

Quick Takes: A Primer on PILOT Bonds

This issue of *Quick Takes* is a quick reference on PILOT Bonds, a “primer”, if you will. But probably the word “primer” itself needs some explanation first, since that’s not a term that’s heard much anymore. According to Merriam-Webster’s On-Line Dictionary, a primer is “a short informative piece of writing.” That’s what I want to do here- briefly provide much needed information to clarify this financing technique.

In the last issue of *Quick Takes*, we looked at TAD, or tax allocation district, financing. (TAD bonds are called TIF, or tax increment financing, in most states). I explained that when property taxes are “monetized”, TADs are just in the middle of the spectrum of choices.

At one end of the extreme, potentially all of the property taxes can be monetized when PILOT Bonds (repayable out of payments in lieu of taxes) are used.

TAD bonds are in the middle of the spectrum. This is because TAD bonds only monetize a “positive tax increment”, and only the positive tax increments of the property taxes of the jurisdictions that can, and do, participate.

At the other extreme, when special tax districts, Community Improvement Districts (“**CIDs**”), or Infrastructure Development Districts (“**IDDs**”) are used (if **IDDs** are approved in a Constitutional referendum in November), only the additional tax or assessment is used.

Now, let’s take a closer look at these PILOT Bonds.

PILOT Bonds are revenue bonds, and the revenue that is the intended source for their repayment is “payments in lieu of taxes”, or “PILOT payments”. In order for these to be payments in lieu of taxes, normal property taxes have to be eliminated or reduced.

This elimination or reduction is usually referred to informally as “abatement.”

However, in Georgia, the circumstances in which the term “abatement” can be used formally and accurately are very limited. Examples include state enterprise zones, and a handful of local Constitutional amendments that exempt specified investments from property taxation within certain parameters.

So, in order to create a situation where a private developer can have cash invested in its project instead of paying property taxes, how do we eliminate or reduce these taxes? We have to design the project along the lines of one scenario or another so that either-

Scenario 1. There is no tangible property interest that is in the hands of the developer to be taxed. Result – taxes are eliminated.

Scenario 2. The tangible property interest has less value for tax purposes in the hands of the developer. Result – taxes are reduced.

As an example of Scenario 1, I don’t own the 17th Street Bridge, so I don’t pay any taxes on it. If I were to receive a lease of the 17th Street Bridge, and the lease were designed so as not to convey to me a tangible property interest, then I still don’t pay taxes on the bridge. (If there is no property interest that is taxable in a lease, it is said to create a “usufruct”.)

As an example of Scenario 2, suppose I received a lease of the 17th Street Bridge and the lease conveyed to me a tangible property interest. Then the lease would be taxable, and I would have an “estate for years.” But what’s the value of that lease? It depends. If that lease were taxed at a level different from normal taxes on outright ownership, this would be the result of “lease valuation” by the Board of Tax Assessors.

It is this potential for leveraging what otherwise would be normal property tax payments that opens the door to PILOT Bonds. However, PILOT Bonds themselves are not new. All that it takes to have a PILOT Bond is someone willing to make payments in lieu of taxes in light of normal taxes being reduced or eliminated.

In fact, PILOT Bonds resemble South Carolina’s Special Source Revenue Bonds. In South Carolina, Special Source Revenue Bonds can be used to finance infrastructure or a prospect’s land and buildings in a multicounty park. Fees in Lieu of Taxes (FILOT) payments that the county receives are the sole source for repayment of the Special Source Revenue Bonds.

Of course, there needs to be a legal basis for the reduction or elimination in property taxes. In South Carolina, this is provided by statute.

In Georgia, for many years development authorities have provided property tax

“abatement” to projects through a bond-financed sale-leaseback structure. The “abatement” is conferred either on a usufruct or lease valuation basis (or, in the case of some “Constitutional” development authorities, because the leasehold under the bond lease is exempt from taxation). The legal title to the project that is held by a development authority is also potentially subject to taxation, but this is regulated by statute and the Constitution.

Many Georgia communities have adopted policies regarding the use of property tax “abatement” as an incentive for prospects. Viewed solely from a legal perspective, the question is whether or not property taxes have been legally reduced or eliminated in a transaction. If the answer is “yes” and the policy has been followed, then the transaction can be said to be “**on policy**”. If the answer is “yes” but the policy has not been followed, then the transaction can be said to be “**off policy**.” Of course, access to the “abatement” is through a bond-financed sale-leaseback structure, so the cooperation of a local development authority (or other appropriate bond issuer) is needed. In any event, being on policy or off policy does not change the governing law applicable to the transaction.

A lot is at stake with PILOT Bonds, especially when a transaction is “off policy.” A recent case, *Diversified Golf*, went to the Georgia Court of Appeals on the issue of taxability. In *Diversified Golf*, the Court of Appeals found that there was no taxable interest in a project where a city recreation authority “...entered into several agreements relative to [City property that had been transferred to it], including a fifty-year lease agreement with Diversified; a “Waste Water Effluent Spraying and Operating Agreement” with Diversified; three construction contracts in which Diversified agreed to build a golf course, clubhouse, wastewater distribution facility, and wastewater storage ponds; and an intergovernmental contract between the City and the authority.” If you would like to have a copy of the *Diversified Golf* case, please let me know.

A PILOT Bond transaction that is off policy will be more complex, and will go to particularly great lengths to eliminate any vestige of a taxable property interest. One implication of this is that, if land and buildings are being financed, a bond investor will need to get comfortable with having as security for its investment something other than normal real estate collateral.

In many PILOT Bond transactions, in order for the bonds to be marketable, the bond issuer’s parent local government has to enter into an intergovernmental agreement (“**IGA**”) with the bond issuer. In the IGA, the local governmental agrees, to the extent allowed by governing law and needed for the financing, to impose property taxes, on all of the taxable property within its jurisdiction. The IGA is then used as security for the PILOT Bonds.

Many PILOT Bonds are issued as federally taxable bonds. When the benefit of tax-

exempt financing is needed, the Internal Revenue Code imposes further requirements.

The U.S. Treasury Department just released new final Regulations to modify and clarify, effective October 24, 2008, the standards for treating PILOT payments as “generally applicable taxes” for purposes of the “private payment or security test” of Section 141 of the Internal Revenue Code. For tax-exempt PILOT Bonds, among other things, either (a) the PILOT payments must be an “eligible PILOT”, or (b) “private business use” of the property being financed must not exceed 10%.

PILOT Bonds have already been used in Georgia to finance, for example, infrastructure for an industrial park, hotels, and the renovation of a convention center. I expect the trend towards the use of PILOT Bonds only to intensify in Georgia if a Constitutional amendment affecting TADs does not pass this November. This Constitutional amendment would restore the option to a Board of Education for it to consent to include its educational millage increment as a source for the payment of redevelopment costs in a TAD.

Meanwhile, you can think of PILOT Bonds as representing a “**synthetic TAD**” or a “**backdoor TAD.**”

If you have any questions or comments on this technique for monetizing property tax “abatement”, please do not hesitate to let me know.

Meanwhile, for more information-

GO TO <http://danmcrae.info/whitepapers.asp>

FOR

White Paper:October 2008 - "Memorandum- Tax-Exempt 'PILOT Bonds' ”

White Paper: July 2008- “New TADs That Can Finance Economic Development.”

White Paper: June 2008- "Bonds for Title" - How to Use Bonds to Obtain Property Tax “Abatement”

White Paper: March 2008 - "How to Use 'PILOT Bonds' to Monetize Property Tax Abatement"

AND GO TO <http://danmcrae.info/quicktakes.asp>

FOR

August 2008 - Quick Takes: “Bridging The Money Gap: Tap TADs To Pay Project Costs”

The “Current Bond Rates” page at danmcrae.info is updated weekly. This week’s version is what you see below.

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General note: This issue of *Quick Takes* is a quick-reference guide for economic developers, community developers, participants in the real estate and financial industries, company executives and managers, and their advisors. The information in this issue is general in nature. Various points that could be important in a particular case have been condensed or omitted in the interest of readability. Specific professional advice should be obtained before this information is applied to any particular case. Any tax information or written tax advice contained herein (including any attachments) is not intended to be and cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer. (The foregoing legend has been affixed pursuant to U.S. Treasury Regulations governing tax practice.)

CURRENT BOND RATES	
EFFECTIVE OCTOBER 30, 2008	
Interest Rates:	
tax-exempt-	floating: 1.68% fixed: 3.56% <small>(eff. 10/24/08)</small>
taxable-	floating: 5.25% - 6.00% fixed: 4.63%
General notes: 1. Rates are posted weekly. These rates are for the effective date indicated above, or as otherwise indicated. For intra-week rates, <u>Contact Dan.</u> 2. These are interest rates on revenue bonds that are variable rate demand bonds; i.e.,	

- floating. These can be synthetically fixed via interest rate swaps, as noted below.
3. Tax-exempt rates are for industrial development revenue bonds (IDB's") that are subject to the AMT and are 7 day general market quotes.
 4. Taxable rates are for taxable IDB's or for taxable "corporate bonds".
 5. Fixed rates are for 10 year terms via swaps.
 6. All rates are market extracted and approximations, and are not guaranteed.
 7. These rates do not reflect all-in costs; e.g., annual letter of credit fees are not included.

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