

PUT OUT WITH OUTPUT CONTRACTS: DON'T BLOW UP YOUR BOND ISSUE

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Any water provider that has ever issued tax-exempt bonds should be familiar with the concept of "private activity bonds." For those who have not issued such bonds or have repressed the memory, the IRS allows state and local governments to issue tax-exempt bonds to finance essential governmental functions, which usually have a lower rate of interest. This is, in effect, a governmental subsidy of projects determined to be vital to the public, such as utilities, highways, public schools, and many other public infrastructure items. Typically, however, the IRS does not want to subsidize a private business.

Unfortunately, drawing the line between private and public projects can be difficult. For example, an international airport owned by a public airport authority sounds like a public project, but what if the airport has terminals that are built for, and dedicated solely to, Southwest Airlines. Similarly, what if a water utility builds a water system and sells 50% of the water to residential consumers and 50% to a privately-owned poultry processor. Can the water utility finance the extension of service to the poultry processor with tax-exempt bonds. The answer is "maybe" and depends on the type of water purchase arrangement between the utility and the private business. The IRS has provided substantial guidance on how to structure these so-called, "output contracts."

Before entering into an arrangement to sell water to a non-governmental entity, a water provider should consult with a bond attorney. In general there is nothing wrong with selling water produced by facilities financed with tax-exempt debt but in some circumstances, certain things should be done to prevent the arrangement from creating a "private activity bond" problem. Because of the complexity of the issue and the substantial negative affect it could have on a provider's ability to obtain or maintain tax-exempt financing, water providers should consult with a bond attorney. Even if a bond issue becomes a "private activity bond" after closing, the IRS would demand the payment of taxes on the interest income retroactive to the date of issue.

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