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A COMPREHENSIVE STUDY OF INDUSTRIAL DEVELOPMENT REVENUE BOND FINANCING

by

Douglas F. Bovard

Master of Business Administration

in the

Finance Program

Gerald E. Smolen — December 3, 1979
Adviser — Date

Leon Rand — December 11, 1979
Dean of the Graduate School — Date

YOUNGSTOWN STATE UNIVERSITY

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ABSTRACT

A COMPREHENSIVE STUDY OF
INDUSTRIAL DEVELOPMENT REVENUE BOND FINANCING

Douglas F. Bovard
Master of Business Administration
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The major objective of this study is to give a concise explanation of a type of financing which is widely used, yet understood by only a few. Much has been written on the historical background as well as the legal and economic impact of industrial development revenue bonds. Few studies, however, have explored the rather complicated financing process involved in an industrial development revenue bond issue. In this study, the financing process is thoroughly explained and outlined on graphics.

This study provides a service, also. It incorporates all the necessary information for the owner of a small business who needs the advantages provided by industrial development revenue bond financing. The study pertains particularly to businessmen in Mahoning County, Ohio. It focuses on this type of financing in Mahoning County and explains the financing process in Ohio as specified by the Ohio Revised Code. Furthermore, the study highlights the important rules of the Internal Revenue Code Section 103 and Regulation 1.103-1-15.

Because industrial development revenue bonds are

issued by a government entity, they are tax-exempt and provide a low cost of capital for a small company. The restrictions of Code Section 103 limit the size of the issue; therefore, these bonds are used primarily by small companies. Other public-purpose bonds are free from such limitations.

In the final chapter, this study presents some important financial and tax considerations involving industrial development revenue bond financing. In their rush to use tax-free funds, both bond users and investors have overlooked some important details. Finally, this study will explore some critical issues which will no doubt affect the future of industrial development revenue bond financing.

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CHAPTER I

THE BACKGROUND OF INDUSTRIAL DEVELOPMENT REVENUE BONDS

The Definition and Purpose of Industrial Development Revenue Bonds

Very simply defined, industrial development revenue bonds (IDRB's) are a company's use of a government's ability to issue tax-free obligations.[1] These bonds are a special type issued in the municipals market.[2] Because they are revenue bonds, they are secured only by the earnings and the assets of the company using them. Contrary to popular belief, IDRB's are not secured by the credit and taxing power of the issuing government entity. The company is not subject to operating rules and regulations by the government entity issuing the bonds. Thus, if the project fails, the bondholder--not the government--suffers the loss. Wise investors

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[1]"A Little-Known Financing Bargain," Industry Week, March 24, 1975, p. 88.

[2]The market for tax-exempt bonds is known as the "municipals market," although it includes obligations of not only municipal but state governments, county governments, and other government-affiliated agencies and projects. These bonds are usually classified in categories based on the sources of funds for their payment, as general obligations, revenue bonds, or special types (mortgage revenue bonds, industrial development revenue bonds, pollution-control bonds, and arbitrage bonds).

simply consider these bonds tax-exempt corporate securities.

In the past, a few industrial development issues were of the general-obligation type. These bonds pledged the credit and taxing power of the issuing government entity. In common parlance, the term industrial development bond is used to mean either a general-obligation or a revenue-type bond. However, very few recent industrial development issues have been of the general-obligation type. Therefore, the focus of this study will be on tax-exempt revenue bonds issued by governments for industrial users.[3]

IDRB's are a form of lease-rental financing. Typically, the bonds are sold by the government entity in order to purchase land, plant, and equipment for a company. These fixed assets are purchased according to the company's specifications. Purchases are paid from a fund monitored by a trustee bank. The assets are then leased to the company for a period of time sufficient for rental payments to cover the principal and interest on the bonds. In case of a default, the company (a tenant) is subject to eviction. However, when the interest and principal are paid, the company can purchase the assets for a nominal sum.

The primary purpose of industrial development bonds is to attract new industries to areas by offering lower costs

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[3]Some distinction must be made between the financing of industrial users and the financing of non-industrial users. Some states use general-obligation industrial development bonds to finance schools and other public buildings. This study will deal primarily with revenue-producing industrial users.

than would be available to the borrower through traditional methods of corporate-bond financing. Since IDRB interest is exempt from Federal income taxes, local governments are usually able to borrow funds in the capital markets at interest rates lower than those available to private borrowers.[4] In addition to attracting new industries, these bonds are widely used to aid expansion of existing industry.

The History of Industrial Development Revenue Bonds

Before the 1850's, large-scale borrowing by local governments occurred rather infrequently. Local borrowing for railroads and canals often resulted in defaults and, in some cases, repudiation by the issuing government. This led to restrictions and laws imposed by the states. The recession of 1870 brought on more defaults and more restrictions.[5]

Economic growth in the 1890's spurred a new demand for funds. Legislators and courts began to take a more liberal view toward government indebtedness. Revenue bonds came into existence early in 1890 when Spokane, Washington issued revenue bonds to finance construction of needed utilities. Thereafter, revenue bonds were used to finance

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[4]Joint Economic Committee, State and Local Public Facility Needs and Financing, II (Washington: Government Printing Office, 1966), p. 162.

[5]Mark Rollinson, Small Issue Industrial Development Bonds (Chicago: Capital Publishing Corporation, 1976), p. 10.

bridges, hospitals, courthouses, and other revenue-producing but essentially public facilities.[6]

Ironically, the Great Depression served as the impetus for the creation of industrial development bond financing. Southern states were particularly hard hit by the depression. A decline in the demand for agricultural products and the virtual nonexistence of industry compounded the problem of economic recovery. Most southern states lacked access to large financial institutions and private sources needed in order to finance new industrial facilities. Therefore, in 1936, Mississippi established its Balance Agriculture with Industry Program.[7] The legislature declared that industrial employment was in the public interest, and that cities and counties could incur general obligation indebtedness to construct industrial buildings for lease to private enterprises. The Supreme Court of Mississippi agreed with the legislature and approved the use of general obligation bonds issued by a local government to be used for industrial development. The decision was appealed to the United States Supreme Court which took the position that no substantial federal question was involved. Thus, Durrant, Mississippi issued $85,000 in bonds for construction of a factory for Realsilk Hosiery.[8]

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[6] Ibid.

[7] The Advisory Commission on Intergovernmental Relations, Industrial Development Bond Financing, (Washington: Government Printing Office, 1963), p. 53.

[8] Rollinson, Industrial Development Bonds, p. 16.

Industrial bond financing did not become widely accepted immediately. By 1950 only Mississippi and Kentucky authorized its use. A significant development occurred in 1950 when Kentucky Court of Appeals upheld the State's use of revenue bonds for industrial development. The Kentucky case spurred the growth of industrial development revenue bond financing. By 1963, twenty-five states had authorized industrial development revenue bonds. By 1973, forty-six states reported issuing these bonds. Currently, all states and Puerto Rico have enacted legislation to issue industrial development revenue bonds.[9]

Early growth of these bonds remained primarily in the southern states. Their use provided locational incentives for industry. The continued exodus of business from northeastern and midwestern states prompted these states, also, to enact legislation for IDRB financing.[10]

This growth was met by opposition from many sources. Legal rulings, opinions, and legislation have greatly affected and restricted IDRB financing. The lag between the creation of this financing and the heavy use of it was caused by the uncertainty of its legality and ultimate effects. In many states, a constitutional amendment was necessary to

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[9]Ibid.

[10]"A Counterattack in the War Between the States," Business Week, June 21, 1976, p. 74.

permit IDRB financing.[11]

In 1951 the Investment Bankers' Association publicly stated opposition to IDRB financing. Until 1960, few investment houses would underwrite IDRB's. Large financial institutions excluded them from their portfolios. Usually, the bonds had to be purchased by small local banks and individuals within the community.[12]

As recently as 1959, the Advisory Commission on Intergovernmental Relations discussed some potential problems relating to IDRB financing.[13]

Despite these problems and criticisms, IDRB financing grew steadily during the sixties. A major factor which led to a wider market for IDRB's was their increasing use by large, nationally known firms with excellent credit ratings. The good credit ratings contributed to greater investor acceptance.[14]

A second factor which contributed to greater investor acceptance was the classification by the Internal Revenue Service of the status of tax-exempt industrial development bond financing. It was clear that obligations of states and their political subdivisions were exempt from taxation. A 1954 ruling certified that this privilege extended to revenue bonds and bonds of municipally owned corporations, regardless

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[11]Daryl A. Hellman, <u>State Financial Incentives to Industry</u> (Lexington, Mass.: D. C. Heath and Co., 1976), p. 6.

[12]<u>Ibid</u>., p. 7. [13]<u>Ibid</u>. [14]<u>Ibid</u>., p. 10.

of the purpose of the bond issue.[15] A 1957 ruling stated that bonds issued by an industrial development board authorized by a state would be considered an issue by a political subdivision of the state and, therefore, would be tax-exempt.[16]

The strongest positive impetus was provided in a 1963 ruling which allowed nonprofit corporations, under certain specified circumstances, to issue tax-exempt industrial bonds.[17] The ruling enabled municipalities to utilize IDRB financing even though their states might not have granted legislative authorization. This led to the rapid growth of IDRB financing between 1963 and 1967, and the tremendous growth in 1968.

In 1969, two governmental actions sharply reduced IDRB financing. The first, and most important, was contained in an amendment to the Revenue and Expenditure Control Act of 1968 which limited federal income tax exemption on the interest payments of IDRB's to those issues of one million or less.[18] Large issues by major corporations were eliminated by this provision. Undoubtedly, this was the major reason

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[15]Rev. Rul. 54-106.

[16]Rev. Rul. 57-187.

[17]Rev. Rul. 63-20.

[18]Section 107 of the Revenue and Expenditure Control Act of 1968, passed in June by the second session of the 90th Congress.

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why the government curbed the growth of IDRB financing.[19]

With the absence of controls, large corporations were having enormous issues floated in order to finance plants and equipment. The four major bond issues of 1967 reflect this growth. They were:[20]

Corporation	Amount
1. Litton Industries, Inc.	$130,000,000
2. Revere Copper and Brass, Inc.	97,000,000
3. U.S. Plywood-Paper, Inc.	85,000,000
4. Armco Steel Corporation	83,500,000

The stampede by large corporations into IDRB financing undoubtedly caused the U.S. Treasury Department to fear enormous future losses of tax revenue. Critics renewed their attack on IDRB financing and the issue limitations followed.

However, many small local governments objected to the new restrictions. After considerable lobbying by nonfederal governmental bodies, Congress modified the law which, in effect, allowed a state or local government, or a nonprofit development corporation, to provide tax-exempt financing of up to one million dollars to a firm without restrictions on capital spending, or a tax-exempt issue of up to five million dollars with the restrictions on capital spending.[21] In 1979, the dollar amount on the restricted issue was raised to ten million dollars.

The second action which slowed IDRB growth was an

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[19]Alan Rabinowitz, Municipal Bond Finance and Administration (New York: John Wiley and Sons, 1969), p. 104.

[20]Ibid., p. 105.

[21]Hellman, State Financial Incentives, p. 10.

administrative ruling by the SEC requiring IDRB issues of more than $300,000 to be registered with the SEC and to be subject to all regulations applicable to issues of a corporate security. The regulations also created additional legal and underwriting expenses, and the registration requirements were very expensive, particularly for small businesses.[22]

Through the use of "industrial mortgages," the State of Pennsylvania bypassed the adverse effects of the SEC rulings. These special issues were privately placed with one or a few buyers, typically with banks. Thus, the underwriter was not used.[23] Currently, a similar process is used for small-issue IDRB's.

In 1970, the SEC registration requirement was dropped. Congress enacted a provision that IDRB's which satisfy tax-exemption requirements are exempt also from SEC requirements.[24] This new provision enhanced the importance of the legal opinions of bond counsels.

By 1970, the total volume of IDRB's had dropped considerably. The seventies saw a more conservative growth pattern for these bonds. However, specific provisions in the Revenue and Expenditure Control Act allowed new uses for IDRB financing. For example, certain types of facilities qualified for an unlimited dollar amount per bond issue.

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[22] Ibid., p. 11.

[23] Ibid.

[24] Ibid.

The facilities of greatest importance to industry, as well as public utilities, were those of "air or water pollution-control facilities."[25]

The environmental legislation of the seventies created financing needs for companies responsible for constructing pollution-control equipment. For many large companies, "pollution-control revenue bonds" have provided low-cost financing for pollution-control equipment.[26]

However, environmental legislation tends to burden small businesses. Large companies, in contrast, have the advantage of staff legal counsel and good credit rating, facilitating their issuance of tax-exempt bonds. In order to help small businesses, the Federal government in 1976 passed a bill giving the Small Business Administration (SBA) the authority to guarantee pollution-control revenue bonds. Thus, a small business bond issue can, in effect, earn an AAA rating like the bonds of Exxon and General Motors. Furthermore, the law allows companies to make up a combined issue which often can make an attractive package to large institutional investors.[27]

The SBA program is not without problems or costs.

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[25]Barry W. Huff, "Financing with Industrial Development Bonds," Public Utilities Fortnightly, Vol. 96, No. 1 (July 3, 1975), p. 32.

[26]Ibid.

[27]"Now Small Business Can Pay Its Pollution Tab," Business Week, Nov. 21, 1977, p. 90.

Each small business must pay the SBA a fee of 3½ per cent of the total principal and interest. Also, the application process is tedious and expensive.

Evidence indicates that most of the small businesses have found the financing benefits worth the effort involved in the lengthy application process. The SBA has been working on streamlining the process.[28]

In 1977, the Treasury Department became critical of advanced refundings of large bond issues made prior to the 1968 restrictions on tax-exempt financing.[29] Typically, a local government floats a new tax-exempt bond issue to refund an old one that has not yet matured and may not even have a call provision. Refunding the bonds at lower interest rates gives the bonds a lower yield and stretches out the maturity. In some cases, the trustee holding the refunding money then invests it in taxable issues with a higher yield; but the governmental unit pays no tax on that yield. Therefore, in August of 1978, the Treasury Department forbade refunding of large issues made prior to the 1969 restrictions. The result was a rush to the marketplace in advance of the August deadline. The August market volume of IDRB refinancing swelled to $6 billion.[30]

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[28] Ibid.

[29] "Blow to Revenue Bonds," Chemical Week, Nov. 16, 1977, p. 20.

[30] Ibid.

Recently, other limit-free IDRB's have made interesting news. Another specific provision allows the construction of public docks, warves, terminals, or ports to be financed by an unlimited dollar amount of IDRB's.[31] A noteworthy example is the IDRB financing of a deepwater port under construction off the Louisiana coast. This bond issue became the largest dollar volume IDRB issue to reach the market.[32] The Louisiana Offshore Oil Port, Inc. (LOOP) required $450 million in tax-exempt IDRB's. The port will be owned by five oil companies. Perhaps the public purpose will be served by the 10-to-15-cents-per-barrel of oil which will be saved through the new efficient process created by their port. For investors, these bonds should be particularly attractive. Basically, the bonds are backed by oil. The port owners have agreed to ship enough oil through the port so that revenues generated by these shipments, together with the revenue collected from other port users, will be enough to pay its debt service and operating expenses.[33]

Another limit-free type is being pioneered by W. James Lopp II, a vice-president of E. F. Hutton and

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[31]Section 103(c) of the Internal Revenue Code.

[32]For this enormous bond issue, the project's bond counsel asked for, and received, a ruling from the U S. Treasury Department. The Treasury Department declared that this was a necessary project and was in the public interest. Also, the companies asked for, and received, a determination letter from the Treasury Department.

[33]"A Tax-Exempt Issue Backed by Oil," Business Week, August 28, 1978, p. 92.

Company. Lopp's latest project involves the financing of residential real property through a type of IDRB called a residential mortgage revenue bond. This scheme, used to date by officials in Chicago, Denver, and Pueblo, Colorado, uses a municipality to issue tax-exempt bonds in order to finance low-rate mortgages for middle-income home buyers.[34] These bonds are used by non-industrial users, even though they are defined by law as a type of IDRB.[35] Recently, a mortgage revenue bond issue raised $86 million for a community near New Orleans, Louisiana. Local residents who qualify can borrow money at a 7.625 per cent interest rate, while commercial lenders charge about 11 per cent.[36]

Officials from the Treasury Department have been critical of mortgage revenue bond financing. Donald E. Lubick, Assistant Treasury Secretary for tax policy stated:

> This type of financing undermines the ability of state and local governments to issue bonds for legitimate municipal projects. And it raises interest costs for all issues of municipal bonds.[37]

The Senate Finance Committee and the Advisory Commis-

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[34]"Jim Lopp's Innovative Bonds," Business Week, Nov. 13, 1978, p. 108. Lopp also pioneered the U.S. Steel pollution-control revenue bonds. (See Supra, p. 20.)

[35]Section 103(c) of the Internal Revenue Code.

[36]Edward McHale, "Thousands Queue Up for Days to Get Cheap Home Mortgages," The Youngstown Vindicator, September 2, 1979, XLVI, p. 6.

[37]"Innovative Bonds," Business Week, p. 108.

sion on Intergovernmental Affairs have also criticized special types of IDRB's. In the United States Senate, Senator Edward M. Kennedy, Democrat from Massachusetts, led a tax reform faction which was attempting to delete certain IDRB provisions. One new provision which Kennedy was opposed to was the use of IDRB financing for certain energy-producing projects.[38]

Despite Kennedy's objection, the provisions of the tax bill were passed by the Senate. Support for the provisions in the House of Representatives came from Ohio's Clarence J. Brown. Brown wanted IDRB financing to be used for construction facilities for coal gasification and liquification facilities. However, other representatives objected, and cited a Treasury estimate that increased IDRB financing would cost the Treasury $607 million by 1983. Thus, on October 4, 1978, members of the House Special Energy Tax Committee rejected the proposals supported by Brown.[39]

In conclusion, the future of IDRB financing lies in the hands of Federal and State legislatures. The Treasury Department is encouraging issuers of IDRB's to request judicial review and rulings pertaining to their particular case. Bond issue "schemes" will bring more restrictions to IDRB

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[38]"Judicial Review of Municipals is Important Feature of Tax Bill," The Bond Buyer, September 9, 1978, p. 5.

[39]"Senate Energy Plan Vetoed by House Conferees," The Bond Buyer, October 5, 1978, p. 3.

financing. Most Treasury Department officials and Congressmen look favorably on IDRB issues which construct facilities that are used by the public. For special limit-free types of IDRB's, the public purpose test is vital. Also, it appears that industrial users will be monitored by the government. Financial managers and investment bankers seem to have unlimited energy when it comes to devising new bond schemes yielding lower tax-free interest. When the volume of any special limit-free type of IDRB has greatly increased, Congress has tended to restrict its use.

Industrial Development Revenue Bond Statistics

Between 1936 and 1950, only the State of Mississippi had authorized the use of industrial development bonds.[40] The dollar volume of issues during this time period was insignificant. The uncertainty as to the legality of these bonds kept most states from enacting legislation for IDRB financing. Obviously, IDRB growth was dependent upon enacting legislation in the states. In 1950, courts in Florida, Nebraska, Idaho, and North Carolina rejected revenue bond financing. Despite these decisions, late in 1950 the Kentucky Court of Appeals upheld the state's Revenue Bond Act. The fact that the state was not liable seemed to calm

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[40]Rollinson, Industrial Development Bonds, p. 16.

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[40]Rollinson, Industrial Development Bonds, p. 16.

the fears of the legislators. The Kentucky ruling started a trend in the South which spread quickly. Within a few years, Alabama, Arkansas, Georgia, and Tennessee enacted legislation for the use of IDRB financing.[41]

Between 1951 and 1957, IDRB growth was very slight. During these years, the volume ($5 million) represented only one-half of one per cent of all tax-exempt issues.[42]

However, during the sixties several significant factors led to the increased total dollar volume of IDRB financing. These factors are as follows:

1. Large banks and insurance companies were investing in IDRB's because large, nationally known firms with excellent credit ratings were using IDRB financing. Also, the tax-exempt feature of IDRB's made them attractive to banks and other investors in high tax brackets.[43]
2. States were increasingly enacting legislation for IDRB financing.[44] In 1960, thirteen states, mainly in

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[41]Ibid.

[42]Rabinowitz, Municipal Bond Finance, p. 103.

[43]Hellman, Incentive to Industry, p. 10.

[44]The increase in state legislation for the use of IDRB financing was prompted by the competitive advantage gained by states using IDRB's to lure industry to their states. Critics of IDRB financing have called luring industry, "pirating." Aggressive campaigns by southern states luring northern industry to the South, prompted one critic to declare that their activity was "a new war between the states." See Edwin C. Gooding, "New War Between the States," New England Business Review, October 1963, p. 1.

the South, had enacted legislation. However, by 1963, twenty-five states had enacted legislation, and the trend was spreading to states in all regions of the country.[45]

3. Rulings in 1954 and 1957 by the Treasury Department helped to clarify the tax-exempt status of IDRB's.[46]
4. A Treasury Department ruling in 1963 enabled municipalities to issue IDRB's, even though their states might not have enacted legislation.[47]
5. General-obligation industrial development bonds were being replaced by revenue bonds. This was particularly true in the case of private industry. This freed the issuing municipality of any liability in case of default. By 1968, fewer than ten per cent of industrial development bonds were of the general-obligation type.[48]
6. Very few IDRB issues defaulted.
7. Some observers felt that the rising interest rates of the sixties contributed to the popularity of tax-exempt issues.[49]

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[45]Hellman, p. 11.

[46]Ibid.

[47]Ibid.

[48]Edwin C. Gooding, "The New Status of Industrial Development Bonds," New England Business Review, November 1968, pp. 3-4.

[49]Hellman, p. 11.

Prior to 1966, the tax-exempt privilege caused very little concern among critics of IDRB financing. IDRB dollar volume as a percentage of all tax-exempt issues remained well below 5 per cent. However, in 1967 the critics found their fears realized, as large corporations rushed into the market with IDRB issues.[50] The period between 1967 and 1968 was the heyday of IDRB financing. It appeared that nearly every new factory and plant in the country would be financed by tax-exempt IDRB's. Table I-1 reveals the enormous growth of IDRB financing during this period.

Benefiting the most from this surge of investment were the southern states. Between 1959 and 1969, southern states accounted for 87 per cent of all issues and 60 per cent of the dollar volume of IDRB's.[51] This is truly one of the greatest attainments of financial leverage in American history.

However, the boom of IDRB financing ended abruptly in 1967. Congress passed an amendment to the Revenue and Expenditure Control Act of 1968 which limited the tax-exemption privilege to $1 million for industrial users.[52] Another blow was dealt to IDRB financing when the SEC required that IDRB's of more than $300,000 be registered

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[50]Rabinowitz, Municipal Bond Finance, p. 104.

[51]Ibid.

[52]Section 107 of the Revenue and Expenditure Control Act of 1968, passed in June by the second session of the 90th Congress.

with the SEC. This registration requirement made IDRB's subject to all SEC regulations. General-obligation industrial development bonds were not subject to these requirements. However, the SEC requirements were soon dropped.[53] Table 1-1 shows the tremendous reduction in volume of IDRB financing.

The moderate growth of IDRB financing in the seventies has been governed by Section 103 of the Internal Revenue Code. The new limitations placed on IDRB issues made their use impractical for industrial expansion by large companies.

Social concern about air and water pollution moved Congress to enact environmental legislation. The new legislation required that industries finance their own pollution-control facilities. For many industries, this new financial burden was alleviated through the use of a type of IDRB called a pollution-control revenue bond (PCRB).[54] These PCRB's were not subject to limitations under Code Section 103. Therefore, the total dollar volume of PCRB's grew rapidly in the seventies. Because of their significance, they have been separated from IDRB's in the tables which follow.

Table 1-1 shows a trend of rising pollution-control dollar volume during the 1970's. The rate of growth in pollution-control financing has declined, however, in recent years.

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[53]Hellman, Incentive to Industry, p. 2.

[54]Huff, "Financing with Industrial Development Bonds," p. 32.

Most of the total number of issues in Table 1-1 are IDRB's. The compound growth rate for dollar volume of IDRB's from 1971 through 1977 was 47.3 per cent. However, this rate is distorted by the unusually large issues by Valdez, Alaska which are included in the total for 1977.[55] The rate of growth for IDRB volume, like the rate of PCRB volume, has slowed during recent years, if the Valdez issues are omitted. However, the recent use of IDRB financing to provide residential real property may increase the volume growth rate of IDRB financing. Currently, estimates of IDRB's used for residential property are available.[56]

Table 1-2 shows the average issue size for pollution-control and IDRB issues. Because issue size limitations do not apply to pollution-control issues, the average size of IDRB's is less than that of PCRB issues. Recently, the issue size limitation on IDRB's was raised from $5 million to $10 million. This should increase the average size of the issues.

Table 1-3 presents the number of states issuing pollution-control and IDRB issues each year. Table 1-4 lists the volume and number of PCRB and IDRB issues by state.

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[55]The IDRB issues by Valdez, Alaska are for the construction of a port to service the Alaska pipeline. Table 1-5 shows the enormous volume of issues from Alaska. Obviously, these issues are related to the pipeline project.

[56]The Public Securities Association reported that a record $2.6 billion in housing bonds came to market in the first three months of 1979. In March, alone, $1.5 billion came to market. Their growth pattern is quite significant.

Table 1-4 shows the widespread use of PCRB and IDRB financing. Table 1-4 indicates, also, that the use of PCRB and IDRB financing among the states has varied from a high of $1.8 billion in Alabama to zero in Hawaii. IDRB volume, alone, has varied from a high of $1.3 billion in Alaska to zero in Idaho, Hawaii, and Nevada. PCRB volume ranges from Pennsylvania's $981 million to zero in Hawaii and Vermont.

Table 1-5 ranks by state the ten largest issues of IDRB's and PCRB's. Similar rankings are listed for PCRB issues in Table 1-6. The ten largest IDRB issues from 1966-1971 and 1972-1978 are given in Tables 1-7 and 1-8, respectively.

All statistics in the tables which follow have been provided by the Public Securities Association, New York, N. Y. Their figures exclude non-industrial users. However, they include the small percentage of general-obligation type issues. The figures do not include small issue bonds placed privately. It would be extremely difficult and costly to obtain this information. The Public Securities Association indicates that an understatement of total dollar volume of 20 per cent is a reasonable estimate.

TABLE 1-1

POLLUTION CONTROL AND
INDUSTRIAL DEVELOPMENT FINANCING
1966-1978
(amounts in thousands)

Year	PCRB		IDRB		Total	
	Total Amount	Total Number	Total Amount	Total Number	Total Amount	Total Number
1966	________		494,303*	125*	494,303	125
1967	________		1,372,383*	180*	1,372,383	180
1968	________		1,610,471*	180*	1,610,471	180
1969	________		50,383*	71*	50,383	71
1970	________		115,872*	85*	115,872	85
1971	104,800	14	201,444	131	306,244	145
1972	404,040	39	335,844	141	739,884	180
1973	1,470,380	105	573,339	253	2,043,719	358
1974	1,455,630	111	493,959	241	1,949,589	352
1975	1,886,320	180	449,960	235	2,336,280	415
1976	1,963,230	170	418,531	247	2,381,761	417
1977	2,623,720	200	2,060,919	295	4,684,639	495
			793,919	289**	3,417,639**	489**
1978***	2,172,545	134	721,425	316	2,893,970	450
TOTAL ALL YEAR	12,080,665	953	8,898,833	2,500	20,979,498	3,453

* Includes PCRB

** Omits Valdez, Alaska Issues

*** Includes only the first 11 months of 1978

TABLE 1-2

AVERAGE SIZE OF POLLUTION CONTROL
AND INDUSTRIAL DEVELOPMENT BOND ISSUES
1966-1978
(in thousands of dollars)

Year	PCRB Average	IDRB Average	Total Average
1966	———	3,954	3,954
1967	———	7,624	7,624
1968	———	8,947	8,947
1969	———	710	710
1970	———	1,363	1,363
1971	7,486	1,538	2,112
1972	10,360	2,382	4,111
1973	14,004	2,266	5,709
1974	13,114	2,050	5,539
1975	10,480	1,915	5,630
1976	11,548	1,695	5,712
1977	13,119	6,986	9,464
		2,747**	6,989**
1978 (11 months)	16,213	2,283	6,431

** Omits Valdez, Alaska Issues

TABLE 1-3

NUMBER OF STATES ISSUING POLLUTION CONTROL AND INDUSTRIAL DEVELOPMENT BONDS 1966-1978[a]

Year	Number of States Issuing PCRB's	Number of States Issuing IDRB's	Number of States Issuing PC's or ID's
1966	--	15	15
1967	--	23	23
1968	--	25	25
1969	--	13	13
1970	--	21	21
1971	8	23	26
1972	16	28	30
1973	38	36	44
1974	34	35	43
1975	33	37	40
1976	39	32	44
1977	40	40	44
1978 (11 months)	35	42	46

[a]Including Puerto Rico

TABLE 1-4

POLLUTION CONTROL AND INDUSTRIAL DEVELOPMENT
BOND FINANCING BY STATE
1966-1978[a]
(amounts in thousands)

	PCRB		IDRB		Total	
State	Total Amount	Total Number	Total Amount	Total Number	Total Amount	Total Number
Alabama	752,095	84	1,076,103	372	1,828,198	456
Alaska	--	--	1,276,505	8	1,276,505	8
Arizona	300,650	9	15,875	11	316,525	20
Arkansas	166,495	18	349,603	69	516,098	87
California	172,785	22	74,036	23	246,821	45
Colorado	142,300	4	70,035	16	212,335	20
Connecticut	29,500	4	58,760	16	88,260	20
Delaware	45,600	5	85,020	15	130,620	20
Florida	366,920	32	163,470	28	530,390	60
Georgia	459,370	39	363,025	117	822,395	156
Hawaii	--	--	--	--	--	--
Idaho	4,000	1	--	--	4,000	1
Illinois	444,350	32	65,760	39	510,110	71
Indiana	635,650	28	47,630	30	683,280	58
Iowa	211,835	26	267,309	63	479,144	89
Kansas	129,325	9	117,874	63	247,199	72
Kentucky	271,865	24	526,793	111	798,658	135
Louisiana	610,460	57	392,521	50	1,002,981	107
Maine	89,300	13	14,400	5	103,700	18
Maryland	248,445	18	27,170	11	275,615	29

TABLE 1-4
(continued)

State	PCRB Total Amount	PCRB Total Number	IDRB Total Amount	IDRB Total Number	Total Total Amount	Total Total Number
Massachusetts	6,200	2	80,882	12	87,082	14
Michigan	517,120	39	261,895	33	779,015	72
Minnesota	322,580	18	185,400	128	507,980	146
Mississippi	164,200	9	337,533	214	501,733	223
Missouri	87,120	8	228,661	65	315,781	73
Montana	203,200	11	20,350	9	223,550	20
Nebraska	2,650	2	65,767	36	68,417	38
Nevada	36,600	4	--	--	36,600	4
N. Hampshire	35,300	3	15,075	7	50,375	10
New Jersey	223,855	19	57,196	39	281,051	58
New Mexico	464,500	9	19,880	6	484,380	15
New York	216,935	29	71,160	36	288,095	65
N. Carolina	6,500	3	12,450	7	18,950	10
North Dakota	111,200	5	24,090	14	135,290	19
Ohio	384,245	42	859,596	296	1,243,841	338
Oklahoma	148,500	11	213,422	83	361,922	94
Oregon	159,545	14	17,600	7	177,145	21
Pennsylvania	981,075	73	273,102	98	1,254,177	171
Puerto Rico	43,225	4	55,000	2	98,225	6
Rhode Island	13,425	2	17,400	9	30,825	11
S. Carolina	102,220	19	207,880	54	310,100	73
South Dakota	37,900	5	22,200	7	60,100	12

TABLE 1-4
(continued)

State	PCRB Total Amount	PCRB Total Number	IDRB Total Amount	IDRB Total Number	Total Total Amount	Total Total Number
Tennessee	138,795	27	347,520	151	486,315	178
Texas	881,820	56	35,650	4	917,470	60
Utah	231,100	7	140,565	13	271,665	20
Vermont	--	--	4,875	3	4,875	3
Virginia	325,550	33	168,390	39	493,940	72
Washington	35,000	1	10,870	4	45,870	5
W. Virginia	613,180	32	56,530	17	669,710	49
Wisconsin	248,605	25	103,335	49	351,940	74
Wyoming	257,575	16	92,670	11	350,245	27

[a]Includes only the first 11 months of 1978

TABLE 1-5

POLLUTION CONTROL AND
INDUSTRIAL DEVELOPMENT REVENUE BONDS

Largest Volume by State
1966-1978[a]
(dollar volume in thousands)

Rank	State	Volume	Number of Issues
1	Alabama	1,828,198	456
2	Alaska	1,276,505	8
3	Pennsylvania	1,254,177	171
4	Ohio	1,243,841	338
5	Louisiana	1,002,981	107
6	Texas	917,470	60
7	Georgia	822,395	156
8	Kentucky	798,658	135
9	Michigan	779,015	72
10	Indiana	683,280	58

[a]Includes only the first 11 months of 1978

TABLE 1-6

POLLUTION CONTROL REVENUE BONDS

Largest Volume by State
1971-1978[a]
(dollar volume in thousands)

Rank	State	Volume	Number of Issues
1	Pennsylvania	981,075	73
2	Texas	881,820	56
3	Alabama	752,095	84
4	Indiana	635,650	28
5	West Virginia	613,180	32
6	Louisiana	610,460	57
7	Michigan	517,120	39
8	New Mexico	464,500	9
9	Georgia	459,370	39
10	Illinois	444,350	32

[a]Includes only the first 11 months of 1978

TABLE 1-7

INDUSTRIAL DEVELOPMENT REVENUE BONDS

Largest Volume by State
1966-1971
(dollar volume in thousands)

Rank	State	Volume	Number of Issues
1	Alabama	556,534	137
2	Kentucky	480,048	86
3	Ohio	385,670	46
4	Louisiana	308,841	17
5	Mississippi	234,751	135
6	Iowa	207,500	16
7	Michigan	196,895	13
8	Georgia	190,305	45
9	Arkansas	186,889	25
10	Tennessee	182,065	49

TABLE 1-8

INDUSTRIAL DEVELOPMENT REVENUE BONDS

Largest Volume by State
1972-1978[a]
(dollar volume in thousands)

Rank	State	Volume	Number of Issues
1	Alaska	1,276,505	8
2	Alabama	519,569	235
3	Ohio	473,926	250
4	Pennsylvania	238,102	95
5	Georgia	172,720	72
6	Michigan	166,165	121
7	Tennessee	165,455	102
8	Arkansas	162,714	44
9	Florida	109,370	20
10	Wisconsin	103,335	49

[a]Includes only the first 11 months of 1978

CHAPTER II

LAWS GOVERNING

INDUSTRIAL DEVELOPMENT REVENUE BOND FINANCING

The Internal Revenue Code, Revenue Regulations, and Revenue Rulings

The legal background to IDRB financing is wrought with a great deal of controversy. In the past, it was not uncommon for states or city governments to issue debt for any public purpose. However, for IDRB financing the exact definition of the term "public purpose" has created much controversy. Many experts debated whether or not industrial development was for any public purpose. If industrial development is in the public purpose, should the issuing government secure the bonds through their taxing power on the public? These questions remained controversial until a landmark decision was made in Mississippi in 1938. In this case, the United States Supreme Court supported the use of industrial development bonds for financing industry which would aid the public. That first issue was considered an industrial aid bond.[57]

The controversy did not end in 1938. The legal sector and the business sector of the country soundly criticized industrial development financing. Despite their

[57]303 U. S. 627, 82 L. Ed. 1088.

objections, this type of financing grew. In 1954, Congress clarified IDRB financing by issuing Internal Revenue Code Section 103.[58] This early law left many questions unanswered. Following the abuse of IDRB financing in the late sixties, the Revenue and Expenditures Control Act of 1968 revised Code Section 103 and added limitations to IDRB financing.[59]

The revised Code Section 103 is used today by bond counsels, accountants, wise investors, and other interested parties. Any businessman who is interested in IDRB financing should read Section 103 carefully. It is vital that the Code, the regulations, and the revenue rulings are followed carefully. The IRS can declare the bonds non-exempt if a law or rule is broken, and such action could be disasterous. The essential highlights of this Section are presented in the following paragraphs.

The Internal Revenue Code defines industrial development bonds as any obligation which is issued as part of an issue, all or a major portion[60] of the proceeds of which are to be used directly or indirectly in any trade or business

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[58]Code Sec. 103.

[59]Code Sec. 103(b) (6) (A-I).

[60]Treasury Regulation Section 1.103.1 specifies the details of the major portion test. For IDRB's, the test is whether more than 25 per cent of the output over the term of the bond issue will be used by a non-exempt person in his trade or business. To qualify as an exempt facility, a facility must serve or be available on a regular basis for general public use.

carried on by any person who is not exempt.[61] For purposes of paragraph (2) (A), the term "exempt person" means either a governmental unit or an organization described in Section 501(c) (3).[62] The payment of the principal or interest on the obligation is, in whole or in major part, (a) secured by an interest in property used in a trade or business or in payments made in respect to this property, or (b) derived from payments in respect to property or borrowed money that is used (or to be used) in a trade or business.[63]

Interest on all industrial development bonds issued before May 1, 1968 is exempt from federal income tax. Interest on bonds where a commitment existed prior to May 1, 1968 is also exempt from income tax. Interest on industrial development bond issues of more than $1,000,000, issued after April 30, 1968, is taxable. Also exempt is the interest from industrial development bond issues of $1,000,000 or less if substantially all of the proceeds are used for the acquisition, construction, reconstruction, or improvement of land or depreciable property.[64] On October 24, 1968, the limit was raised to $5,000,000 or less.[65] The Revenue Act of 1978 raised the limit to $10,000,000 for bonds issued after December 31, 1978.[66]

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[61]Code Sec. 103(b) (2) (A). [62]CS 103(b) (3) (A, B).
[63]CS 103(b) (2) (B). [64]CS 103(b) (6) (A).
[65]CS 103(b) (6) (D). [66]CS 103(b) (6) (D) (1).

When considering IDRB financing, it is important that a company check the restrictions concerning capital expenditures in Section 103. In determining whether the $10,000,000 tax-exempt limit has been exceeded, capital expenditures, other than those financed by the exempt bond issue proceeds, must be taken into account. Capital expenditures made during a six-year period, beginning three years before and ending three years after the issuance of IDRB's, must first be totalled and then subtracted from the $10,000,000 limit. However, this rule applies only to the funding of facilities located in the same municipality or in the same county.[67] This important rule is often overlooked by businessmen considering IDRB financing. Certain capital expenditures are not taken into account. The replacement of property damage by fire, storm, or other casualties will not count as a capital expenditure. Similarly, changes in plant and equipment due to Federal or State ordinances do not count. Finally, cost overruns are permissible, but shall not exceed $1,000,000. Permissible overruns are such factors as erroneous cost estimates, strikes, delays, or increases in costs due to inflation.[68]

Specifically excluded from dollar limitations are IDRB's issued where substantially all[69] of the proceeds are

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[67]Code Sec. 103(b) (6) (F).

[68]Code Sec. 103(b) (4) (F) (iii).

[69]Treasury Reg. 1.103.8 specifies that "substantially all" means 90 per cent or more of the bond proceeds.

used for the following:[70]

1. Residential real property for family units
2. Sports facilities
3. Convention or trade-show facilities
4. Airports, docks, wharves, mass commuting facilities, parking facilities, or facilities for training or storage related to the foregoing
5. Sewage or solid waste disposal facilities, or facilities for the local furnishing of electricity or gas
6. Air or water pollution-control facilities
7. Facilities for the furnishing of water, if available, to the public
   a. The facility should not be a production facility.
   b. The facility should be operated by a governmental unit or a regulated public utility.

Advance refunding of IDRB issues is permitted if the proceeds of the refunded issues were used for the public facilities mentioned above in numbers 3 and 4. This does not include the foregoing facilities mentioned in number 4.[71]

For further detailed explanation and legal interpretation of Code Section 103, the Treasury Department issued Regulation Section 1.103-1-15. This lengthy Section provides interpretations, examples, and tests for qualification.

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[70]Code Sec. 103(b) (4) (A-G).

[71]Code Sec. 103(b) (7) (B).

A restatement of this section is not necessary. However, there are some important matters that will be studied by the bond counsel.

1. IDRB financing is used for the purchasing of long-term assets. Logically, these bonds can not be used to finance working capital.[72]
2. Arbitrage bonds can be used temporarily[73] to service the interest on an IDRB issue. After July 1, 1972, arbitrage bonds will not be taxable if the yield does not exceed one-eighth of one percentage point over the IDRB yield.[74]
3. IDRB's issued for industrial parks are not subject to face amount limitations. However, this includes the financing of roads and utilities, only; not the construction of buildings and other structures.[75]
4. Regulations 1.103-8 through 1.103-12 explain the details concerning interest paid on IDRB's.
5. Arbitrage rules must be followed in order for the bonds to remain tax exempt.[76]

The APPENDIX lists applicable revenue rulings and procedures.

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[72]Reg. 1.103-1, CCH explanation, paragraph 947.0157.

[73]"Temporarily" means three years. Many state laws require that a company financed by IDRB's have a signed construction contract, six months after the bond issuance.

[74]Reg. 1.103-1, CCH explanation, paragraph 947.0125.

[75]Reg. 1.103-1, CCH explanation, paragraph 947-015.

[76]Reg. 1.103-13.

Revenue Ruling 68-590 provides some important guidelines for bond counsels, corporations, and state and local governments. This ruling has helped to establish the financing process for IDRB's. Also, the necessary legal documents are mentioned, and the relationship between the financing participants is explained. This ruling states that the corporation will be considered the owner of the project for Federal income tax purposes. Also, it states that the parties intend that the legal title to the project is to eventually pass to the corporation. The following general tax treatment will apply to the corporation:

1. The corporation will be allowed an investment tax credit subject to Internal Revenue Code Sections 38, 46, 47, and 48.
2. The corporation will take into account any premium or discount on the bonds pursuant to Code Section 61.
3. The corporation will not be entitled to rental deductions.[77]
4. The corporation will be entitled to deductions for all ordinary and necessary expenses paid or incurred in the operation of the project, including, but not limited to, the annual trustee's fees allowed by Code Section 162.

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[77]Any chance of a double tax advantage was eliminated in Revenue Ruling 68-590. For instance, a corporation could not take rental deductions and depreciation deductions on essentially the same assets.

5. The corporation will be entitled to interest deductions with respect to that portion of the rentals which represents the interest payable on the bonds, pursuant to Code Section 163.
6. The corporation will be entitled to deductions for state and local taxes imposed with respect to the project, pursuant to Code Section 164.
7. The corporation will be entitled to depreciation deductions with respect to all depreciable property in the project, pursuant to Code Section 167.

The Ohio Revised Code

In 1966, legislators in the State of Ohio enacted legislation for IDRB financing for the purpose of advancing, encouraging, and promoting the industrial, economic, and commercial development of the State of Ohio. Ohio has several IDRB-enabling statutes; however, Title VI, Chapter 165, of the Ohio Revised Code, contains most of the important legal information regarding IDRB financing. In August, 1975, Chapter 165 was amended, and the changes resulting in current law are discussed in this section.

IDRB's may be issued by the State of Ohio through the Ohio Development Financing Commission or any state board granted authorization by the state government. IDRB's may be issued, also, by a county or municipal corporation via a community improvement corporation, or directly by a municipal corporation. If the county or municipality refuses to issue

bonds for a qualifying industrial project in its jurisdiction, the industry can bypass the local authorities and have the state issue the bonds.[78]

Although Title VII, Chapter 761, "Industrial and Economic Development," has never been repealed, it is generally regarded as dead-letter law and has not been used in recent years. It will not be considered in this study.

Title I, Chapter 165, "Industrial Development Bonds," provides businessmen and bond counsels with a detailed and concise law. The 1975 amendment broadened the use of IDRB's and streamlined the financing process. The important information from the sections of Chapter 165 are presented in the following summary:

1. Section 165.01 defines the important terms in regard to IDRB financing.
   a. Bond proceeds may be used to acquire, purchase, construct, reconstruct, enlarge, improve, furnish, or equip any project for lease, sale, exchange, or other disposition.
2. Section 165.02 discusses the powers of the issuer.

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[78]The jurisdictional boundaries for IDRB issuance is hierarchical. A city or (in the case of Ohio) an incorporated municipality can issue IDRB's for projects within its municipal boundaries. The county commissioners can issue bonds for projects in the unincorporated areas within the county's boundaries, as well as within the boundaries of the incorporated municipality. The State of Ohio can issue bonds for projects in any municipality or county in the State. Obviously, this jurisdiction carries over to the Federal government in like fashion.

a. In addition to the traditional lease-rental IDRB arrangement, paragraph (D) of this Section authorizes conditional and installment sales, and direct loans by the issuer to the corporation.[79]

b. Fire and extended coverage, and liability insurance for the project can be purchased by the issuer.

c. The bonds can be secured by: a pledge, assignment, hypothecate, or otherwise encumber the rentals, revenues, and other income, charges, and money realized from use, lease, sale, or other disposition of one or more projects; and enter into trust agreements or indentures of mortgage for benefit of the bondholders.[80]

3. Section 165.03 describes the purpose for which the bonds may be issued, and their form.

   a. The 1975 amendment added that IDRB's may be issued to create and preserve jobs and employment opportunities, and to improve the economic welfare of the people of Ohio.

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[79]Essentially, this section has streamlined the financing process by providing a traditional loan agreement between the banker and the company. The banker is lending money to the government entity (a conduit for tax-exempt status), who in turn lends the money to the company. In this situation, the underwriter is bypassed and the lease-rental procedure is avoided.

[80]This refers to the previous footnote. As in traditional financing, the mortgage is used to secure the debt.

b. No limitations on the interest rates.

c. The maturity dates shall not exceed 30 years.

d. A public or private sale may be used.

e. There is no requirement that the bond issue be registered or reviewed by any state agency; however, the state's Department of Economic and Community Development must be notified prior to the bond issuance.

f. A local community improvement corporation or a state agency must present certification to the issuer that the project is in accordance with local development plans.

4. Section 165.031 requires payment of prevailing rates of wages on projects funded by IDRB's.
5. Section 165.04 discusses bond indentures. The provisions in this Section are fairly traditional.
6. Section 165.05 discusses further the securing of bonds by a mortgage indenture or a trust agreement.
7. Section 165.06 states the traditional provisions and procedures to be followed by the bondholders in case of default.
8. Section 165.07 allows the issuing authority to issue refunding bonds.
9. Section 165.08 declares that these bonds are lawful investments for financial institutions. This Section describes how underwriters and bond users place IDRB's.

Financial institutions include life insurance companies, savings and loan associations, banks, trust companies, the state teachers' retirement system, public employees' retirement system, and other pension funds.

10. Section 165.09 states that the bond fund user shall be taxed in the same manner as a property owner. The issuer is exempt from taxes.
    a. The bond user is subject to sales, use, and franchise taxes; and to zoning, planning, and building regulations and fees.
    b. The bond issuer is not exempt from taxes if the issuer is using the property for otherwise taxable use.
11. Section 165.10 and Section 165.11 explain special assessment taxes, and taxing districts and authorities.
12. Section 165.12 is a very important Section which explains the fact that the bonds are not a debt of the issuer.
13. Section 165.13 restricts the purchase of the bonds by any officer, director, employer, or owner of the IDRB-financed project.
14. Section 165.14 declares that certain regulations in the Ohio Revised Code are not applicable to IDRB financing.
15. Section 165.15 designates the Ohio Development Financing Commission as the financing agent for the State of Ohio.

IDRB financing in the State of Ohio is available for a broad classification of projects. In general, these projects should deal with industry, manufacturing, commerce, research, distribution, and pollution control. Projects should be reviewed by the local community improvement corporation. Projects should always be reviewed by a law firm which specializes in municipal-bond financing. The issuing authority can then meet with the company and sign an agreement to issue the bonds. This agreement must be obtained before work on the project begins.

Finally, IDRB financing used for residential real property was disallowed in a 1976 court case (State, XEL Rail Brown v. Beard 48 Ohio 2nd 290). However, other limit-free, public-purpose bonds (i.e. pollution-control revenue bonds) can be used in Ohio.

CHAPTER III

FINANCING WITH
INDUSTRIAL DEVELOPMENT REVENUE BONDS

The Financing Process

Industrial development revenue bond financing involves a rather complicated process. This is not intended to suggest that companies have been reluctant to use IDRB financing. The process simply involves a few extra intermediaries who are needed to eventually obtain tax-exempt financing for a company. There are variations to this process, particularly in the case of private placements made directly with banks. Nevertheless, the financing process described in the following paragraphs represents a common practice.

Industrial development revenue bonds usually require six participants which are:

1. A local development agency (such as an industrial development association or, in the case of Ohio, a community improvement corporation).
2. A company with a plan for industrial development.
3. A bond counsel (lawyers) with a reputation in municipal financing.
4. An underwriter who specializes in municipal financing.
5. The government entity which will issue the bonds.

6. A bank, which serves as a trustee.[81]

The financing process begins when a local development agency and a company with a proposal come into contact. The company usually has a brief project description.[82] Among the many promotional tools, the agency uses IDRB's to induce the company to invest in the agency's geographical area. If the company needs IDRB financing, the agency recommends that it seek bond counsel.[83]

Most agencies have a number of requirements for any future industrial projects. First, the agency requires that the company complete an application. Most applications require that the company describe the project, estimate the cost, and state the number of new jobs the company is planning to create. Many agencies have an overall development plan for their region, and the company's proposal should fit into this plan. Some agencies will analyze a company's financial statements and check their credit ratings.[84] Virtually all agencies are concerned with the creation and preservation of jobs in their region. Finally, the agency seeks the recommendations and instructions made by the

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[81]"Financing Bargain," Industry Week, p. 88.

[82]Ibid.

[83]Laird Eckman, private interview held at the Mahoning Valley Economic Development Improvement Corporation, Youngstown, Ohio, August, 13, 1979.

[84]Ratings are usually done by investors' services such as Dunn and Bradstreet, and Moody's.

bond counsel throughout the financing process.[85]

If the company qualifies for IDRB financing, the board members of the development agency can pass a resolution asking a local government entity and the company to enter into an agreement to issue the bonds.[86]

The most important participant in the financing process is the bond counsel. Once contacted by the company, the bond counsel literally "orchestrates" the financing process. The counsel's main function is to insure that Federal and state laws are carefully adhered to.

The bond counsel prepares numerous legal documents. Some of the more important documents are:

1. The Trust Indenture (bond indenture). This establishes the financial and legal relationship between the borrower and the lender.
2. The Bond Issuance Agreement. This states the specifics of the bond issue as agreed upon by the company and the government.
3. The Project Certificate. This certifies the feasibility and legality of the company's project within the geographical bounds of the government entity.
4. The Lease Agreement and Option to Purchase. This establishes between the government and the company the lease-rental agreements and payments necessary to

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[85]Eckman, private interview, August 13, 1979.

[86]*Ibid*.

service the bonds. Also, it establishes a nominal sum to be paid by the company in order to purchase the project.

5. The Underwriting Agreement. This establishes the selling arrangement (best efforts or guarantee) and the commission for the underwriter.[87]

The bond counsel studies the feasibility of the project. In order to qualify for IDRB's, the project must satisfy the laws and revenue rulings of the Federal and state government.[88] Many new situations created by the project can not be determined or defined by revenue rulings or laws. In such a case, the bond counsel will obtain a special ruling or a letter of determination from the Internal Revenue Service.[89]

The company has the responsibility to find an investment banker who is willing to purchase the bonds. This might be a difficult task for small companies. Before any of the legal work of the financing process has begun, the company should have found a purchaser. Some bond counsels will remind the company of this responsibility. An embarrassing and costly mistake can be made if the bond counsel has completed the legal work and the company has failed to find a purchaser

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[87]Richard K. Desmond, Attorney, private interview and documents supplied at the firm of Squire, Sanders, and Dempsey, Cleveland, Ohio, August 13, 1979.

[88]No attempt will be made here to explain the legal details of laws and revenue rulings pertaining to IDRB financing. CHAPTER II reviewed the laws and rulings.

[89]Desmond, private interview, August 13, 1979.

for the bonds.[90]

If the company satisfies all the legal requirements, the bond counsel will direct the company to a government entity for bond issuance. The government entity is the "conduit" through which the company gains tax-exempt financing.[91] Most government entities do little more than stamp and sign the documents.[92] Simply having a government entity issue these bonds does not guarantee a tax-exempt status. In reality, the tax-exemption stems from the careful application of the law by the bond counsel to the company's project.

The bond counsel, the investment banker, and the company will meet to work out the details of the issue. Coupon bonds are issued in most cases. Typically, the bonds are issued in serial form with repayments ranging from five to twenty-five years.[93] In contrast to corporate bonds, IDRB's do not have to be registered with the Securities Exchange Commission.[94]

When the investment banker purchases the bonds, the money is placed immediately in a construction fund with the trustee bank. Normally, the bank invests the money in high-

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[90]*Ibid*.

[91]*Ibid*.

[92]William E. Rapasky, private interview at Mahoning County Office Building, Youngstown, Ohio, August 16, 1979.

[93]"Financing Bargain," *Industry Week*, p. 88.

[94]Hellman, *State Financial Incentives*, p. 11.

yielding and highly liquid money-market instruments. Certificates of Deposit and Repurchase Agreements are common instruments used by the trustee bank. The bank provides the bookkeeping service and pays the interest directly to the investors.[95] The difference between the tax-exempt interest payment and the money-market yield, in effect, pays various administrative expenses. Essentially, this is a form of arbitrage, and Treasury Department Regulations limit the yield from these bonds. When the company is ready for construction or equipment purchases, the bank will pay the costs from the construction fund. When the fund is exhausted, the lease-rental payments made by the company are used to service the bond interest payments and principal.[96]

Restrictions under the Glass-Steagall Act of 1933 disallowed banks to underwrite revenue bonds. Therefore, banks do not try to sell IDRB's. However, as a show of good faith in a local issue, the trustee bank will purchase a percentage of the issue. Purchasing these bonds does create some problems for a bank. The Comptroller of the Currency considers revenue bonds a loan if they are held in the bank's portfolio. Banks can lend only ten per cent of their deposits to companies for capital expenditures. In the

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[95] Lewis J. Qualman, Vice-President and Trust Officer, Union National Bank, private interview at Union National Bank. Mr. Qualman verified his statements by contacting the bank's controller. Youngstown, Ohio, August 28, 1979.

[96] Qualman, telephone interview, September 4, 1979.

future, a bank's ability to lend money to a company may be severly limited.[97]

In the past, the leading purchasers of IDRB's were commercial banks. Recently many bank portfolios have been saturated with tax-exempt issues.

Usually, bankers will accept small issues from reliable and established customers. Placement of larger issues requires the use of an underwriter. Increasingly, insurance companies, savings and loan associations, and other financial institutions have been called upon to absorb large IDRB issues. Also, individuals in high tax brackets (usually 33 per cent or above) have been purchasing IDRB's.[98]

When the bonds are purchased and the trustee bank has established the construction fund, the financing process is complete. Chart 2-1 at the end of this section illustrates the basic steps in the financing process. The process is complicated and understood by only a few persons, including many of the participants. The companies that have understood the process have benefited and have often reused this type of financing.

Consider Allied Products Corporation as a case in point. Recognizing the competitive advantage in tax-exempt financing, Allied laid out a $38 million expansion program,

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[97] Ibid.

[98] Joint Economic Committee, Needs and Financing, p. 164.

mostly in its agricultural equipment business, to be financed primarily through IDRB's. Each bond would be issued by a community in which Allied had a facility, or planned to build one, with the company gaining the use of the money. Each would be for a separate project, and each would be for under five million dollars.[99]

Criticized as a complicated way to obtain cash, Allied's chief bond counsel, Kenneth B. Light, replied:

> If it's difficult, then we've done the difficult. It takes some perseverance, and a lot of talking and convincing. But the local bankers have been very keen on expansion.[100]

Richard A. Drexler, Allied's vice-president, added:

> We're taking advantage of some very attractive avenues of finance. A lot of the secret of this type of financing is initiating and maintaining a relationship with a municipality. Once they get acquainted with the company, they get excited about having us and our new jobs there. The whole idea here is to build up the credibility of the company.[101]

A manufacturer of spools for the bias-binding industry was able to obtain benefits provided by the New York City Industrial Development Agency. The company had outgrown its existing plant and needed to expand. The Development Agency assisted the company in locating a building near their existing plant. The one-hundred per cent financing through IDRB's

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[99]"A Cheap Way to Raise Cash," Business Week, January 27, 1975, p. 76.

[100]Ibid.

[101]Ibid.

fit the company's needs. The total project cost was $1.44 million. Of that amount, $1.1 million represented land and buildings; $240,000 was for renovation; $100,000 was for machinery and equipment, and related expenses such as legal fees, architectural fees, and financing charges. The interest came to eight per cent over twenty years which was about two percentage points below the conventional rate.[102]

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[102]Ruben Cardona, CPA, and Samuel Coleridge, "Financing Facilities at Lower Costs," The CPA Journal, XLVIII, March, 1978, p. 29.

CHART 2-1

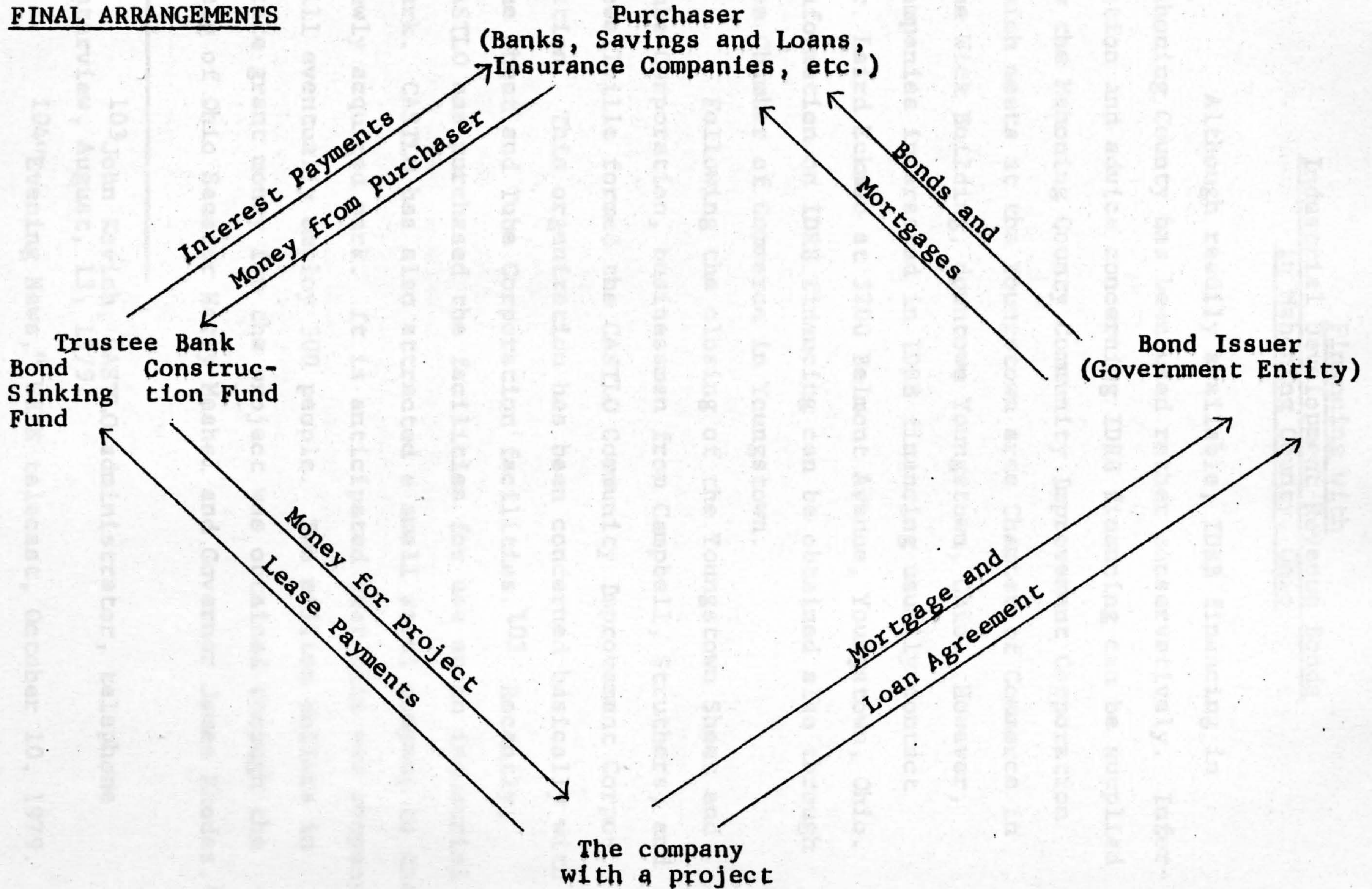
THE FINANCING PROCESS

Project considered by:				
Company Community Improvement Corporation Bond Counsel The Government Entity	The company locates an IDRB purchaser.	The government entity agrees to issue the bonds.	Legal Work Prepared	Bond Issuance

Timing:

Up to 30 days	Up to 30 days	30-120 days

CHART 2-2



Financing with Industrial Development Revenue Bonds in Mahoning County, Ohio

Although readily available, IDRB financing in Mahoning County has been used rather conservatively. Information and advice concerning IDRB financing can be supplied by the Mahoning County Community Improvement Corporation which meets at the Youngstown area Chamber of Commerce in the Wick Building, downtown Youngstown, Ohio. However, companies interested in IDRB financing usually contact Mr. Laird Eckman at 3200 Belmont Avenue, Youngstown, Ohio. Information on IDRB financing can be obtained also through the Chamber of Commerce in Youngstown.

Following the closing of the Youngstown Sheet and Tube Corporation, businessmen from Campbell, Struthers, and Lowellville formed the CASTLO Community Improvement Corporation. This organization has been concerned basically with the Sheet and Tube Corporation facilities.[103] Recently, CASTLO has purchased the facilities for use as an industrial park. CASTLO has also attracted a small steel company to the newly acquired park. It is anticipated that this new company will eventually employ 500 people. Two million dollars in State grant money for the project was obtained through the help of Ohio Senator Harry Meshel and Governor James Rhodes.[104]

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[103] John Kovich, CASTLO administrator, telephone interview, August, 13, 1979.

[104] "Evening News," WKBN telecast, October 10, 1979.

However, IDRB financing could one day be part of this project's future development, and there is evidence that CASTLO intends to promote and participate in some IDRB financing in the future.

The Mahoning County Commissioners have been the primary issuers of IDRB's. The County has traditionally been the local channel for bond issuance. Moody's Investor Service has given the County an A-minus rating. However, recently IBM Corporation had $3 million in IDRB's issued by the municipality of Youngstown.[105]

Local politicians have fought to have these bonds issued from their particular government office. Also, there appears to be a political association between the Mahoning County Commissioners and the Mahoning County Community Improvement Corporation.

Table 3-1 shows the IDRB's issued in Mahoning County for the years 1978 and 1979. The 1979 volume, as of September 1979, has exceeded the 1978 volume. Approximately 500 new jobs were created by IDRB's in the Youngstown area in 1978.[106] All of the IDRB's were issued by the County, and most of these issues were placed privately; that is, without the use of a public securities offering.

The Tamarkin Company, one of the IDRB participants

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[105] Laird Eckman, interview, August 13, 1979.

[106] Ibid.

shown in Table 3-1, has been busy purchasing buildings from the Atlantic and Pacific Tea Company. Tamarkin will use its IDRB funds to build a warehouse in order to service its new stores.[107]

Wean United, Incorporated, has purchased five computerized machines for two separate projects. Wean has been updating their production process and is attempting to preserve jobs.[108]

FYDA Truck is building a large terminal for truck sales and service. Mr. Walter F. Fyda, Chairman of the Board of FYDA Truck, was pleased with IDRB financing. Mr. Fyda felt that with the recent increase in interest rates, IDRB's were the only financing alternative. This new terminal will create 32 new jobs in the county.[109]

The volume and number of IDRB issues in Mahoning County have been generally lower than the volume in other counties. The following factors have probably contributed to this situation:[110]

1. Bond counsel is unavailable in the county.

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[107] Michael Monus, Tamarkin executive, telephone interview, August 16, 1979.

[108] William E. Rapasky, interview at the Mahoning County Commissioners' Office, August 16, 1979.

[109] Walter F. Fyda, interview at the Mahoning County Commissioners' Office during the bond issuance for FYDA Truck Company, September 19, 1979.

[110] Most of the IDRB issues in Mahoning County have been arranged by two Cleveland law firms: Calfee; Halter and Griswold; and Squire, Sander and Dempsey.

2. Local businessmen are unaware of the availability of IDRB financing.
3. The high cost of labor in the county
4. The conservative practices of local bankers
5. Poor promotional efforts by the CIC, the city and county government
6. The availability of IDRB's nationally has reduced their value as an industrial relocation inducement tool.
7. The capital expenditure limitation rule limits the size of the projects.

One of the more curious local IDRB projects involves IBM; Youngstown City Hall; Richard E. Mills, a local developer; and the bond counsel of Squire, Sander and Dempsey from Cleveland, Ohio. The bonds were issued by the City and the yield on the bonds was a fairly high 8.8% (at the time similar issues were yielding 7.75% to 8.2%). Mr. Mills was not sure why the yield was so high. Mr. Mills and the bond counsel were attempting to obtain additional financing through an Urban Development Action Grant. Mills plans to construct the IBM building on urban renewal property near downtown Youngstown, but the project has run into numerous legal problems. As a result, legal fees have soared from $10,000 to $90,000. Mr. Mills has nothing but harsh words for IDRB financing.[111] Meanwhile, the project is at a standstill.

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[111]Richard E. Mills, private interview at City Center One, Youngstown, Ohio, August 20, 1979.

TABLE 3-1

INDUSTRIAL DEVELOPMENT REVENUE BOND FINANCING
IN MAHONING COUNTY, OHIO

PROJECTS 1978	PURPOSE
$3,500,000 M. W. Kasch Co. February, 1978	Warehouse
$2,405,000 Omni Manor, Inc. (Windsor House) May, 1978	Nursing Home
$1,300,000 Willow Molded Plastics October, 1978	Manufacturing
PROJECTS 1979 up to OCTOBER	
$1,850,000 FYDA Truck February, 1979	Truck Sales and Service
$600,000 Do-Cut Sales and Service February, 1979	Lawn and Garden Sales and Service
$1,500,000 Health Care Fund March, 1979	Nursing Home
$5,000,000 Tamarkin Co. April, 1979	Warehouse
$265,000 Wean United, Inc. July, 1979	Equipment
$1,200,000 Wean United, Inc. August, 1979	Manufacturing

Source: Office of the Mahoning County Commissioners

CHAPTER IV

FINANCIAL CONSIDERATIONS

Financial Advantages, Disadvantages and Other Considerations

The savings available through the use of IDRB financing lies principally in interest rates, cash flows, and taxes. It is wise to consider each of these items separately. Essentially, a good analysis would require a case-by-case study of each proposed project. Other factors, such as the cost of labor, the availability of resources, and the legal complications should be considered along with any detailed capital budgeting analysis.

In most cases, IDRB financing will provide the following advantages:

1. Interest cost savings of 1½ to 4 per cent
2. The right to an investment tax credit
3. One hundred per cent financing which covers legal fees, architects' fees, etc.
4. Interest deduction for the interest portion of the lease payments
5. Noninterference by the issuing government entity
6. Private or public placement
7. No registration or regulation by the SEC
8. Varying loan payout periods (5-25 years)

9. Guarantees for loan repayments (This is arranged in Ohio by the Ohio Development Financing Authority.)
10. In some areas, exemption from local taxes (commercial rent and occupancy tax) Also, a ten-year stabilization of real estate taxes is sometimes granted by the issuing government entity.

These factors, combined with a good location and available resources, can make good economic sense for a small industry considering relocation. In most cases, all of the above advantages can be obtained. Some communities, hungry for industry, will offer other incentives and services.

It is not difficult to understand the considerable advantages provided by the lower interest rates of IDRB's. In terms of present value analysis, the costs of an IDRB-financed project can be compared to the costs of a project financed through traditional methods. However, there are some important consequences which must not be overlooked. When comparing two projects, the earnings will not be the same.[112] The project with the lower interest expense will have lower interest deductions and, consequently, a greater tax liability. Consider the following calculations in Table 4-1:

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[112]Present value analysis requires a yearly net cash flow composed of earnings after taxes, plus depreciation. For income tax purposes, both arrangements would be treated as a purchase; thus depreciation would be the same.

TABLE 4-1

PROJECT A
8% IDRB FINANCING

Earnings Before Interest and Taxes	$2,000,000
8% Interest Deduction	160,000
Earnings Before Taxes	1,840,000
Less: Corporate Tax (46%)	846,400
Earnings After Taxes	$ 993,600

PROJECT B
12% TRADITIONAL FINANCING

Earnings Before Interest and Taxes	$2,000,000
12% Interest Deduction	240,000
Earnings Before Taxes	1,760,000
Less: Corporate Tax (46%)	809,600
Earnings After Taxes	$ 950,400

The calculations in Table 4-1 show that the earnings of Project A before taxes are $80,000 greater than the earnings of Project B. However, Project A's tax liability is greater, and its earnings after taxes are only about $43,000 greater than Project B's earnings after taxes. This tax consequence is important when considering any present value analysis. If earnings and tax liabilities are the same (as in the example), then the IDRB-financed project will be advantageous. However, the chances of all things being the same are highly unlikely. The net cash flows used in any present value analysis must be determined carefully on a case-by-case basis. Other factors, such as the cost of labor, transportation, and resource availability, as well as the project size may offset the advantage of IDRB financing.

Many people fail to consider the seemingly basic fact that the lease-rental arrangements of IDRB financing create for a company a rather large capital lease. Financial Accounting Standards Board, Number 13, requires that an obligation be capitalized on the asset side, with a related lease obligation on the liability side of the balance sheet. Capitalization will represent the present value of the minimum lease payments less the portion of lease payments representing executory costs, such as insurance, maintenance, and taxes to be paid by the lessor (including any profit return he includes in such charges). The asset is to be amortized in a manner consistent with the lessee's normal depreciation policy for owned assets. During the lease term,

each lease payment is to be allocated between a reduction of the obligation and the interest expense to produce a constant rate of interest on the remaining balance of the obligation.[113] Therefore, one must capitalize the present value of the lease payments. As mentioned earlier, the lease payments are not allowed as deductions for income tax purposes.

Another important financial consideration involves the location of a purchaser of the bonds (investor). For a price, a corporation can obtain the services of an investment banker. Small issues can usually be placed at local banks. However, bank portfolios have become overloaded with low-yielding, tax-exempt bonds. Increasingly, insurance companies and other financial institutions are absorbing these bond issues.

Before investing, a financial institution should consider its tax bracket percentage. The investor needs to know the percentage yield which a bond or other security, with a fully taxable income, would give in order to provide an after-tax yield equivalent to a given tax-exempt yield. A fairly simple ratio can give this taxable equivalent yield:[114]

$$\frac{\text{Tax-exempt yield}}{\text{100\% minus tax-bracket yield}}$$

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[113]Financial Accounting Standards Board, Statement of Financial Accounting Standards, No. 13 (Stamford, Conn.: FASB Publications, November 1976).

[114]Jerome B. Cohen and Edward D. Zinbarg, Investment Analysis and Portfolio Management (Homewood, Ill.: Richard D. Irwin, Inc., 1967), p. 46.

Obviously, investors in high tax brackets are receptive to tax-exempt bonds. Currently, an investor who is in a tax bracket of 33 per cent or above, would find a tax-exempt bond more advantageous than a higher yielding, taxable bond.

There are some other tax considerations of which the investor should be aware. IDRB's do provide the investor with tax-free interest, and his profits and earnings are increased.[115] Likewise, interest expense incurred to produce tax-exempt income decreases a company's earnings and profits. For income tax purposes, interest expense can not be deducted it if was incurred to produce tax-exempt income.[116]

Many investors do not realize that the Treasury Regulations require those who receive tax-exempt income to file an itemized allocation statement with their income tax return. This statement should list in detail the classes of exempt and non-exempt income. Furthermore, the taxpayer must state that any deduction in his tax return is not attributable to tax-exempt income. However, this does not apply to the tax returns of individual investors.[117]

Guidelines for taxpayers investing in tax-exempt bonds were stated in 1972 in Revenue Procedure 72-18. This

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[115]Reg. Section 1.312-6 (b).

[116]Rev. Code Section 265 (2).

[117]Rev. Code Section 265-1 (d) 1.

ruling states that if it is determined, by direct or circumstantial evidence, that the taxpayer's purpose was to obtain or carry tax-exempt securities by using debt, he can be denied an interest deduction for such debt.[118] Tax courts have ruled in favor of the IRS in cases relating to this issue. Whether tax-exempt interest was accrued or paid has made no difference.[119] This applies, also, where such securities are used as collateral for the loan.[120]

The IRS has set up an objective test to determine whether an investor's debt will be deemed as used to carry tax-exempt securities. This is a yearly test and applies to proprietorship and partnership investors. The test is as follows:

$I = t \leq 2\%$ (P and B)

I = investment

t = average amount of tax-exempt securities valued at their adjusted basis

P = average adjusted basis of portfolio investments

B = assets held in the active conduct of a trade or business

Where the 2 per cent test is violated, the IRS can infer

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[118] Rev. Procedure 72-18, 1972-1CB740.

[119] Illinois Terminal Railroad Co. v U.S., 357 F. 2d. 1016, 1022 (1967).

[120] Wisconsin Cheeseman v U.S., 338 F. 2d. 420, (1968).

that the primary purpose of obtaining or carrying indebtedness is to finance tax-exempt securities. However, the taxpayer can rebut this IRS test if he can show that (1) the indebtedness is directly related to personal expenses, and (2) the indebtedness was due to nonrecurring business reasons.[121]

In the promotional literature and advertisements concerning tax-exempt bonds, no mention is made of the potential federal tax problems. Furthermore, in the prospectuses observed by the author, no mention was made of Code Section 265 which is vital to an investor.

Before any investor will purchase these bonds, a number of risk factors must be considered. An investor who understands IDRB financing will realize that these bonds are simply tax-exempt corporate securities. The quality of such bonds is dependent upon the ability of the company to make the lease payments. The key ratio for IDRB analysis is the earnings-coverage ratio. A good quality is usually 1½ to 2 times. This ratio simply places earnings available for payment of bond charges over the amount of bond charges. The quality of an IDRB is also partly a function of the ability of the government entity to replace the defaulted tenants rapidly. Few investment bankers and bond-rating services are willing to evaluate these factors. Therefore, it might be worthwhile for an investor to investigate these risk factors.

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[121]Rev. Procedure 72-18.

It should be remembered that the ratings given these bonds by the investor services reflect the quality of the issuing government entity, and not the quality of the company paying the bond interest and principal. This is a major risk problem in IDRB financing. Investors should also carefully read the bond prospectus and the bond indenture. In the case of a decline in sales, the bond indenture will often require that a company hold a reserve for servicing their debt. This can be an important cushion for an investor during a troublesome economic period for the business.

The historical record for IDRB financing provides good security for the investor. In the early sixties there were a few defaulted issues emanating from aggressive investment bankers in Memphis, Tennessee. Few recent issues have defaulted, however. In the State of Ohio only three IDRB issues have defaulted and, currently, only one of these issues is in arrears.[122]

Although IDRB's do not have to be registered by the SEC, they are monitored by the SEC. However, many small issues go unnoticed and unreported, and the SEC often can not intercede. Recent defaults have occurred in Mammoth Springs, Arkansas; Haysville, Kansas; and Prue, Oklahoma.[123] Most of these defaults can be attributed to over-zealous

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[122]Desmond, interview, August 13, 1979.

[123]"The Haysville Hustle," Forbes, Oct. 1, 1978, p. 29.

investment bankers and risky, venturesome projects. Despite these problems, IDRB's have a good record.

Finally, it would be only fair to mention some of the disadvantages associated with IDRB financing. A major disadvantage involving nearly all issues is the substantial legal expense. Legislation requires that bonds must be issued strictly according to the law. Bonds issued otherwise are void.[124] Other disadvantages are listed below:

1. Legal restrictions (expenditure limitations and purpose limitations)
2. The illiquidity of small-issue IDRB's
3. Loans from Small Business Administration may provide better financing.
4. Political problems may arise between the issuing government entity and the company.
5. Money needed immediately for working capital is not available through IDRB's.
6. Cost of labor, proximity of suppliers, resources, and customers all play an important role in determining a new location for an industry. Such circumstances may offset the use of IDRB financing.

Critical Issues

Two participants, the banks and the securities firms, will undoubtedly change the financing process of IDRB's. For

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[124]Rollinson, Industrial Development Bonds, p. 13.

the third time in a dozen years, legislation has been introduced to Congress to permit the banks to underwrite municipal revenue bonds. The bill, introduced by Representative Gladys Spellman of Maryland, will knock down the venerable Glass-Steagall Banking Act of 1933 which forbade banks to underwrite state and local revenue bonds. Banks have been allowed to underwrite general-obligation bonds and revenue bonds specifically designated for housing, universities, and dormitories. With the huge $30.7 billion in revenue bonds issue in 1978, there appears to be substantial profit to be made by the bankers.[125]

The bankers, however, are meeting with strong opposition from the securities firms who have taken to the lobbying offensive. Most of these firms feel that this is a strong threat to their survival. Most experts agree that if the banks are allowed to underwrite revenue bonds, the smaller securities firms will be crushed.[126]

The small securities firms argue that they are providing a vital service to small communities. They contend that only large banks have the capacity and ability to underwrite issues for small communities. These larger banks may not be interested in small-issue revenue bonds. Furthermore, the small securities firms feel that small-town banks lack

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[125]Lawrence Rout, "Securities Firms Score Bankers' Bid for Part of Revenue-Bond Sales," Wall Street Journal, April 17, 1979, p. 1.

[126]Ibid.

the ability needed in order to place these bonds with investors.[127]

The bankers have countered with arguments of their own. In 1978, a commercial bankers' lobby group, the Dealer Bank Association, hired Columbia University's economist, Phillip Cagan, who prepared a study detailing purported savings in costs if banks were allowed to underwrite revenue bonds. The bankers feel that it is nonsense to argue that they are unable to place revenue bonds with investors.[128] As the volume of revenue bonds increases, the debate heats up.

Perhaps one of the best comments on this issue was in an editorial in <u>Financial World</u> by publisher Robert I. Weingarten whose position is as follows:

> As far as I am concerned, there is nothing inherently wrong with the banks getting into the underwriting of revenue bonds. Competition never hurt any truly sound business. But the legislation must be evenhanded. That is, if the commercial bankers are permitted to become investment bankers, then the investment bankers should have the freedom, if they choose, to become commercial bankers. After all, fair is fair.[129]

Weingarten points out, also, the fact that securities firms are not allowed to offer checking accounts and make consumer loans to their customers. To allow one financial institution a big advantage over another would obviously be inequitable.[130]

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[127] <u>Ibid</u>. [128] <u>Ibid</u>.

[129] Robert I. Weingarten, "The Bankers vs the Brokers: Fair is Fair," <u>Financial World</u>, May 1, 1979, p. 4.

[130] <u>Ibid</u>.

It appears that this debate will continue, and Congress will probably think twice before passing any legislation that would give any financial institution a major competitive advantage. Whichever choice Congress makes, the IDRB financing process will probably change.

Since the inception of tax-exempt revenue bonds, an ongoing debate has challenged the legality and justification for tax-exempt revenue bonds. Proponents of tax-exempt revenue bond financing have presented good arguments. Opponents have presented good arguments, also. The debate has never been totally resolved.

Arguments in defense of tax-exempt revenue bonds will be considered first. The strongest arguments are as follows:[131]

1. A local community has the right--or, perhaps, the duty--to define its own best interests and to take such steps as it can, within the law, to win the prize in the nationwide competition for local employment and economic growth.
2. Revenue bonds, particularly IDRB's, must run the gamut of legal scrutiny.
3. Using tax-exempt bonds to induce industry to small communities does not increase national productivity; however, it does distribute economic growth potential

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[131]Rabinowitz, Finance and Administration, p. 108.

evenly among the various communities.

4. During periods of high interest rates, these bonds provide needed capital for small-to-medium-size industries.

Opponents of tax-exempt revenue bonds have always pointed to the abuse of what is called a privilege rather than a right to issue such bonds. The use of tax-exempt revenue bonds for arbitrage profits is one example of misuse. However, recent arbitrage rules have eliminated some of these problems. Whether these rules are being followed in the case of small issues is questionable. Other objections are as follows:[132]

1. The use of public funds for private industry, if allowed at all, should be used only after approval by the local electorate through a special referendum.
2. These bonds are simply a deliberate and unnecessary avoidance of taxable private capital sources.
3. The U.S. Treasury Department loses about $1 billion a year in taxable revenue.
4. Without SEC rules and regulations, tax-exempt revenue bonds will continue to be abused. Over-zealous investment bankers and bond schemers will create problems for the Treasury Department and turmoil for investors.

The use of IDRB's as a locational incentive has been criticized by economists who feel that such incentives are

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[132] Ibid., p. 111.

often inefficient and unnecessary. Jobs and new industries are not really being created, they are simply being relocated. In some cases, these bonds are used to subsidize activity in a costly or ailing location.[133]

The struggle between the State of Ohio and the State of Pennsylvania for a Volkswagen plant illustrates the abuse of financial incentives. Using IDRB's together with an additional $200-million package of funds and loans, Pennsylvania induced Volkswagen to establish operations in a plant in New Stanton. In an attempt to "steal" Volkswagen from Pennsylvania, Ohio offered IDRB's together with a $25-million package of other financial inducements. Volkswagen eventually settled in Pennsylvania. Observers believed that Pennsylvania had paid an extremely high price. Much of such criticism was directed toward Pennsylvania Governor Milton J. Shapp, a key proponent of the Volkswagen deal. Furthermore, this event fueled the criticism of financial incentives used by regional governments to induce business. The tactic is often called interregional pirating, and IDRB's are one of many tools in this area.[134]

Another critic of IDRB's is Ralph Nader who conducted a study which determined that the U.S. Treasury Department loses over $1 billion a year because of IDRB financing.

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[133]"A Counterattack in the War Between the States," Business Week, June 21, 1976, p. 71.

[134]Ibid., p. 72.

Nader says that IDRB financing saves $714 million a year for corporations. He found that most IDRB financing helps large corporations and believes that if the trend continues, the U.S. Treasury will lose over $20 billion in the next decade.[135] It appears that Nader believes that economic wealth emanates from the U.S. Treasury Department rather than through corporate investment and financing. Through IDRB financing, the U.S. Treasury is actually allowing communities to use monies where they see fit to do so. Also, it might be costly and inefficient for the Treasury to tax and then redistribute money for small projects in communities.

It is the opinion of the author that IDRB financing will be used heavily in the near future. Undoubtedly, the rise in interest rates will accelerate IDRB growth. Currently, the use of IDRB's for financing real residential property is mushrooming. If Congress responds to this bond scheme as it has in the past, IDRB's used to finance housing will be restricted.

With the passing of Proposition 13 in California, and similar legislation pending in other regions, financing of needed public facilities may increasingly depend upon IDRB's.

It appears that investment bankers will be excluded from IDRB financing in the future. For small issues,

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[135]"Tax-Exempt Bonds for Industry Called Extortion by Nader," Wall Street Journal, August 2, 1979, p. 19.

companies can place these bonds with their local bankers; or, with a little effort, companies can locate other investors. There is a definite cost savings if the investment banker is "skipped over." Also, through perseverance, bankers will eventually be able to underwrite revenue bonds. These changes, however, will evolve slowly.

The long-run future of IDRB's lies primarily in the hands of Congress. The willingness of Congress to allow local communities the privilege of tax-exemption in the future is uncertain. An opponent and critic of IDRB financing, Senator Edward M. Kennedy, is also a strong potential candidate for the presidency of the United States. A Kennedy administration could conceivably eliminate the use of IDRB financing.

In the future, abuse of IDRB's will lead to strict regulations by Congress and the SEC. IDRB's, as well as other financial incentives, will continue to be restricted if they are used too heavily for any single purpose; or, if they are used too often to pirate industry from another region. In another case, IDRB's could be misused by politicians seeking personal political gain. Tax dollars, combined with IDRB's, could be used inefficiently by political opportunists.

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"A Tax-Exempt Issue Backed by Oil." Business Week, (Aug. 28, 1978), 92.

"Blow to Revenue Bonds." Chemical Week, (November 16, 1977), 20.

"Jim Lopp's Innovative Bonds." Business Week, (November 13, 1978), 108.

"Judicial Review of Municipals is Important Feature of Tax Bill." The Bond Buyer, New York, N. Y., (September 9, 1978), p. 5.

"Now Small Business Can Pay its Pollution Tab." Business Week, (November 21, 1977), 90.

"Senate Energy Plan Vetoed by House Conferees." The Bond Buyer, New York, N. Y., October 5, 1978, p. 13.

OTHER

Public Securities Association, One World Trade Center, New York, N. Y.

APPENDIX

In order for an IDRB issue to qualify as tax-exempt, the opinion of a bond counsel must be obtained. The bond counsel will carefully study the Treasury Code (Section 103) and the Regulations (Section 1.103.1-15), and will also consider revenue rulings and private letter rulings. These rulings are useful also to anyone using IDRB financing and to those investing in tax-exempt IDRB's. The important rulings are listed in this Appendix.

Revenue Rulings:

Rev. Rul. 54-106, 1954-1 C.B. 28

Rev. Rul. 55-541, 1955-2 C.B. 19

Rev. Rul. 57-187, 1957-1 C.B. 65

Rev. Rul. 60-248, 1960-1 C.B.

Rev. Rul. 63-20, 1963-1 C.B. 24

Rev. Rul. 72-134, 1972-1 C.B. 29

Rev. Rul. 72-190, 1972-1 C.B. 29

Rev. Rul. 72-399, 1972-2 C.B. 73

Rev. Rul. 72-575, 1972-2 C.B. 74

Rev. Rul. 73-186, 1973-1 C.B. 48

Rev. Rul. 73-263, 1973-1 C.B. 49

Rev. Rul. 73-462, 1973-2 C.B. 22

Rev. Rul. 73-464, 1972-2 C.B. 674, 675

Rev. Rul. 73-481, 1973-2 C.B. 23

Rev. Rul. 73-516, 1973-2 C.B. 23

Rev. Rul. 73-563, 1973-2 C.B. 24

Rev. Rul. 74-207, 1974-1 C.B. 32

Rev. Rul. 74-289, 1974-1 C.B. 32

Rev. Rul. 74-290, 1974-1 C.B. 41

Rev. Rul. 74-380, 1974-2 C.B. 32

Rev. Rul. 74-381, 1974-2 C.B. 34

Rev. Rul. 74-485, 1974-2 C.B. 32

Rev. Rul. 75-147, 1975-1 C.B. 41

Rev. Rul. 75-167, 1975-1 C.B. 40

Rev. Rul. 75-184, 1975-1 C.B. 41

Rev. Rul. 75-185, 1975-1 C.B. 43

Rev. Rul. 75-193, 1975-1 C.B. 44

Rev. Rul. 75-208, 1975-1 C.B. 46

Rev. Rul. 75-332, 1975-2 C.B. 39

Rev. Rul. 75-333, 1975-2 C.B. 40

Rev. Rul. 75-334, 1975-2 C.B. 37

Rev. Rul. 75-403, 1975-2 C.B. 37

Rev. Rul. 75-404, 1975-2 C.B. 39

Rev. Rul. 75-411, 1975-2 C.B. 41

Rev. Rul. 76-11, I.R.B. 1976-2, 5

Rev. Rul. 76-78, I.R.B. 1976-10, 7

Rev. Rul. 76-98, I.R.B. 1976-12, 7

Rev. Rul. 76-202, I.R.B. 1976-22, 5

Rev. Rul. 76-222, 1976-1 C.B. 26

Rev. Rul. 76-375, 1976-2 C.B. 27

Rev. Rul. 76-406, 1976-2 C.B. 30

Rev. Rul. 76-427, 1976-2 C.B. 28

Rev. Rul. 76-480, 1976-2 C.B. 25

Rev. Rul. 76-494, 1976-2 C.B. 26.

Rev. Rul. 77-14, 1977-1 C.B. 18

Rev. Rul. 77-27, 1977-1 C.B. 23

Rev. Rul. 77-55, 1977-1 C.B. 18

Rev. Rul. 77-122, 1977-1 C.B. 23

Rev. Rul. 77-146, 1977-1 C.B. 24

Rev. Rul. 77-164, 1977-1 C.B. 20

Rev. Rul. 77-165, 1977-1 C.B. 21

Rev. Rul. 77-186, 1977-1 C.B. 22

Rev. Rul. 77-224, 1977-1 C.B. 25

Rev. Rul. 77-233, I.R.B. 1977-28,5

Rev. Rul. 77-234, I.R.B. 1977-28, 5

Rev. Rul. 77-253, I.R.B. 1977-30, 5

Rev. Rul. 77-262, I.R.B. 1977-31,6

Rev. Rul. 77-281, I.R.B. 1977-33, 12

Rev. Rul. 77-292, 1977-2 C.B. 35

Rev. Rul. 77-317, 1977-2 C.B. 32

Rev. Rul. 77-324, 1977-2 C.B. 37

Rev. Rul. 77-352, 1977-2 C.B. 34

Rev. Rul. 77-353, 1977-2 C.B. 44

Rev. Rul. 78-12, 1978-1 C.B. 25

Rev. Rul. 78-21, 1978-1 C.B. 26

Rev. Rul. 78-59, 1978-1 C.B. 30

Rev. Rul. 78-159, 1978-1 C.B. 29

Rev. Rul. 78-171, 1978-1 C.B. 29

Rev. Rul. 78-247, 1978-1 C.B. 29

Rev. Rul. 78-260, 1978-2 C.B. 99

Rev. Rul. 78-300, 1978-2 C.B. 100

Rev. Rul. 78-347, 1978-2 C.B. 101

Rev. Rul. 78-421, 1978-2 C.B. 100

Private Letter Rulings:

Doc 7732064

Doc 7744027

Doc 7746015

Doc 7747056

Doc 7747061

Doc 7749032

Doc 7750011

Doc 7751101

Doc 7752023

Doc 7752047

Doc 7752055

Doc 7801011

Doc 7801021

Doc 7804075

Doc 7805022 and 7805053

Doc 7805049

Doc 7806052, 7806059, 7806077, and 7806089

Doc 7807068

Doc 7807076

Doc 7808023

Doc 7810054

Doc 7814028

Doc 7815036

Doc 7815038

Doc 7816025

Doc 7816068

Doc 7817028

Doc 7817130

Doc 7817078

Doc 7817025

Doc 7817072

Doc 7817108

Doc 7818032

Doc 7819069

Doc 7820019

Doc 7822029 and Doc 7822030

Doc. 7823038

Doc 7823041

Doc 7824040

Doc 7824059

Doc 7825033

Doc 7747061 and Doc 7825050

Doc 7826102

Doc 7827030

Doc 7828013

Doc 7828022

Doc 7827027

Doc 7828071

Doc 7829123

Doc 7830018

Doc 7830023

Doc 7830159

Doc 7830160

Doc 7832026

Doc 7832113

Doc 7833014

Doc 7833070, 7833092, 7833095, and 7833102

Doc 7835090

Doc 7834074

Doc 7835034

Doc 7835075

Doc 7836034

Doc 7838022

Doc 7840035

Doc 7843069

Doc 7844025

Doc 7845023

Doc 7845049

Doc 7845053

Doc 7846065

Doc 7847027

Doc 7847037

Doc 7847038

Doc 7849016

Doc 7849028

Doc 7851033

Doc 7852015

Doc 7852089

Doc 7902059

Doc 7903087

Doc 7904035

Doc 7904054

Doc 7904122

Doc 7905076

Doc 7906053

Doc 7907062

Doc 7907072

Doc 7907134

Doc 7907143

Doc 7909018

Doc 7911026

Doc 7911051

Doc 7911066

Doc 7911097

Doc 7911123

Doc 7912098

VITA

Douglas F. Bovard was born in El Paso, Texas on December 15, 1951. He attended elementary school and high school in El Paso. During high school he participated in numerous activities and clubs, and distinguished himself in football. Also, he served his church, supervised a ghetto playground, and often vacationed on a family farm in Western Pennsylvania.

In 1970, Mr. Bovard enrolled at Grove City College in Grove City, Pennsylvania. In college he played football and served as an officer in Nu Lambda Phi Fraternity. In 1974 he graduated with a teaching certificate and a Bachelor's degree in Communication Arts.

In the fall of 1974, he accepted a teaching position at Lakeview High School in Stoneboro, Pennsylvania where he taught English on both the junior- and senior-high level. He served as sponsor of the National Honor Society, assistant football coach, senior-class play director, and an officer of various committees.

In the fall of 1978, Mr. Bovard entered the graduate school of business at Youngstown State University, and in 1979 he received a Master of Business Administration degree in Finance.

Master's Theses No. 231 Bovard, Douglas F.

Yo. State Univ. MASTER'S THESES No. 231

Bovard, Douglas F.
A comprehensive study of industrial development revenue bond financing.

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