deferred until the higher interest rate taxable bonds are extinguished. In either case, the taxable bond interest rate, which is typically lower than the prime rate, is blended with the tax-exempt interest rate, resulting in an overall cost of capital that is still materially lower than conventional bank debt or other forms of taxable debt, depending on the balance of taxable to tax-exempt bonds.

An additional benefit of tax-exempt bonds results from the natural "hedge" that can occur for those organizations with reserves and endowments – or for those endeavoring on a capital campaign whereby the funds are invested in more traditional investments pursuant to the organization's investment policies (generating yields at least equal to or higher than the tax-exempt bond interest rate being paid). This is especially apparent with organizations that have issued tax-exempt variable rate bonds, as the costs of the financing will rise and fall in much the same way as investment returns. This "hedges" interest rate risk, as the economic impact of changes in tax-exempt interest rates are offset by changes in investment earnings. For in-depth information about these strategies, see Lynn Daly's article, "Project Finance: Borrow or Use Cash?".