WHAT ARE TAX-EXEMPT BONDS?
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TAX-EXEMPT BOND BASICS

Most borrowers embarking on a major project are familiar with conventional bank debt or other forms of debt or loans that are based on taxable interest rates such as the Prime Rate or the London Interbank Offered Rate (LIBOR). However, nonprofit entities – specifically 501(c)(3) organizations such as Charter Schools, 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 bonds are securities issued by a school to fund the cost of a project. They generally bear interest rates that are lower than other sources of capital such as a conventional bank loan or even taxable bonds. 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.

A good way to look at this is from the perspective of an investor in tax-exempt bonds. An investor holding a bond that has 5.00% coupon rate in the top marginal federal tax bracket of 39.5% is receiving an effective return of 8.26% on their investment. That yield can go even higher should the bond be exempt from state taxes, as some charter school bonds are. So you can see how the tax-exempt bond is a "win-win" for both investor and borrower. The borrower pays only 5.0% interest and the investor in this case has a return north of 8.0%. The Federal (and sometimes State) Government picks up the difference in the form of lost tax revenues.

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 charter schools and other 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.

HOW DO OUR BONDS QUALIFY AS "TAX-EXEMPT"?

For bonds to be classified as Tax-Exempt, they must be issued by a governmental subdivision or authority that is authorized to issue such bonds. An example of this might be your local municipality or could be a specialized state agency such as a redevelopment or educational facilities authority. An underwriter such as Ziegler can help you locate a proper issuing authority for your project.

The authority or agency that issues your bonds will then loan the proceeds to your school, with the authority acting as a conduit. Your local taxpayers are not obligated on any of the bonds. Your School is solely responsible for repayment of the debt according to the terms of the bonds. The authority involved simply allows the bonds to be classified as tax-exempt, as set forth in an opinion provided by a law firm that prepares the documents (the law firm being known as the "bond counsel").

CAN ANYTHING BE FINANCED TAX-EXEMPT?

Typically tax-exempt bond proceeds can be used for construction of school facilities, including the acquisition of land, architectural fees, soft costs and furniture, fixtures and equipment. Tax-exempt bonds are not available to fund items like working capital or other non "land, brick and mortar" costs. Additionally, tax-exempt bonds generally are not able to be used to fund projects where the main purpose of the building is for either private use by a for-profit entity or buildings used for religious worship purposes.

If your organization decides to embark on a project while using your own cash before issuing tax-exempt bonds, it is important that your board of directors pass a "reimbursement resolution" in which you note that you might choose to spend your cash to later have such funds reimbursed with borrowing proceeds from tax-exempt bonds. Typically you are not allowed to reimburse yourself for project funds spent more than 60-days prior to passing a reimbursement resolution. Regardless of whether you end up issuing tax-exempt bond or not, passing a reimbursement resolution does not cost anything and is a wise idea to do early on in the process.

HOW LONG DOES THIS PROCESS TAKE?

The underwriting process can take from 60-90 days from start to finish. Ziegler can help you with a turn-key process to ensure a successful underwriting.

We encourage your organization to seek out a partner like Ziegler early-on in the process to learn more about tax-exempt bonds. For more information please email us at srolfs@ziegler.com or call us at 800-558-1776, ext 6576 for more information.