Will Your Financing Be Taxable or Tax-Exempt?

Ohio Economic Development Association (OEDA)
2017 Annual Summit – October 19, 2017

Presented by

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How does economic development intersect with tax-exempt financing? The view from 30,000 feet.

- Public entities such as states and their political subdivisions often view the development of private sector projects as important to their communities.
- States and local governments can use a variety of tools to help facilitate that private sector development.
- Depending upon the expiration dates of various federal statutes, those tools can include federal grants and subsidies such as Community Development Block Grants; New Market Tax Credits (NMTC); Historic Tax Credits (HTC); Low Income Housing Tax Credits; and Tax-Advantaged Bonds, including tax-exempt bonds, enterprise zone bonds, renewable energy bonds, and energy conservation bonds.

Tools available in a particular state

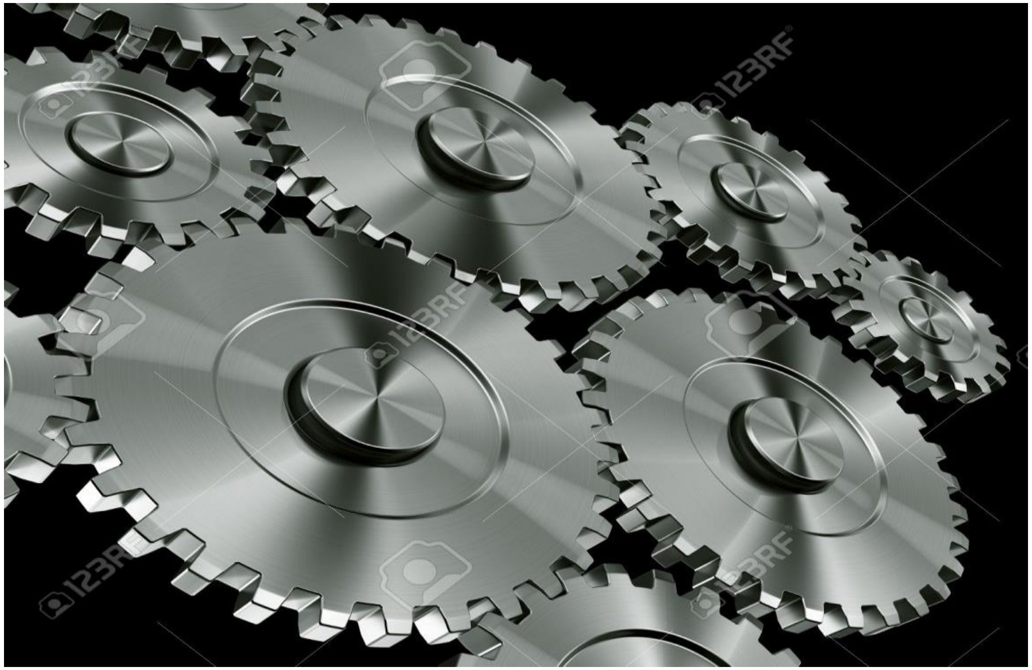
- In addition, states and local governments often have available tools facilitated by legislation applicable only in that state. While there are many similar tools among the states, there can also be some tools unique to that state.
- Among the many tools available under applicable circumstances in Ohio are property tax abatements, sales tax exemptions, New Community Authorities, Community Reinvestment Areas, Cooperative Economic Development Agreements, tax increment financing (TIF) bonds, special assessments, Joint Economic Development Districts (JEDD), and Downtown Redevelopment Districts.

Combining tools – connected gear wheels

- Structuring an economic development package often involves a complex assortment of federal and state tools combined with private sector contributions, which can be a combination of equity and private loans.
- This structure is typically documented in a Development Agreement. Negotiating that agreement often means balancing the requirements of all of these different elements of the transaction. Often, fixing a problem for one element can cause problems with other elements. In other words, the gear wheels are all connected and each time one wheel spins, they all spin.

The tax-exempt financing gear wheel

- To work through the complex interaction of the many elements of a development package, the rules applicable to each element must be known and a balance must be struck to reach the optimal solution.



What is tax-exempt debt?

- Tax-exempt debt is debt the interest on which is excluded from gross income for federal income tax purposes for the holders thereof.
- Issued by, or on behalf of, a state or local government.
- Issuer must comply with the Internal Revenue Code, state law, local laws, existing agreements, and, where applicable, municipal charters.
- **Failure to comply with ongoing Internal Revenue Code requirements could result in the need for remedial action or interest on the bonds becoming taxable, possibly from the original date of issuance.**

Use of tax-exempt financing proceeds: overview

- **In general, what can be financed on a tax-exempt basis?**
  - Asset based – capital projects.
  - Two fundamental rules govern the interaction of the governmental entity and the private entity.
  - Private loan prohibition.
  - Private business tests:
    - 90% state/local government ownership/use requirement, <u>and</u>
    - 90% governmental sources of repayment or security requirement.

Private loan test

- If more than the lesser of (i) 5% or (ii) $5M of the proceeds are loaned to a nongovernmental person, the bonds will not be tax-exempt.
- A grant of proceeds of a tax-exempt bond secured by generally applicable taxes is not a loan.
- A tax assessment loan will not be treated as a private loan if:
  - The assessment is mandatory, imposed by a state law of general application, applied equally to natural persons not acting in a trade or business and persons acting in a trade or business, and used to finance the project for which the assessments are levied.

Private loan test (continued)

- The project is an "essential governmental function."
  - Improvements to utilities and systems owned by a governmental entity and available for use by the general public.
  - Facilities which provide a service customarily provided by governments with general taxing power.
  - The assessments are repayable on the same basis by all property owners (the "Equal Basis Requirement"). A guarantee of the assessments or the bonds by a property owner violates the Equal Basis Requirement and makes the bonds taxable.

Private business tests

Part 1 of test: what is private business use?

- **Use By a “Nongovernmental Person.”**
  - Federal government.
  - Section 501(c)(3) nonprofit organization.
  - Other private entity (corporation, partnership, LLC, natural person engaging in trade or business).

Part 2 of test: what are private payments or security?

- Private payments are all payments by Nongovernmental Persons to the state/local government for use of bond-financed assets.
  - E.g., lease payments, license payments.
  - Taxes of general applicability are NOT private payments.
- Private security is property that is security for, or the source of, the payment of debt service on bonds, if provided directly or indirectly by a user of bond-financed assets.
  - E.g., debt service guarantee by the private entity benefitting from the bond-financed assets.
  - Exception for commercial credit enhancements (e.g., bond insurance, letters of credit).

Private payment exceptions

- Payment of generally applicable taxes (enforced contributions with a uniform rate) are not private payments.
  - A qualified PILOT is a generally applicable tax.
    - Amount of payment cannot exceed the equivalent tax.
    - The amount must be "commensurate" with the equivalent tax (the value is determined in the same way and levied at the same times as the equivalent tax).
    - The project must be one that could be financed directly with the equivalent tax.
  - A special charge is not a generally applicable tax. Assessments are special charges.

Private business use examples: general

- Ownership of a bond-financed facility by a Nongovernmental Person.
- Lease of a bond-financed facility by a Nongovernmental Person.
- Management of a bond-financed facility by a Nongovernmental Person, unless the management agreement is structured to fall within certain "safe harbors."
- Any other comparable "special legal entitlement" or special economic benefit.

Private business use examples: leases

- Lease or sublease of bond-financed asset to a Nongovernmental Person.
  - E.g., rentals or leases of all or a portion of recreational facilities, parking garages, advertising arrangements, solar panel arrangements, wind turbines, wireless equipment, computers, photocopiers, any of which are located on tax-exempt financed or improved land or buildings, etc.

Private business use examples: management contracts

- Nonqualified management contracts (Rev. Proc. 2017-13).
- Definition: management, service or incentive payment contract for provision of services by a Nongovernmental Person involving part or all, or any function, of a bond-financed facility.
  - Common examples: management of restaurants; parking lots and parking garages; and recreational facilities such as golf courses, pools, tennis courts.
  - Exceptions: "incidental services" such as janitorial and equipment maintenance and repair.

Management contracts:
Revenue Procedure 2017-13 safe harbors

- Do NOT apply to leases, only to management and service contracts.
- Term of the agreement cannot exceed the lesser of (i) 30 years or (ii) 80% of the remaining life of the financed asset.
- No portion of the compensation can be based on net profits (revenues or expenses are okay, but not both) and the manager cannot bear any risk of loss from the operation of the financed asset, whether financial or due to damage or destruction.
- The governmental entity retains control of the managed property, e.g., sets rates, approves budgets.
- The service provider cannot take an inconsistent tax position, such as depreciating the asset.
- The service provider does not have an ability to limit the rights of the governmental entity.

Private use measurement

- If the asset is used for both exempt and private uses, you need to determine the amount of private use of the asset; common methods for measurement include:
  - Discrete area.
  - Time based.
  - Revenue based.
- Generally, private business use is measured using the average of the annual percentages of private use during the measurement period.
  - Measurement period = life of the bonds plus any refunding bonds.
  - Average percentages = average of the percentages of private business use during the 1 year periods within the measurement period.
- Annual averaging does not apply in cases where there is a disposition of ownership.

Simple hypothetical – tax-exempt bonds allowed

- City forms a New Community Authority (NCA) and appoints the board.
- Developer, NCA, and City execute a development agreement whereby developer agrees to build apartments, condos and single family homes inside the NCA limits along with the necessary infrastructure, parking garages, and recreational facilities, including a pool, tennis courts, fitness facility and a restaurant.
- The NCA issues tax-exempt bonds to buy the infrastructure, parking garages and recreational facilities, but does not acquire the restaurant.

Simple hypothetical – tax-exempt bonds allowed (continued)

- The amount of the bonds is based on an independent appraisal of the facilities purchased by the NCA.
- The NCA executes a safe harbor management agreement with the developer for the developer to manage the parking garages and the recreational facilities.
- The developer uses separate financing for the restaurant, which is owned and operated by the developer.
- The Bonds are paid from special assessments levied on the benefitted properties.

Simple hypothetical – tax-exempt bonds allowed (continued)

- There is no private loan as a result of the assessment exception. The infrastructure, parking garages, and recreational facilities are essential governmental functions.
- There is no private use because the NCA owns the financed facilities and only safe harbor management contracts are used.
- There is no need to consider private payments since there is no private use.

Simple hypothetical – taxable bonds must be used

- City executes a development agreement with a developer who will build an office building on top of a parking garage, both of which will be owned by the developer.
- The city issues TIF bonds to finance the related infrastructure and a grant to the developer to pay a portion of the project. The TIF bonds are secured by PILOT payments.
- The development agreement requires the developer to make minimum service payments sufficient to cover the debt service on the TIF bonds in the event the PILOT payments are not sufficient to pay all of the debt service.

Simple hypothetical – taxable bonds must be used (continued)

- The TIF bonds are a private loan because the minimum service payments are an impermissible agreement to secure the TIF bonds.
- There is private use of the financed facility because the developer owns the parking garage and office building.
- There is private payment or security because of the minimum service payments.

The real world

- In many cases, a development project will be financed with both tax-exempt and taxable bonds where the parties solve for the maximum amount of tax-exempt bonds that can be used and the rest is financed with taxable bonds and often other financing vehicles such as NMTC's, HTC's, and JEDD income taxes.

What if change in use results in private use?

- Changes in use can be remediated if identified timely.
  - Alternate use of disposition proceeds (for assets sold for cash).
  - Redemption of nonqualified portion of bonds within 90 days of change in use (if callable 10.5 years from issue date or sooner).
- If remediation is not possible (i.e., discovering a problem too late to remediate), VCAP is available.
  - IRS Voluntary Closing Agreement Program.
    - Can approach on a “no names” basis.
    - Agreement results in lower penalty than would be imposed if problem were found in audit.
    - Written compliance procedures result in lesser penalty.

Post-issuance compliance: best practices

- Written procedures.
- Assignment of responsibility and training for appropriate staff.
- Identify financed property for each issue (each issue identified separately).

Post-issuance compliance: best practices (continued)

- Track use and disposition of bond-financed property.
  - Ongoing for life of the bonds plus the life of any refunding bonds.
  - At least an annual review process.
  - Monitor for changes in use including new leases, management contracts or sale, etc.
- Evaluate any new, or change, in private use and before any RFPs, etc., are finalized.
- If a potential problem is identified, consult with bond counsel quickly.

Post-issuance compliance: private use related document retention

- All bond related documents should be maintained for the life of the bonds, plus the life of any refunding bonds, plus 3 years.
  - Closing documents (bond transcript).
  - Development agreements, leases and management contracts.
  - Other agreements with third parties to use bond-financed property.
  - Documents generated during an ongoing compliance review process including floor plans, questionnaires and spreadsheets.

Conclusion/Q&A

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