

Industrial Revenue Bond Basics

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***Disclaimer:** The law and legal rules are subject to continual revision and change. This article is dated January 10, 2018. No attempt has been made to update this article to reflect pertinent changes or developments in the law, if any, since that date. The following discussion necessarily simplifies issues concerning industrial revenue bonds.*

Industrial revenue bonds (IRBs) are the pre-eminent economic development tool in New Mexico. Since 1985, well over one hundred series of bonds totaling many billions of dollars have been issued by over 40 municipalities and counties, ranging in size from Albuquerque to Grady. A wide variety of large and small companies have benefited from IRBs. Businesses that have utilized IRBs (and the corresponding IRB projects) include Facebook (Los Lunas data center), Intel (Rio Rancho semiconductor plant), Wal-Mart (Los Lunas distribution center), General Mills (Albuquerque cereal plant), TriGas Corporation (Albuquerque air separation plant), Border Foods (Deming chile processing plant), McKinley Paper Company (Prewitt paper mill), Leprino Foods Company (Roswell cheese factory), Karr Tool (Santa Teresa metal stamping plant), Franklin Industries (Velarde mica mill), Universal Printing Company (printing press for Albuquerque plant), Marcy Plaza Associates (Santa Fe office building and parking garage), Red Mesa Wind (Cibola County wind farm), America Online (Albuquerque call center), and the Red River Ski Area.

What are IRBs? IRBs are, fundamentally, tax subsidies. Depending on the type of IRB project, the holder of the bonds, and other factors, the subsidies may be one or more of (i) a property tax exemption, (ii) a gross receipts tax deduction (and/or compensating tax exemption), (iii) an exemption of bond interest from New Mexico income taxation, and (iv) an exemption of bond interest from federal income taxation. IRBs may be the actual mechanism for financing the IRB project, although (as discussed below) this is not mandatory, and is increasingly rare.

How do IRBs work? In an IRB transaction, the real and/or personal property comprising the IRB “project” is deeded from the benefiting company to the IRB issuer (either a municipality or a county). The issuer then simultaneously leases the project back to the company for the term of the bonds, with the company being obligated to purchase the project (for a nominal sum) at the bond maturity date. Since the project property is owned by a governmental entity during the bond term, the company essentially acquires the state and local tax status of a governmental body with respect to that property. Thus, the project property is exempt from property taxation during the term of the bonds, and purchases of depreciable, tangible personal property (to the extent that such property is part of the project and is purchased with bond

proceeds) is deductible from gross receipts for purposes of the gross receipts tax, or is exempt (if purchased out-of-state) from the New Mexico compensating tax.

What is the maximum bond term? IRBs can be issued for a maximum of 30 years. Additional IRBs, with independent 30-year lives, can be issued for expansion projects, or for separate, additional projects of a company already benefiting from IRBs, so long as the property comprising the later project is different from the property comprising an earlier project.

Who can issue IRBs? All New Mexico counties and municipalities can issue IRBs. Municipalities can issue IRBs for projects located within, or not more than 15 miles outside of, their municipal limits. County IRB projects may be located anywhere within the county outside of municipalities, except that Bernalillo County's IRB projects may also be located within the City of Albuquerque. Municipal IRBs and county IRBs are authorized by two separate statutes, which are similar but not identical.

Do issuers provide credit enhancement for IRBs? Debt service on IRBs, and all other costs pertaining to IRB projects, are entirely the responsibility of the benefiting company. Issuers are prohibited from paying principal or interest on the bonds, or guaranteeing or otherwise providing credit enhancement on the bonds, or incurring any other contingent or noncontingent pecuniary obligation in connection with the bonds. The issuer is lending the company its tax status with respect to the project, and nothing else. This means, among other things, that the fact that the IRBs are issued by a governmental entity makes them no easier to market than any other debt of the company.

What qualifies as an IRB "project"? A wide variety of business activities qualify for IRB treatment, including (i) "manufacturing, processing or assembling of any agricultural or manufactured product", (ii) "any commercial enterprise in storing, warehousing, distributing or selling products of agriculture, mining or industry", but generally excluding retail sales of goods, (iii) businesses involving the supply of services, (iv) certain electrical generating plants (including wind and solar photovoltaic farms), (v) new mining operations, and (vi) new refineries. Activities that would not qualify include traditional farming and housing. Businesses primarily involving retail sales of goods would not qualify for municipal IRBs, but may qualify for county IRBs.

What types of property may be included in an IRB? An IRB project may be comprised of any combination of fee or leasehold interests in real property and/or fee or leasehold interests in tangible, depreciable personal property. If the benefiting company's original property interest is a lessee's interest, then the benefiting company subleases that interest to the IRB issuer, and the IRB issuer sub-subleases that interest back to the benefiting company.

Can nonprofits utilize IRBs? Both for-profit and nonprofit entities can take advantage of IRBs. In fact, the IRB statutes imply that any activity of a 501(c)(3) corporation (including housing) may qualify as an IRB project. IRBs are used by nonprofits primarily for the federal income tax exemption, rather than the property tax exemption.

Can foreign companies benefit from IRBs? IRBs can be issued for the benefit of any business, including established New Mexico businesses wishing to expand as well as companies from outside New Mexico or the U.S. that wish to move to or establish operations in New Mexico.

What are the arguments in favor of IRBs? Those favoring IRBs argue that they are a rational subsidy, because the IRBs generate business activity that otherwise would not occur. According to this view, the issuer typically loses only the property tax revenues corresponding to the value of the unimproved project site, while the project indirectly generates far more than this amount through construction expenditures, wages, purchases from local businesses, and so forth. In general, projects that will pay high wages and benefits are favored over projects that employ less skilled workers, although the relative attractiveness of projects varies considerably depending on the nature of the community, the economic climate and other factors.

What are the arguments against IRBs? Those opposing IRBs frequently suspect that the benefiting company will move ahead with its project even if IRBs are not issued, and that therefore the subsidy is unnecessary. Opponents may also object to IRB projects that are low-tech, and that pay low wages, and to using IRBs to support out-of-state companies as opposed to home-grown businesses. It should also be noted that although the decision to provide the property tax exemption is being made by one governmental entity (the municipality or county issuing the bonds), all of the local entities that rely on property taxes are affected. New Mexico municipalities generally obtain little of their revenues from property taxes, while counties and school districts rely significantly on this revenue source.

What is the IRB approval procedure? IRBs are authorized by a bond ordinance, which may be adopted only after published notice and a public hearing. If the company desires to begin substantial planning or development of the project prior to the scheduled adoption of the ordinance, the company may request the issuer to adopt an “inducement resolution” early on in the process, thereby providing the company some comfort that the issuer will in fact act favorably on the authorization of the bonds. Although an inducement resolution does not (and legally cannot) guarantee the adoption of the IRB ordinance, it is very unusual for a New Mexico issuer to pass an inducement resolution and then subsequently refuse to adopt the IRB ordinance, or to issue the bonds. (The terms of the ordinance, however, may not be as favorable as the company had imagined they would be at the inducement resolution stage.) The approval process may or may not be politicized, depending on the nature of the community and the nature of the project.

How long does IRB approval take? The notice of consideration of the bond ordinance must be published at least two weeks before the hearing, and a 30-day statute of limitations on challenges to the ordinance is almost always allowed to run following publication of notice of adoption of the ordinance and prior to the issuance of the bonds. Thus, the minimum legal period required for issuance of an IRB will be about seven weeks. To this needs to be added time for document drafting, securing a bond purchaser, compliance with additional procedural steps (if any) imposed under local law, and persuading the issuer and the community of the project’s desirability. As a practical matter, even an uncomplicated project with strong political

support will require about ten weeks between the time that the issuer is first approached until the bonds are issued. Complicated or less popular projects can take weeks or months longer. An inducement resolution can frequently be obtained in less than a month.

How can issuers limit IRB subsidies? Issuers are free to place restrictions on the amount of the property tax subsidy, or to negotiate for payments or services from the company in return for the issuance of the IRBs. One way of limiting the subsidy is to limit the term of the bonds. The City of Albuquerque, for example, will not issue IRBs with a term of more than 20 years, while the City of Rio Rancho restricts its IRBs to 25 years. In recent years it has been more frequent for issuers to require PILOTs (payments in lieu of taxes) for the benefit of the issuer and/or other local governmental units. It is not unknown for council or commission members to lobby for funds for favorite causes shortly before the consideration of the bond ordinance, although publicity appears to have put a damper on this practice. It is important for the company, and it should be important for the issuer, to discuss and settle any conditions of issuance or subsidy restrictions in an open, businesslike manner early in the IRB process. Ideally, all material subsidy reductions should be negotiated prior to, and addressed in, the inducement resolution.

What is a typical PILOT? PILOT terms can vary greatly. Historically, PILOTs have ranged from very low, symbolic amounts to as much as 50% of what the total property tax bill would have been without the exemption. Some issuers wish to receive all or the lion's share of a PILOT, while others have imposed PILOTs only for the benefit of the local school district or community college, on the assumption that the increased employment associated with the project will result in increased enrollment and associated increased costs. Rio Rancho, for example, requires a PILOT that is equal to the amount of property tax revenue the school district would have received but for the IRB exemption.

Are PILOTs required by statute? With one exception, PILOTs are not mandated by statute, but rather are entirely a matter of negotiation between the benefiting company and the issuer. The exception pertains to IRBs for electrical generating facilities, which may not be issued without the approval of the local school district, and without the benefiting company, the issuer and the local school district having agreed upon an annual PILOT to be paid to the district. The statutes do not specify the amount of this PILOT, but only state that the district's approval may not be unreasonably withheld.

What is a "self-funded" IRB? For many companies, both large and small, IRBs are not needed to provide any financing for the project. The company already has the funding in hand, or can raise it more efficiently by other means. Instead, the only purpose of the IRBs for these companies is to generate the property and gross receipts/compensating tax subsidies. However, in order to respect the legal form of the IRB transaction, bonds still need to be issued, and to avoid a potential merger of the debt (i.e., the legal extinguishment of a debt because the creditor and debtor are the same person), such bonds need to be purchased by a legal entity other than the benefiting company. In such a case, the bonds are ordinarily purchased, and held until maturity, by a corporate affiliate. Almost all IRBs issued in recent years have been in self-funded form.

Who may purchase IRBs? Any person or entity may purchase IRBs. If IRBs are not self-funded, then the company must find a “real” purchaser; an independent party that delivers value for the bonds. In some cases, this may be the founder or majority shareholder of the company. If the company has a good banking relationship, its bank may be willing to purchase the bonds, or provide a letter of credit or other credit enhancement for the bonds. The company may also engage an investment banking firm to serve as an underwriter or a placement agent for the bonds.

Can a company redeem bonds prior to maturity? The debt service and redemption provisions of the bonds can take essentially whatever form the company and its bond purchaser agree upon. An IRB lease, however, terminates when all of the principal amount of the bonds is paid. It is important, therefore, to keep at least some principal amount of the bonds outstanding until the final maturity date, in order to preserve the property tax exemption for the maximum period.

What is the flow of funds in an IRB transaction? Although various IRB payments are made “for the credit of the issuer”, the issuer does not handle any bond proceeds, debt service payments, or other money (excluding PILOT payments). Typically, the bond price is paid to a trustee, who in turn disburses it to the company upon receipt of requisitions. The company pays debt service (equivalent to rental payments under the lease) to the trustee, who passes such payments through to the bondholder. In the case of a self-funded IRB, bond proceeds are passed through a trustee or trust depository for tax accounting purposes, but all other payments (or arrangements for reciprocal book entries) are made directly between the company and the bondholder.

How are IRBs secured? Payment of IRBs is secured by a lien on the project revenues. Many bondholders and credit providers require additional security, which frequently includes a mortgage and security interest on the project property, senior to the lease and to the lien of the bonds, as well as a mortgage on the lease itself. This arrangement gives the bondholder or credit provider the option of foreclosing on the lease (that is, keeping the bond regime, and the property tax exemption, in place), or foreclosing on the project property (wiping out the lease, and with it, the tax exemption).

What can IRB proceeds be used for? Generally, IRB proceeds can be used to pay for any of the costs of the acquisition, construction and equipping of an IRB project, as well as most issuance costs. IRBs whose interest is exempt from federal taxation, however, are subject to additional restrictions on the use of proceeds (discussed below).

How does the gross receipts tax deduction work? Following the adoption of the bond ordinance, or the adoption of the inducement resolution, the company can request, from the state Department of Taxation and Revenue, Non-taxable Transaction Certificates (NTTCs), which the company will deliver to suppliers of qualified project property. Relying on the NTTCs, such suppliers will not charge the company gross receipts tax. Only sales of certain tangible personal property that is depreciable under the federal tax code (as 3-, 5-, 7-, 10- or 15-year property) qualifies for the gross receipts tax deduction. Sales of personal property that is incorporated into

project real estate (i.e., construction materials such as lumber, concrete, structural steel, etc.) are not deductible from gross receipts tax. The company, and not the issuer, is responsible for the proper use of the NTTCs. It is important that the company clearly communicate to each supplier which sales are deductible and which sales are not.

How does the compensating tax exemption work? New Mexico gross receipts tax is applicable only to sales by New Mexico suppliers. However, a more or less parallel tax, the New Mexico compensating tax (also called the “use tax”), applies to purchases from out-of-state suppliers. Any purchases of project property that would be deductible for gross receipts tax purposes (if purchased in-state) will be exempt from compensating tax (if purchased out-of-state). The exemption is automatic, and there is no requirement to supply NTTCs or other documentation to the seller.

What IRBs are exempt from federal income taxation? IRBs must satisfy numerous requirements in order to qualify for the federal income tax exemption. Key requirements are that the IRB project be a manufacturing facility, and that the total capital expenditures of the company in the jurisdiction of the issuer during the period extending from three years before bond issuance until three years after bond issuance not exceed \$10 million. Other restrictions include (i) limitations on the amount of the bond proceeds that may be used for issuance costs, land acquisition and the purchase of existing equipment and improvements, (ii) a limitation on the maximum term of the bonds (which may be considerably less than the 30-year maximum permitted under state law), and (iii) a ceiling on the total amount of tax-exempt bonds outstanding for the benefit of all affiliates of the company. An allocation of the state cap for private activity bonds must be also obtained from the State Board of Finance. Although the State Board appears to favor such allocations, private activity allocations overall are generally made early in the calendar year, so that allocations for IRBs may not be obtainable in the latter part of the year.

How does a bond purchaser obtain the New Mexico income tax exemption? The interest on all New Mexico IRBs is exempt from New Mexico income taxation, regardless of whether or not such IRBs qualify for the federal exemption. Thus, any bondholder whose income is subject to New Mexico income tax will be able to take advantage of this exemption.

What are the securities law requirements for IRBs? IRBs that are exempt from federal taxation are also exempt from federal securities registration requirements. They are not, however, exempt from anti-fraud requirements. All other IRBs are fully subject to all federal and state securities requirements. The consequences of such requirements, however, vary greatly, depending mainly on the nature of the bond purchaser and the relationship between the company and that purchaser. Since, for example, self-funded bonds are unquestionably private sales under the meaning of the federal Securities Act, and the purchaser may be deemed to have full knowledge of the company and the project, such bonds are exempt from registration, and no disclosure is required. Broad securities exemptions are also available for sales to banks, and for bonds that are guaranteed by banks. Many IRBs are sold using the Regulation D exemption from registration, with disclosure ranging from minimal (in the case of a sale to a majority

shareholder of the company, for example) to extensive. Since disclosure costs can be significant, a sale to a party that has prior knowledge of the company is often preferred.

What are “low-floaters”? Low-floaters are bonds that are payable from a direct-pay letter of credit issued by a bank with a good credit rating, with the bondholders having the right to put the bonds (that is, demand their payment) on short notice. Bonds that are put are resold to other buyers. The highly liquid nature of the obligation, together with the high credit rating backing the bonds, results in the bonds having a low interest rate. On the other hand, (i) the obligor must pay a fee (typically of 1-1.5%) on the letter of credit, plus generally higher transactional costs, (ii) the interest rate, being variable, may change significantly over the term of the bonds, and (iii) the term of the letter of credit is typically much shorter than the term of the bonds, and if the company’s financial standing declines, the letter of credit provider may require a higher fee or additional security as the price of renewing the letter of credit, or may even refuse to extend the letter of credit, thereby probably collapsing the deal.

What legal counsel are involved in an IRB transaction? At a minimum, an IRB transaction will require the services of a “bond counsel”, who represents the company. An issuer may be content to be represented by its in-house attorney, or it may retain outside counsel who is more experienced with IRBs. In the latter case, the issuer may require the company to pay the fees of such counsel. An underwriter or placement agent is typically also represented by counsel. Trustees frequently rely on their in-house counsel, but may retain outside counsel if the IRB is structured in a novel or unusually complicated way. Credit enhancement providers will also be represented by counsel.

What happens if the company ceases to operate the project? The IRB statutes do not address this issue. Absent some specific remedy included in the lease, it appears that the property tax exemption may continue until the bonds mature, even though the project is inactive and the issuer is not receiving the jobs and other economic benefits that it bargained for. Most issuers now insist on a lease provision that places the project property back on the tax rolls if the project is closed. Some issuers may also require a clawback remedy (that is, retroactive payment of foregone property taxes) to be included in the lease. Almost all issuers, however, would prefer that another company take the project over and operate it, and to facilitate this, the issuer will generally be willing to delay enforcement of its lease remedies for some period of time.

Are benefiting companies required to provide certain benefits? Companies whose projects have a value of \$8,000,000 or more, and that are issued (i) by municipalities with a population of more than 40,000 or (ii) by counties with a population of 100,000 or more, must, as a condition of the issuance of the IRBs, offer their employees health insurance in compliance with state law, and contribute not less than 50% of each employee’s premium (but not the premiums for the employee’s dependents).

What factors increase IRB costs? In theory, many IRBs, and particularly self-funded IRBs, should require not much more than cutting and pasting of well-established forms. In reality, a number of factors can complicate IRB transactions and increase legal and other costs, including: (1) project-related traffic, noise, utility requirements and other issues that are

independent of the IRB but that compromise IRB scheduling; (2) public confusion about the nature of IRBs, and concern that the IRB issuer will be paying or guaranteeing the IRB debt; (3) principled opposition to governmental subsidies, especially if first raised late in the IRB process; (4) pre-existing political rivalries, with one faction hostile to the IRBs because an opposing faction is promoting them; (5) demands from different governmental taxing units for significant PILOTs, cumulatively eroding the economic rationale of the IRB; and (6) poor planning by the benefitting company, resulting in a continually changing project or public explanation for the project.

Are IRBs constitutional? New Mexico has had since statehood a constitutional provision, commonly known as the “Anti-donation Clause”, that broadly prohibits all forms of subsidies to private individuals and businesses. The Industrial Revenue Bond Act, first enacted in the mid-1950s, was purposefully designed to operate in a convoluted manner in order to disguise its subsidy purpose and thereby circumvent the Anti-donation Clause. There is no particular reason to believe that this fooled the New Mexico Supreme Court in any way, but the court nevertheless went along, and found the Act to be constitutional, in the 1956 case Village of Deming v. Hosdreg Co. The constitutionality of the Act has not been challenged since. (The New Mexico statute appears to have been derived from the “Balance Agriculture with Industry Act”, a Depression-era Mississippi law that was drafted to avoid similar constitutional prohibitions.)

How can IRBs be challenged? In general, the issuance of IRBs can be legally challenged in the same manner and for the same reasons as the adoption of any other local legislation. Like other types of governmentally-issued bonds, however, IRBs are subject to a very short statute of limitations. Any suit challenging the validity of IRBs must be filed no later than 30 days after the publication of notice of adoption of the bond ordinance. The limitations period does not apply to constitutional defects, but since the specific authority for IRBs is entirely statutory, once the limitations period has run, IRBs are essentially immune from attack.

How can business competitors challenge the issuance of IRBs? A competing business that is not a beneficiary of IRBs can challenge the issuance of IRBs by a county (but not by a municipality) by filing a written complaint with the county within 15 days after the adoption of the bond ordinance. In that case, the IRBs may not be issued until the State Board of Finance holds a hearing and makes a determination that the IRB project will not compete “directly or substantially” with the business of the complaining entity. The Board must make its determination within 90 days of a request from the county. Such challenges are rare.

Where can I find copies of the IRB statutes? The IRB statutes are available on the State of New Mexico website (www.newmexico.gov), under the “Business” tab. The [Municipal] Industrial Revenue Bond Act consists of Chapter 3, Article 32, and the County Industrial Revenue Bond Act consists of Chapter 4, Article 59.