ELA Municipal Leasing Forum

"Exploring Public Finance Opportunities"

Public Finance 101

Michael P. Gallo, ESQ
Municipal Leasing Committee, Chair
Cisco Systems Capital

Introduction

- Setting the Stage
  - Tax-exempt Financing
  - Federal Tax Aspects
  - Municipal Lease Purchase Agreement
  - Private Activity Bonds
    - Qualified 501 (c)(3) Bonds
    - Qualified Small Issue Bonds (IDBs)

- What is tax-exempt financing?
- Distinguishing between tax-exempt and conventional financing.
- Historical Prospective

Tax-exempt Financing
An Introduction

- Tax-exempt financing is a lending relationship in which the interest component of payments is excluded from the lender's gross income for federal tax purposes. This translates into a lower interest rate and payment to the borrower.

- Traditionally tax-exempt transactions have taken the form of bonds, which represents debt of the borrower, but also includes municipal leases, qualified 501(c)(3) bonds (also known as third-party conduits) and qualified small issue bonds (also known as Industrial Development Bonds).

Who qualifies for Tax-Exempt Financing?

- Issuers (Lessees) of tax-exempt obligations include State or possessions of the U.S., the District of Columbia, and political subdivisions thereof. These include: school districts, county and city governments, special purpose districts, fire districts and state educational institutions.

- Other entities that qualify include 501(c)(3) private not-for-profit corporations that are generally tax exempt but do not issue tax-exempt obligations on their own and commercial companies who qualify under special programs such as Industrial Development Bonds or Enterprises Zone Bonds.

Calculating Tax-Free Yield

$$(1)\quad \text{Taxable Equivalent Yield} = \frac{\text{Tax-Free Yield}}{1 - \text{Your Federal Tax Bracket}}$$

$$(2)\quad \text{Target Lessee Return} = \frac{\text{Tax-Free Yield}}{1 - 35\%}$$

$$(3)\quad 9.80 * 0.65\% = 6.37\% = \text{Tax-Free Yield}$$

How are Tax-Exempt Transactions Structured?

The transaction structure of tax-exempt financing is dependant on the legal status of the issuing Authority. Following is a list of borrowers, or lessees, and the corresponding transaction structure.

Borrower / Lessee	Structure	Tax Treatment
State and Political Subdivisions	Municipal Lease	Tax-exempt Taxable
Non-Profit Corporation	Third-Party Conduit	Tax-exempt
Commercial Company	IDBs	Tax-exempt

Federal Tax Aspects

- Basic framework and statutory scheme.
- What is a "Bond"?
- Source of tax exemption – Section 103.

Section 103. Interest on State and Local Bonds

(a) EXCLUSION – Except as provided in the subsection (b) gross income does not include interest on any State or Local Bond.

(b) EXCEPTIONS – Subsection (a) shall not apply to – (1) Private Activity Bond which is not a qualified bond (within the meaning of Section 141) . . .

It goes on to define State and Local Bonds as those *obligations of* a State or political subdivision thereof.

Federal Tax Aspects

- Stated interest and borrowing power requirement.
- Tax-exempt lease transaction – a quick note.
- State law is determinative.
- Federal guarantee prohibition.
- Source of repayment.

Who can issue tax-exempt bonds?

(Restated, who can borrow on a tax-exempt basis?)

- Generally
- States and political Subdivisions – Issued "by"
- Issued "on behalf of" Authorities
- Governmental Bonds and Private Activity Bonds
- Bank Qualified Bonds
- Arbitrage and Rebate Bonds
- Reimbursement Regulations
- Interest Expense Disallowance – De Minimis Rule

Municipal Lease Purchase Agreements

- The municipal lease purchase agreement traditionally has been the primary structure of tax-exempt transactions for equipment Lessors.

- It offers quality transactions with minimal credit risk represented by a estimated default rate of less than one-half of one percent.

- For the customer, it provides a cost-effective financing alternative to bonds and bond referendums with lower issuance costs and less administrative entanglements.

- Other benefits of a municipal lease include:
  - (1) Preservation of capital dollars.
  - (2) Flexible structure to meet budget needs.
  - (3) Pays for the equipment as it is used - not before.

Municipal Lease Purchase Agreements

- The municipal lease actually is a *conditional sales contract* whereby the borrower, as lessee, makes periodic payments of principal and interest to the lender, as lessor. As a result, the lease contemplates that the lessee will obtain the *use* as well as the *ownership* of the equipment - "Dollar-out-Lease."

- Not considered "debt" because, in effect, the lease is a one-year renewable obligation. Other considerations - preserves debt limitations, voter approval not required, reduced costs and timing.

- *Non-appropriation* - the lessee has the contractual "right" at the beginning of each fiscal year not to appropriate funds from which rental payments would be made. Although this can be viewed as a default it is not a breach of their promise to repay.

- A *non-substitution clause* provides that if a lease is terminated for non-appropriation, the lessee may not replace the leased equipment with equipment that performs the same or similar functions. Prohibited in the majority of jurisdictions and not used by the most of Lessors.

Municipal Lease Purchase Agreements

- Credit Considerations
  - General
  - Financial Information
  - Bond Rating
  - Demographic Information
  - Equipment and Project Information

The legal mechanism of the municipal lease is based on the appropriation of funds for specific equipment, therefore, the *Use* and *Service* it provides is *Essential* to assessing the risk of the transaction.

- The *higher* the essential use of the equipment and the service it provides, the less likely the lessee will not appropriate funds for the equipment - lower risk.

- Examples: *High* essential use - school buses and fire trucks; *Low* essential use – water parks or golf courses and vehicles for social services.

Municipal Lease Purchase Agreements

- Documentation
  - Equipment Lease Purchase Agreement
  - Lease Rental Payment Schedule (Identifying interest component and prepayment schedule)
  - Delivery and Acceptance
  - Board Resolution (Municipal Certificate)
  - Attorneys Opinion (Legal, Valid, Binding)
  - Tax Opinion (If required)
  - UCC/Title
  - 8038 G
  - Escrow Agreement
  - Arbitrage Certificate (Over $1 million)

Private Activity Bonds

- Introduction to Private Activity Bonds (PABs)
  - Private Business Test
  - Private Loan Test
- Types of Qualified Private Activity Bonds
  - Qualified Small Issue Bonds *
  - Qualified 501(c)(3) Bonds *
  - Enterprise Zone Bonds
  - Exempt Facility Bonds
  - Qualified Mortgage Bonds
  - Qualified Redevelopment Bonds
  - Qualified Student Loan Bonds

  * To be discussed in more detail.

Other Requirements for PABs

- Volume Cap
- Alternative Minimum Tax (AMT)
- Use of Proceeds
- Maturity Limitation
- TEFRA Hearing
- Alternative Minimum Tax
- Land Acquisition Prohibition
- Acquisition of Existing Property

Qualified 501(c)(3) Bond

- 501(c)(3) refers to a section of the Internal Revenue Code which characterizes organizations as *exempt* from federal income tax which may be educational, religious or charitable organizations (e.g. private colleges, archdioceses, and not-for-profit hospitals).
- A tax-exempt issuer such as a city, county or state entity is needed to issue *"on behalf"* of the 501(c)(3) organization.
- Typically structured as a lease / sublease transaction and generally contains all of the same terms as a municipal lease.
- Follow many of the same regulations of Municipal Lease transactions
- Some 501(c)(3) are also considered governmental bonds if the entity possess *sovereign powers.*

501(c)(3) Purposes

- To qualify under Section 501(c)(3), an organization must be organized and operated exclusively for one or more of the following purposes: *Religious, charitable, scientific, public safety testing, literary, educational, fostering national or international sports, and prevention of cruelty to children or animals.*

- Typical organization include hospitals, universities, religious organizations, low-income housing, and nursing homes.

- Charitable organizations also include organizations which promote health such as medical clinics, medical research groups, blood banks, health maintenance organizations, senior citizens centers; libraries; and museums).

501(c)(3) Basic Requirements

- For a bond to be a qualified 501(c)(3) bond, two basic requirements must be met.
  - *First*, property that is to be provided by the net proceeds of the issues must be owned by a 501(c)(3) organization or by a governmental unit.
  - *Second*, the private business tests must applied - at least 95% of the net proceeds of the bond must be used by a 501(c)(3) in furtherance of it exempt purpose or by a governmental unit. The activity must not constitute and "unrelated trade or business" which is not substantially related to its purpose. Exceptions to this include:
    - 1) When such trade or business is done without compensation,
    - 2) When it is for the convenience of its students, patients and employees, or
    - 3) When it is selling merchandise which has been received as a gift.

501(c)(3) Basic Requirements

Continued

► Examples of acceptable trade or business exceptions -

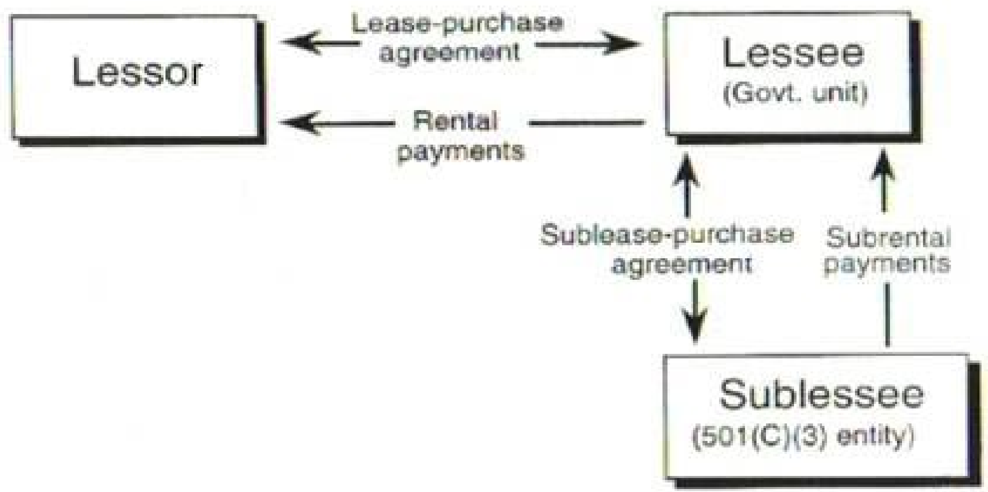
1) Gift shop in a tax-exempt hospital
2) Bookstore located on a college campus
3) Facility in which a food court is located at a university

► Bonds receive certain exemptions when they are classified as Qualified "Hospital" Bonds. Defined as:

1) Facility for impatient diagnostic and therapeutic services.
2) Accredited by the Sec. of Health and Human Services.
3) Patients under the care of physicians and nursing services.
4) Does not include day cares, nursing homes, etc.

► $150MM limitation does not apply to qualified "Hospital" bonds or bonds issued after August 5, 1997.

501(c)(3) Basic Structure



Industrial Development Bonds (IDBs)

- IDBs, also referred to as Industrial Revenue Bonds (IRBs), are a type of Private Activity Bonds as opposed to a Governmental Bonds (e.g. a municipal lease).

- These bonds were created to allow private businesses to utilize tax-exempt financing if they *qualify* within a proscribed *activity*, typically for economic development of a specific type of private company or an identified enterprise zone.

- *Public Offerings* - State or local Industrial Development Authorities issue tax-exempt bonds which are sold to investors. The proceeds are then disbursed to the participants by a Trustee who also oversees repayment.

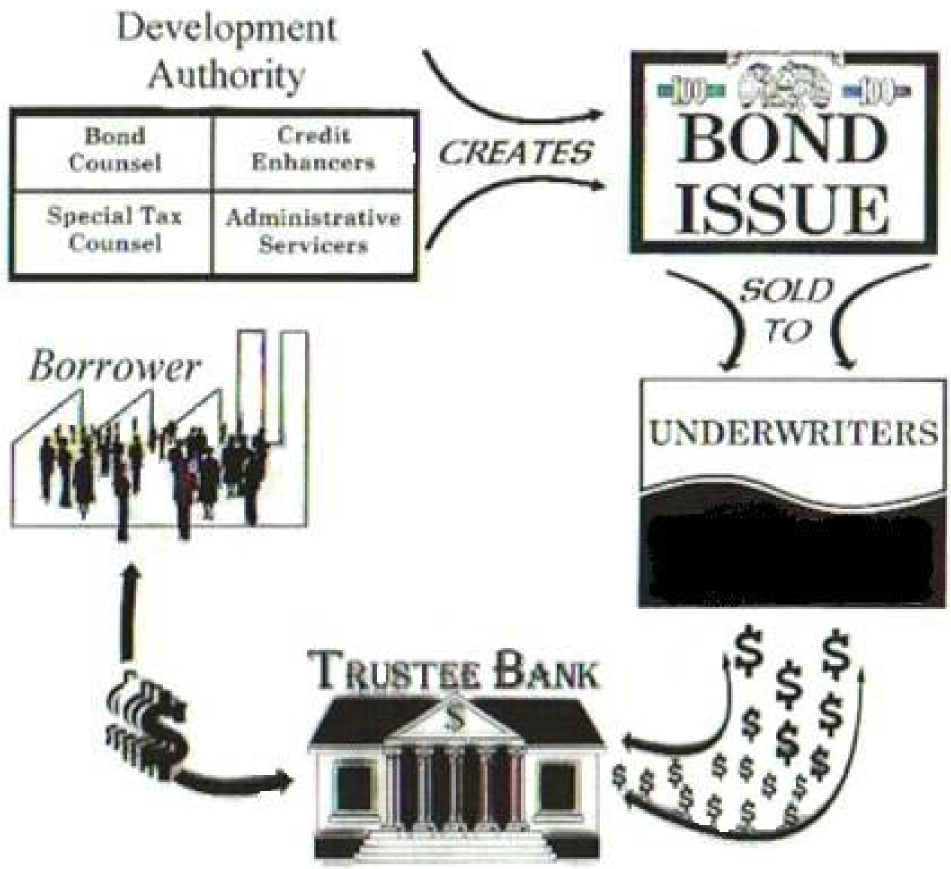
- Most equipment Lessors utilizes a simplified structures on a direct basis known as a *Private Placement.* Under this structure there are few participates and documents are required and is therefore less costly to the customer.

What are Industrial Development Bonds?

Lender (Bondholder)	⇨	Governmental Authority (Issuer)	⇨	Local Manufacturer (Borrower)

- Conduit Financing
- Issuer has no obligation for debt repayment.
- Repayment terms set by lender and borrower.
- Benefits:
  - Lender receives tax-exempt income ⇨ Higher Profitability
  - Borrower gets lower interest rate
  - Issuer stimulates local economy
  - Increases transaction margin

IDB Flowchart



What is the Process for Tax-Exempt Financing?

Step 1	Step 2	Step 3	Step 4
Proposal from Lender to borrower	Inducement Resolution allows for reimbursement of expenses from bond proceeds- inducement is inexpensive and not binding on borrower	Official application for tax-exempt allocation from state's private activity volume cap	Closing generally within 60 days of receiving allocation

<-----------------------------90 to 120 days----------------------------->

Critical step is to get Induced ASAP

Note, once induced the customer can borrow on a taxable basis (or spend cash) to fund the project on an interim bases.

General Requirements for an IBD

► As per the Tax Code, *manufacturers* are the primary entity which qualify for an IBD. Also, companies companies to attract specific commerce - vary by jurisdiction.

► Manufacturing must constitute *substantially* all of the on-site economic activity and be a change in the condition of *tangible personal property*.

► $10 million limitation on capital expenditures over a six year period.

► Various other tests, including private business use, use of proceeds, and maturity test - Bond Counsel required.

Highlight of Federal Tax Requirements

- Manufacturing Facility - Must finance facility used for the Manufacturing, production or processing of tangible property.
- $10MM Limitation - Capital expenditures for project, when added to capital expenditures in 3 years immediately preceding and 3 years following closing of financing plus any outstanding IDBs in jurisdiction (generally defined as the same city) where project located, cannot exceed $10MM.
- $40MMAggregate Limitation – The IDBs outstanding nationwide of manufacturer, including affiliated persons or companies, cannot exceed $40MM.
- Issuance Costs - No more than 2% of bond proceeds can be spent on issuance costs.
- Qualifying Costs - At least 95% of bond proceeds must be spent on qualifying costs -land, building, equipment and other depreciable property.

Highlight of Federal Tax Requirements
(Continued)

- Ancillary Space - No more than 25% of bond proceeds can be used for office, warehouse or other ancillary space.
- Land - No more than 25% of bond proceeds can be used for land.
- Working Capital and Inventory - Bond proceeds cannot be used to finance working capital or inventory.
- Acquisition of Existing Facility - Existing facility financed must be refurbished within 2 years of closing with at least 15% of bond proceeds.
- Used Equipment - Used equipment cannot be financed unless; 1) Part of existing facility acquisition, or 2) within 2 years of closing, 100% of purchase price is spent to refurbish equipment.
- Maturity - Maturity of bonds cannot exceed 120% of economic life of asset financed.
- Depreciation - Property financed personal or real must be depreciated on straight-line method.

Three Keys of Industrial Development Bonds
(Summary)

- Manufacturing Test - The financing must be used to finance a capital project that will be used in the manufacturing or production of tangible personal property, including the processing resulting in the change of such property
- Capital Expenditure Test - The capital expenditures for the project, when added to the capital expenditures in the 3 years immediately preceding and following the closing of the financing plus any IDBs outstanding, in the governmental jurisdiction (generally defined as the same city) where the project is located, cannot exceed $10 million.
- Inducement - The first step in the bond process is where the governmental agency adopts a formal resolution establishing the project's tax-exempt status. Any expenditures made or obligations incurred prior to inducement cannot be financed with an IDB.

What are Typical Investment Parameters?

- Target market - manufacturers with track record of success and reasonably strong financial condition, no Moody's/S & P rating required.
- Projects financed - equipment and real estate (25% or greater must have enhancements).
- Transaction size - $1 MM to $10 MM cap; or $40 MM cap; or unlimited.
- Financing term - from 5 to 12 years based on useful life of project; for real estate, generally matched coterminous with equipment, but amortization period may be longer (12 – 15 years) for better credits
- Costs financed - up to 100% of project costs, plus issuance costs up to2% maximum allowed.
- Financial covenants, ownership restrictions and guarantees may be required.
- If equipment only security interest required, vendor paid upon acceptance of equipment no progress payments.

What are Advantages of IDBs for Equipment Lessors?

- Invest for our own account.
  - No letter of credit for equipment. Due to the low interest rate, the customer will be able to afford a L.C. if a credit enhancement is required.
  - No trustee typically required.
  - No rating or official statement required.
- “Value-priced" source of funds
  - Reduced costs of issuance
  - Quick, personal response with tax-exempt solutions.
- Standardization of the process/documentation, when appropriate.
- Offer structuring alternatives.
  - Escrow funding with principal repayment beginning after acceptance of project   interest paid offset by interest earned.
  - Taxable/tax-exempt convertible structure to accommodate early equipment deliveries or yearend time constraints.
  - Equipment tax lease product bundled with IDB for transactions over $10MM cap.
  - Rate lock program to take away interest rate risk.

Marketing Industrial Development Bonds

- ►There are two channels in which IDBs can be sourced, one is through the local Industrial Development Authority and the other is working with a potential customer.
- ►Identify the local or state Industrial Development Authority and make contact to determine the criteria for their programs.
- ►Research which companies within the jurisdiction qualify under the Authorities programs.
- ►Contact the identified companies and create the opportunity.
- ►When calling on a manufacturer ask if they have participated in an IDB program before, if not, then there may be an opportunity to offer lower cost financing.
- ► *Value added* - help walk them through the application process. This should be completed prior to submittal.