

Spotlight *on* Capital Resources:

Tax-Exempt Bonds



What are Tax-Exempt Bonds?

Tax-exempt bonds are a special form of debt financing for capital projects. Federally Qualified Health Centers¹, along with many other types of nonprofit corporations and certain types of for-profit corporations, are (or may be) eligible to access this tax-advantaged form of financing. In the most general sense, a tax-exempt bond is similar to a bank loan; just as a bank loan agreement represents the bank's willingness to lend a certain sum of money to a borrower in exchange for the borrower's promise to repay the loan with interest, so a tax-exempt bond represents a bond holder's investment of a certain sum of money in a borrower, in exchange for the borrower's promise to repay the principal of the bond, plus interest, over a specified period of time.

The major difference between tax-exempt bonds and conventional loans is that tax-exempt bonds do not require the payment of federal taxes on interest income generated from the bonds; sometimes the bonds are also exempt from state taxes as well. Because of the tax exemption, investors are willing to accept a lower rate of return than they would if they had to pay taxes on this income. Borrowers benefit from the lower interest rate, while investors that wish to shield income from taxes benefit as well. In the current market, the resulting tax-exempt interest rate is generally 65% to 70% of taxable interest rates. This benefit can make a critical difference in the financial burden placed on a center to service the debt incurred in funding capital projects.

Who is Eligible to Borrow through the Tax-Exempt Bond Market and How are Bonds Issued?

Federal and state law provisions determine whether a health center is eligible to receive tax-exempt bond financing. From a federal law perspective, virtually all health centers that are 501(c)(3) entities and are undertaking "qualified projects" (discussed later) are eligible to receive tax-exempt bond financing issued through bonding authorities known as "conduit issuers." Generally quasi-public entities created through an act of the State's legislature, conduit issuers have the authority to issue tax-exempt bonds on behalf of various eligible borrowers. Any given state may create multiple conduit issuers, each with enabling legislation allowing them to issue bonds for certain types of borrowers.

Health centers must investigate which, if any, issuers may be available to work with them in a given state. Sometimes health centers can work with more than one issuer in a state. On the other hand, in some states none of the issuing authorities may be authorized to issue bonds on behalf of health centers.² Still other states may have established county-wide or local issuers to which health centers may apply. In any case, every nonprofit must work through an authorized issuer in order to gain access to the tax-exempt bond market. For a listing of the various entities throughout the United States that may be eligible to issue tax-exempt bonds on behalf of health centers, see the website for the National Association of Health and Educational Facilities Finance Authorities, www.naheffa.com/members.html. You can also Google "Economic Development Authorities" and "Industrial Development Finance Authorities" to see if your state has one of these authorities; in some states, these entities may be able to work with health centers as well.

¹ In this document, we use the terms "community health center," "CHC" and "health center" to mean any Federally Qualified Health Center or similar nonprofit, community-based clinic, whether federally-funded or not.

² As of this writing, there are statewide issuers in approximately 33 states that are authorized to issue bonds on behalf of health centers.

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What Types of Projects Can Be Financed with Tax-Exempt Bonds?

The federal tax code defines the types of projects that are financeable through tax-exempt bonds. The law firm that serves as Bond Counsel on the transaction bears the responsibility for providing the legal opinion that says that the bond issuance meets the requirements of the tax code for federal tax exemption on the bonds. As a result, Bond Counsel is the ultimate arbiter of what is and is not financeable through a tax-exempt issuance. In general, bond counsels usually determine that the following types of costs can be included in a tax-exempt issuance:

- refinancing of existing debt originally issued for qualified purposes (and in certain cases, refunding of existing tax-exempt bonds)
- purchase of land, buildings and equipment
- construction and/or renovation costs (including leasehold improvements if the term of the lease is at least as long as the term of the bonds)
- capitalized interest during construction
- certain pre-development costs (that are deemed capitalizable costs by the health center's auditor)
- debt service reserve of up to approximately 10% of the principal amount of the bonds
- certain costs of issuance (attorneys' fees, credit enhancement fees, etc.)
- a *de minimus* amount of "bad money" (see explanation below)

It is important to remember that only "qualified borrowers" can benefit from tax-exempt bond proceeds. For health centers, that generally means that the financed project can only be used by qualified nonprofit organizations. This provision basically precludes a health center from developing a facility and leasing some or all of the space to a for-profit entity.

The "bad money" allowance does allow the inclusion of a small amount of costs that might not otherwise qualify for tax-exempt financing. For example, a health center might be able to develop a small amount of space for lease by a for-profit pharmacy if the cost and amount of space allocated to this piece of the project does not exceed a *de minimus* amount of the project costs and a *de minimus* amount of the overall space. Usually, *de minimus* is defined as an amount not to exceed 5% of the cost of the project or the gross square footage of the project. A *de minimus* amount of working capital may also be included as a part of a tax-exempt issuance, even though working capital does not meet the IRS definition of a financeable cost for the purposes of tax-exempt bonds.

Why Are Tax-Exempt Bonds Especially Important to Consider Now?

In two words: "interest rates." Interest rates are at historic lows since the days of the Great Depression. Both long-term and short-term interest rates are extremely low, and tax exempt bond rates are even lower. Currently bond rates fixed for seven (7) to ten (10) years are in the 3% to 3.5% range as compared to conventional financing rates of 5% to 6%. Needless to say since we are experiencing interest rates that are at historic lows, there is only one way for them to go ... up. An increasing interest rate scenario over the next decade is almost certain.

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Let's just look back a few years to get a comparison. Just prior to the economic downturn that began in 2008, tax-exempt bond rates were 2.5% higher than present ... at or around 5%. And, briefly during the 2008 “sub-prime mortgage crisis,” these same equivalent tax-exempt bond rates ballooned to 10%. Nearly all economists predict increasing interest rates in the near future, so the point is obvious. Using tax-exempt bonds to finance your project is not only usually beneficial—it is doubly so today with rates at historic lows. It is quite likely that using tax-exempt bonds to fund your capital improvements during this window of opportunity will provide the most advantageous financing terms for the foreseeable future.

Typical Tax-Exempt Bond Structures for Community Health Centers

Typically, tax-exempt bonds for community health centers can be structured in two ways: either as “private purchases” or as “public offerings” (or its close relative, “limited public offerings”). The presence or absence of credit enhancement generally constitutes the defining distinction between these two structures. Each of these structures is described below:

Public Offering

For large projects it is possible to offer tax-exempt bonds to the public through an investment banking firm. To do so requires that the health center obtain credit enhancement, usually through a renewable letter-of-credit from a financially strong commercial bank to secure the bonds so that the public will purchase them.³ This method requires the health center to pay the bank an annual fee for its letter-of-credit, typically 1% to 2.0%, in addition to the interest rate on the bonds. The bonds are then sold to the public based on the credit worthiness of the bank. In the current environment, this method is seldom used by health centers because the underwriting costs are high and the offering needs to be in excess of \$20-to-\$25 million to be cost-effective. In addition, as a result of the recent banking crisis, fewer banks have attractive enough credit ratings to offset the cost of the credit enhancement—making these types of transactions less beneficial to health centers.

In some states, issuers have assembled bond pools to allow smaller borrowers to access the market on a cost-effective basis. In theory, several health centers with current projects could work with a single bank to issue a letter-of-credit to cover a bond issue that would fund all of the projects at once. For example, three projects of \$10 million each would combine to form a \$30 million bond issue. This method has been completed on several occasions but requires a good deal of cooperation and coordination among the health center participants. It can be cost effective because the health centers share in the bond issuing costs and receive the full benefit of the tax exempt rate as set by a competitive market.

Private Purchase

This method is by far the most appealing for financing health center projects. A bank simply agrees to purchase the bonds once issued. For example, a bank willing to extend a conventional loan to your health center at an interest rate of 5% would instead purchase tax-exempt bonds from you at 3.5%. The after-tax income to the bank is the same while the cost to you is significantly less. Also, the cost of issuing the bonds in this manner is relatively low—not much more than the fees for obtaining a conventional bank loan. As a result, smaller transactions can be completed in a cost-effective manner. In the current market, Private Purchase is by far and away the most popular and simple process for using tax-exempt bonds for health centers.

³ Bond insurance can play the same role as a credit enhancement source—however, only in California do health centers have access to a reliable source of bond insurance. See CalMortgage: www.oshpd.ca.gov/calmort.

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How to Use Tax-Exempt Bonds

Utilizing tax-exempt bonds for financing a health center project is not as complex as one might think. Although it is advisable to obtain overall financing advice from someone with experience in issuing tax-exempt bonds, the process of learning whether this is an option for you is fairly straight-forward. Begin by determining whether or not there is an issuer in your state that can issue bonds on behalf of a community health center. Assuming there is, you should consult with the issuer to make sure your project is eligible for tax-exempt financing. If you qualify, you may wish to have a discussion with your local bank or banks to determine their interest in participating in a bond financing. Finally, identify which law firms in your community are experienced in tax-exempt bond financing.

Once you have determined that the use of bonds is possible, you will need to go through an approval and issuance process. Although each issuer sets its own specific processes, in general, you should expect the following steps in most states.

<i>File an Application</i>	The CHC must file an application with the bond issuing authority for approval to use tax-exempt bonds.
<i>Review by Issuer</i>	The issuer reviews the application and takes a "Preliminary Action" vote, indicating that it believes that your project is eligible for tax-exempt bond financing.
<i>Public Notice & Hearings</i>	Following this initial vote there are various public notice and public hearing (TEFRA) requirements; sometimes there are required historic and/or environmental reviews as well.
<i>Bond Purchase Commitment</i>	The CHC must obtain a bond purchase commitment from the bank/purchaser. This like a loan commitment.
<i>Attorney Provides Bond Opinion</i>	A bond attorney, engaged by the CHC, must provide a bond opinion stating that the CHC bonds meet all legal criteria for tax exemption.
<i>Final Action</i>	Once all the legal documentation for the transaction is substantially complete, the issuer will take a second vote called "Final Action," indicating that the bond issuance is ready to close.
<i>Bond Issuance</i>	The issuing authority issues the bonds.
<i>Bond Purchase</i>	The bank purchases the bonds.
<i>Funds into Escrow for CHC Use</i>	The funds go into escrow for use by the CHC for its project.

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Conclusion

With rare exceptions you should explore the use of tax-exempt bonds as an alternative for financing a capital project. Moreover, if you are contemplating capital expansion in the next ten years, you may wish to consider initiating the process soon. With interest rates so low, we are undoubtedly in a financial and economic window of opportunity that will certainly close in the future.

Acknowledgement

This publication was supported by Grant/Cooperative Agreement Number U30CS09741 from the Health Resources and Services Administration, Bureau of Primary Health Care (HRSA/BPHC). The contents of this publication are solely the responsibility of the author(s) and do not necessarily represent the official views of HRSA/BPHC.

About Capital Link

Capital Link is a non-profit organization that has worked with hundreds of health centers and primary care associations over the past 15 years to plan capital projects, finance growth and identify ways to improve performance. We provide innovative advisory services and extensive technical assistance with the goal of supporting and expanding community-based health care. Additionally, Capital Link works in partnership with primary care associations, the National Association of Community Health Centers and other entities interested in improving access to capital for health centers. For more information, visit www.caplink.org.