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OVERVIEW OF LEASE-PURCHASE FINANCING AND "COPS"

Introduction

This Memorandum provides a brief explanation and overview of tax-exempt lease-purchase financing and certificates of participation ("COPs") in Georgia. Counties, cities and school districts (referred to as "Local Governments" in this Overview) are authorized by Georgia law to obtain tax-exempt lease-purchase financing as described below. By this method Local Governments can acquire real property, buildings, vehicles and equipment without incurring a traditional form of debt, such as general obligation bonds or revenue bonds, and no voter referendum or court bond validation is required. The simplified procedures make lease-purchase financing particularly suitable for shorter-term or smaller financings of essential governmental facilities, such as facilities to be paid for by special county 1% sales and use tax ("SPLOST"), or other instances in which bond financing is not attractive. COPs may be appropriate for larger financings.

<u>2000 Legislation</u>

Lease-purchase financing by cities and counties was reaffirmed by the General Assembly in 2000 for vehicles, equipment and real estate, with some new restrictions imposed on *real property financing only*. On and after July 1, 2000, two limitations apply:

- the aggregate amount outstanding of lease-purchase financing for real property may not exceed $25,000,000; and

- the average annual payments on the aggregate of all outstanding real property lease-purchase financings may not exceed 7.5% of the city's or county's governmental fund revenues for the calendar year preceding the closing, plus any SPLOST taxes available for the financed projects (the "7.5% Test").

Lease-purchase financing is permitted regardless of such limitations for projects approved by the last SPLOST referendum, and for court buildings authorized by law to be paid from fines. Cities and counties that have a balance of lease-purchase contracts subject to and in excess of the $25,000,000 limitation on July 1, 2000 may continue those contracts, but may not refinance or restructure them until the excess is paid off.

The 7.5% Test can be difficult to interpret. A Local Government should obtain the advice of legal counsel if it is not clearly in compliance with the 7.5% Test after determining the "average annual payments" both as (i) the sum of the average annual payments for each such lease-purchase contract, and (ii) the average of the consolidated annual payments for all such lease-purchase contracts. If a financed project is partially but not fully to be paid for by SPLOST, legal counsel should be consulted as to the application of the 7.5% Test.

<u>What is Lease-Purchase Financing?</u>

Lease-purchase financing is a method for a Local Government to acquire real property or personal property (such as vehicles and equipment) by paying over its full term an annually renewable contract for the use and acquisition of the property. The contract might be called a lease, an installment sale agreement or a lease-purchase agreement. The contract must not bind the Local Government for a period in excess of a calendar year, but may provide for automatic renewal unless positive action is taken to cancel it. Although lease-purchase financing sometimes is sold as COPs (discussed below), in many cases the contract is held by a single bank, vendor or other financing institution.

In the typical lease-purchase contract, a third party acquires or provides the property and makes it available to the Local Government in return for monthly, quarterly, semi-annual or annual payments consisting of principal and interest. The principal amount of the lease-purchase contract will be the acquisition and/or construction price of the property, and interest will be determined by agreement with the lender and based on market conditions. The term of the agreement will be set by the parties, with consideration given to the life of the property financed. Prepayment is usually permitted, but may be constrained. The contract may contain other covenants and restrictions that are negotiated.

Local Governments must make an annual appropriation for payments owing with respect to a lease-purchase contract. Should the Local Government fail to make an appropriation, or should it take affirmative action under the terms of the contract to cause it not to renew at the end of any calendar year (called a "nonappropriation"), the Local Government would lose the property and all payments it had made or committed through that year. After a nonappropriation, the Local Government would not be responsible for payments called for in future years. Nonappropriation has serious consequences, however, because the Local Government would forfeit needed property as well as all payments made for its acquisition, and its failure to complete the contract would hinder it from obtaining credit in the future. If the contract is completely paid, the Local Government acquires the property free and clear of any lien or restriction.

Lease-purchase financing is frequently used in financing projects to be paid for by a SPLOST. A SPLOST project cannot be let for bid until actual funding is available and the gradual accumulation of the sales tax may result in a prolonged delay before the voted-for project is actually available. However, if lease-purchase is used to finance the project after the approval of the SPLOST referendum, the project can be undertaken immediately and the sales tax receipts can be used to make the lease-purchase payments. Lenders favor such arrangements because by law the SPLOST receipts cannot be diverted to other projects.

<u>What Are Certificates of Participation (“COPs”)?</u>

Certificates of Participation (“COPs”) are a specialized subset of lease-purchase contracts sold as securities resembling bonds. Typically, a trustee issues securities that represent a percentage interest in the right to receive payments from the Local Government under the lease-purchase contract. Although the same state and federal restrictions apply to COPs as apply to other lease-purchase financings, the COPs financing is more complex and generally resembles bond financing. An underwriter or placement agent of the COPs will be required, as will various fiscal agents. An official statement providing disclosure to the investors must be approved by the Local Government and in most cases the Local Government in most cases must contract to make continuing disclosures under SEC Rule 15c2-12.

100% Financing Requirement

Lease-purchase financing must be 100% financing. Because lease-purchase financing is distinct from Local Government debt and must be cancellable by the Local Government at the end of each calendar year, a Local Government may not have “equity” in the project at the outset of the contract. Equity may arise by the Local Government paying rather than financing a portion of the cost of the property, or where it seeks to finance improvements or additions to existing buildings or property it owns. The financing must be for the full cost or value of the property subject to the lease-purchase arrangement, otherwise the Local Government would improperly be placing itself in a position where it would forfeit its contribution if it terminated the contract in the first year.

If a Local Government does not wish to finance the full value of the project, the project might be subdivided so that only a portion is subject to the lease-purchase arrangement. Alternatively, the Local Government might use lease-purchase financing with respect to a different asset that more nearly approximates the principal amount that it wishes to finance, a technique sometimes referred to as a “collateral substitution.” Bond Counsel should be consulted about these arrangements to assure that they comply both with state law and the federal tax-exemption rules.

Special care must be exercised when the Local Government already owns the land on which it wishes to finance a building, lest the no-equity principal be violated. One solution is to have the real property transferred to a third party lessor, after complying with applicable bidding requirements, and to have the amount of the lease-purchase contract cover both the construction cost and the value of the land. In such a case, the proceeds of the lease-purchase attributable to the land value must be allocated to and used for another appropriate purpose. Bond counsel should assist with any such matter. Alternatively, the land can be “ground leased” to the third party which will construct the building that, alone, will be the subject of the lease-purchase financing.

Other State Requirements for Lease-Purchase Financing

A Local Government may not enter into a lease-purchase contract for a project if it has been the subject of a failed bond referendum within the four preceding calendar years, unless the project is required to be financed pursuant to a federal or state court order or eminent threat thereof.

Lease-purchase financing is not treated as a debt of a Local Government. For cities and counties, however, the principal amount of such financing, when added to the amount of Local Government debt, cannot exceed 10% of the assessed valuation of all taxable property.

For a school board to enter into a lease-purchase contract, the combined annual payments for all such contracts (excluding guaranteed energy savings contracts) must not exceed 7.5% of the total local revenue collected for maintenance and operations for the last fiscal year.

A city or county must hold a public hearing with respect to its real property financing contracts prior to closing, and after two weeks' notice in the appropriate newspaper.

A lease-purchase contract must terminate absolutely and without further obligation on the part of the Local Government at the close of the calendar year in which it was executed and at the close of each succeeding calendar year for which it may be renewed, and the Local Government is obligated only for those sums payable during the calendar year of execution or, in the case of renewal, for those sums payable in any calendar year for which the contract is renewed. The lease-purchase contract must set out what payments will be due in each year. A Local Government should not covenant, however, that it will make annual appropriations or renewals, that it will renew the contract or that it will not acquire other property to replace the property that is the subject of the lease-purchase, as this may void the contract.

Due to the risk that a Local Government could "nonappropriate" and terminate a lease-purchase contract, persons providing credit through the lease-purchase contract may require a showing that the particular project being financed is "essential" to the Local Government's operations. Local Governments may be unsuccessful in obtaining financing for "non-essential" projects such as recreational facilities.

In real property financing, the Local Government usually agrees to contract for the construction of the facilities in accordance with public bidding procedures. If the lessor/seller is to construct the facilities, the new public works proposal procedure of O.C.G.A. Title 36, Chapt. 97 (H.B.1079) may be applicable to the selection of the lessor/seller.

Prior Intent to Finance Costs Must be Documented

A Local Government cannot use lease-purchase financing for property it has already paid for, except as described below. If property costs are paid prior to the lease-purchase financing, a "declaration of official intent" to finance costs will preserve the ability to finance costs paid after the declaration and as early as 60 days before the declaration. As a result, if a Local Government is to pay costs of property to be later lease-purchased, it should formally adopt a declaration of official intent to use up to a specific amount of financing for the described project as soon as possible, before or within 60 days after payment of such costs.

Lease-purchase financing can be used to reimburse preliminary expenses such as engineering and architecture, and up to 5% of the financing or $100,000 (if less) can reimburse other costs paid more than 60 days before declaration of official intent.

A simple form of such a declaration is a resolution of the governing body of the Local Government. An "official intent" must declare an intention to finance, establish a maximum amount of financing, and generally describe the property. We have a form available for use. Bond Counsel should be consulted to prepare or determine the sufficiency of a declaration.

If a declaration of official intent is made, lease-purchase financing generally may be closed as late as 3 years after the declaration, if the financing is closed within 18 months after the property is acquired or completed. There is no downside to adopting an "official intent," as it does not bind the Local Government and it preserves the option of using lease-purchase financing in the future.

Federal Requirements for Tax Exemption

"Private Activity Bond" Tests. In order for lease-purchase financing to be and remain tax-exempt it must not constitute a "private activity bond." Private activity bonds include financings that meet the "private business test," and arise, for example, when the property financed is used significantly in the business or operations of a private entity. A more detailed description of this test appears below.

> ***Private Business Test***. Lease-purchase financing meets the private business test if more than 10% of the proceeds (or property financed) is to be used directly or indirectly in private business use, and if more than 10% of the proceeds is directly or indirectly secured by or to be derived from property put to a private business use (or payments with respect to such property). Private business use means generally use by private persons or entities other than as members of the general public, or by the federal government. For example, if more than 10% of a facility is to be used by private businesses (e.g., a parking deck with reserved spaces, or a utility facility where a portion of the output is contracted for), and payments for such use will be available to pay the financing, an otherwise "governmental" lease-purchase financing would become a "private activity bond." Any private business issues should be analyzed by Bond Counsel.
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> ***Management Contract Safe Harbors***. Part or all of facilities to be financed by a Local Government are sometimes managed or operated by for-profit companies. "Safe harbor" guidelines can be used to assure that such arrangements do not impair the tax exemption of obligations issued for such facilities. Briefly, the guidelines require that the manager's or operator's compensation be determined by a periodic fixed fee, a capitation fee (an amount per person, regardless of services rendered), a per-unit-of-services fee, or a percentage of gross revenues or expenses, but in no case by a percentage of net revenues or profits. The permitted length of a contract (including all binding renewal options) is limited depending on the type of compensation; the more fixed compensation, the longer a contract may extend. If compensation is based on at least 95% fixed fees, contracts may be for a term up to 15-years; if at least 80% fixed fees, 10-years; if 50% fixed fees or 100% capitation fees (or a combination), 5-years (if the contract is cancellable by the Local Government within 3 years); if per-unit fees, 3-years (if the contract is cancellable by the Local Government within 2 years). A special rule applies to new

facilities during a start-up period or to facilities primarily providing services to third parties: compensation can be based entirely on a percentage of fees charged, or a combination of per-unit-of-services fees and a fixed fee (or during the start-up period, a percentage of gross revenues, adjusted gross revenues or expenses), if the contract has a term of 2-years or less (cancellable by the Local Government within 1 year).

Registration Requirement. Lease-purchase financing, like bonds, must be in registered form. Provision must be made for the registration of the recipient of the tax-exempt interest on a register maintained by or on behalf of the Local Government, and assignments must be registered.

Federal Guaranty Prohibition. Lease-purchase financing is not entitled to tax exemption if the payment of principal or interest is directly or indirectly guaranteed in whole or in part by the United States or any of its agencies or instrumentalities. This might arise if the financed property were to be paid for with federal funds.

Information Reporting. An information report on Form 8038-G must be filed with the Internal Revenue Service not later than the 15th day of the second calendar month after the close of the calendar quarter in which any lease-purchase financing is closed. Form 8038-GC should be utilized to consolidate lease-purchases of less than $100,000 each, and must be filed annually by the February 15th following the calendar year of the financings.

Arbitrage Restrictions. Lease-purchase financing is not entitled to tax exemption if it is deemed an "arbitrage bond." Although arbitrage is a concept generally applied to bonds, it can apply to lease-purchase also. It will apply when the financing proceeds are not immediately spent for the financed property (e.g., construction projects) and on COPs. Arbitrage rules are exceedingly complex, and only a brief sketch is provided below. Obligations are arbitrage bonds if more than 5% or $100,000 of the proceeds are reasonably expected to be used, or to replace funds used, directly or indirectly to acquire higher yielding investments. This concept of "investments" is broad, including virtually any contract or property to which a rate of return can be ascribed. Although lease-purchase proceeds can be invested in tax-exempt governmental bonds, they cannot be invested in higher yielding private activity bonds subject to alternative minimum tax. Exceptions are made for investment of lease-purchase proceeds during certain temporary periods, including the temporary investment of monies in a bona fide debt service fund and in a fund for lease-purchase proceeds awaiting use. The temporary period for investment of proceeds pending use in the acquisition or construction of property is three years. Amounts in a reasonably required reserve or replacement fund are not subject to investment yield restrictions, provided that the reserve or replacement fund cannot generally exceed 10% of the proceeds of the financing, 125% of average annual debt service or 100% of maximum annual debt service.

Arbitrage Rebate. Even though lease-purchase financings may comply with the arbitrage rules referred to above any arbitrage earnings in excess of the yield on the obligations must be rebated periodically to the federal government. The rebate rules require that periodic computations and filings be made. However, there are limited "Small Issuer," "2-year," "18-month" and "6-month" exemptions from the rebate requirement. A typical equipment lease-purchase where the equipment is fully paid for when the financing originates satisfies the 6-month exception.

Small Issuer Exemption. An exemption from the rebate requirement applies if only Local Government public activities are being financed, and the total of tax-exempt governmental and 501(c)(3) obligations (other than some refunding obligations) to be closed in that calendar year by or on behalf of that Local Government and its subordinate units is not reasonably expected to exceed $5,000,000 ($10,000,000 in the case of public school financings).

2-Year Exemption. The 2-year exemption applies where at least 75% of the "net proceeds" of the lease-purchase financing are to be used for construction, reconstruction or rehabilitation of real property. The rebate requirement does not apply if the net proceeds are expended in accordance with the following minimum requirements: 10% within six months; 45% within one year; 75% within 18 months; and 100% within two years (except that the two-year period may be extended to three years if the requirement would have been met within two years but for a reasonable retainage not exceeding 5% required to ensure compliance with terms of a construction contract). "Net proceeds" includes the proceeds of the lease-purchase financing (except for amounts placed in a reasonably required reserve fund) plus investment proceeds earned before the close of the period. If, however, the Local Government elects on the closing date, net proceeds excludes interest earnings on any reasonably required reserve fund, but interest earnings on such fund will be subject to the rebate requirement from the closing date, rather than from the end of the two-year expenditure period. If the Local Government elects on or before the closing date to pay a penalty in lieu of payment of the rebate amount, the rebate requirement is deemed to be satisfied if the Local Government pays a penalty with respect to the close of each six-month period after the closing date equal to 1.5% of the amount of the net proceeds of the financing, which as of the close of such period are not spent as required.

18-Month Exemption. An exemption from the rebate requirement applies if all gross proceeds (except for proceeds placed in a reasonably required reserve fund) are expended in accordance with the following schedule: At least 15% within 6 months; at least 60% within 12 months; and 100% within 18 months (with an exception for reasonable retainage spent within 30 months).

Six-Month Exemption. An exemption from the rebate requirement applies if all gross proceeds (except for proceeds placed in a reasonably required reserve fund) are expended within six months.

Limitation of Exemptions. Compliance with the 2-year, 18-month or 6-month exemptions does not relieve the Local Government from rebating arbitrage from investment of a reasonably required reserve fund, or arbitrage on a bona fide debt service fund containing more than $100,000. Compliance with the spending guidelines of the 2-year, 18-month and 6-month exceptions includes spending of interest earnings as well as the borrowed amounts.

"Bank-Qualified" Obligations

A Local Government that reasonably anticipates issuing not more than $10,000,000 of governmental obligations during any calendar year may designate lease-purchase contracts, as "Qualified Tax-Exempt Obligations". Generally, a bank or another financial institution holding a tax-exempt governmental obligation is not entitled to a deduction for its related carrying costs. The institution's carrying cost is considered that portion of the cost of the obligation determined by the ratio of the institution's borrowed funds to its equity. Qualified Tax-Exempt Obligations are subject to only a 20% disallowance of the allocable carrying cost, and are attractive for bank and other financial institutions to hold. For the purpose of determining compliance with the $10,000,000 limitation, obligations of the Local Government and all of its subordinate entities must be aggregated, and obligations of all superior entities issued on behalf of the Local Government must be included.

Refundings

Tax-exempt lease-purchase financing may be refinanced or "refunded." An unlimited number of "current" refundings may occur, in which the prior lease-purchase financing is retired within 90 days. However, most lease-purchase financings may be "advance" refunded (refunding occurs more than 90 days before the lease-purchase financing will be retired) only once, and the outstanding financing must be retired on the first possible date. Because COPs are commonly issued as non-callable for a fixed period, the only refinancing possible sometimes is an advance refunding. Special arbitrage rules apply to refundings.

Bond Counsel

Counsel qualified in tax-exempt municipal financing law should be retained to serve as Bond Counsel. The function of Bond Counsel is to structure and document the lease-purchase transaction or COPs under state and federal law and to issue an opinion on the validity and tax status of the financing. Fees of Bond Counsel are payable by the Local Government from financing proceeds. Smith, Gambrell & Russell, LLP is a "Red Book" listed Bond Counsel firm.

Summary

Lease-purchase financing and COPs are important items in a County's financing toolbox, allowing tax-exempt financing without a voter referendum and other procedures associated with bonds. However, the legal structure that they take, with acquisition of the property by a third party and an annually renewable lease-purchase contract, limits flexibility, and a number of restrictions described above apply. With proper planning and structuring, and the assistance of Bond Counsel where appropriate, lease-purchase financing or COPs can be just the tool needed to finance needed assets.

This memorandum provides an overview of tax-exempt lease-purchase financing and COPs from both a Georgia law and federal tax prospective. This brief treatment can do no more than touch upon some of the more important issues. Many details have been omitted, and additional information is available from the writer.

Jim Monacell

July, 2000

MATERIALS AVAILABLE ON REQUEST

1. How Counties Borrow
2. How Cities Borrow
3. How School Systems Borrow
4. Living With a Governmental Bond Issue – A Compliance Guide
5. How To Live With a 501(c)(3) Bond Issue
6. Overview of Private Activity Bond Financing and Incentives
7. Overview of Governmental Financing
8. Overview of Bond Financing for 501(c)(3) Nonprofit Organizations
9. Overview of Bond Financing for Nonprofit Schools
10. Overview of Tax-Exempt Financing for Nonprofit Hospitals
11. Overview of Revised Special Purpose Local Option Sales Tax (SPLOST) and Related Financing
12. Overview of Special Purpose Local Option Sales Tax for Educational Purposes (Education SPLOST) and Related Financing
13. Overview of Lease-Purchase Financing and COPs
14. Overview of Georgia Debt Referendum Requirements
15. Overview of Continuing Disclosure Requirements for Tax-Exempt Bonds
16. Regional Solid Waste Management Authorities
17. Taxable Versus Tax-Exempt Bond Financing for Project Financing
18. Georgia Ad Valorem Tax Incentives through Bond – Lease Transactions in Georgia
19. Tax-Exempt Financing for Waste Disposal/Recovery and Wastewater Treatment
20. Community Improvement Districts as a Tool for Infrastructure Financing
21. Reimbursement of Prior Expenditures with Bond Proceeds – Final Reimbursement Bond Regulations
22. Requirements for a "True Lease" for Exclusion From Treatment as a Capital Expenditure
23. Smith, Gambrell & Russell, LLP Public Finance Resume

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