

*HOW TO USE "PILOT BONDS" TO
MONETIZE
PROPERTY TAX ABATEMENT*

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Introduction

Cash is the best incentive, but is in shortest supply. This White Paper explains how to take a more available incentive, property tax abatement¹, and, in effect, “trade” it for cash.

In situations where a project is titled to a development authority in a bond-financed sale-leaseback transaction, property tax abatement is a possible incentive. Such leases are commonly used in connection with the financing of a project with an authority’s industrial development revenue bonds. In connection with the issuance of the bonds, the title to the project would be vested in the authority and the project would be leased to the company under a bond lease. The bond lease would be structured so that the leasehold interest of the company is non-taxable, or taxable only in accordance with an agreed abatement schedule.²

The bonds could be used to raise capital for the project as well as to provide the structure needed for the property tax abatement. Alternatively, the bonds are frequently issued to the company itself, in which case the primary reason for the bond issue is to establish a lease structure that permits property tax abatement.³

This White Paper addresses situations in which the company is interested⁴ in “swapping” the abatement for the proceeds of the “monetization” thereof as described in this White Paper. For purposes of this White Paper, we are assuming, therefore, that the only cash raised is in connection with the monetization of the tax abatement.

¹ “Abatement” is used informally in this White Paper to refer to such relief from *ad valorem* property taxation as may result from the bond-financed sale-leaseback structure described herein.

² Details of structuring *ad valorem* property tax abatement programs are beyond the scope of this White Paper.

³ See our White Paper, “Bonds for Title.”

⁴ As will become clearer from the discussion below, economically this monetization is equivalent to a borrowing by the company. Still, there may be reasons for the company to prefer monetization to direct borrowing; *e.g.*, choices between reducing operating costs and obtaining an allocation of capital internally, seeking an operating lease as opposed to a capital lease, etc. See *Quick Takes*, March 2006: “No Equity, No Letter of Credit, No Problem”.

How to “Monetize”

The first step in the monetization is to determine the terms of the property tax abatement that the community is willing to provide to the project, and then to establish the bond-financed sale-leaseback structure that is necessary for the abatement.

The abatement structure would be designed so that no actual property taxes are payable on the project. Rather, the company would be required contractually to make payments in lieu of taxes, or PILOT payments. The contract could be termed a “PILOT Agreement”. The PILOT Agreement is between the company and the development authority, and often is acknowledged by other public bodies. The PILOT Agreement spells out the abatement schedule that applies to the project. In some cases, communities have one or more abatement schedules that they regularly use. Without monetization, the economic benefit to the company of the tax savings would be spread over the number of years for which abatement has been provided.

The monetization of the property tax abatement would accelerate the economic benefit of the tax abatement so that the present value of the tax savings would be realized “up front” in cash. The monetization would normally be accomplished in the following manner. The authority would issue two bonds, a “PILOT Bond,” and a “Lease-Backed Bond.”

The company would guarantee both bonds (company guaranties are normal with authority-issued revenue bonds where the lease structure is used). The company and the authority would execute a bond lease and a PILOT Agreement. This can be called the “2 Bond Model” for monetization. A flowchart depicting the basic “2 Bond Model” is attached to this White Paper.

The PILOT Agreement would provide for the company to make two annual payments in lieu of taxes: (i) one such payment would be equal to the unabated portion of normal taxes, which would be paid to the taxing authorities, and (ii) the second payment would be equal to the abated portion of normal taxes (the annual tax savings amounts that result from the abatement percentages.) The second payment would be made to the authority and used to pay debt service on the PILOT Bond. The aggregate of the two payments would be equal to 100% of normal taxes.

Because tax rates may vary from year to year, it would be desirable, in lieu of using actual normal taxes as the measure of payments under the PILOT Agreement, to agree in the PILOT Agreement as to a fixed dollar amount per year which shall be the deemed “normal taxes.” That number could be based on the estimated value of the project on completion, the applicable assessment percentage (generally 40%) and the assumed millage rates of the various

taxing authorities (such as the prior year's millage rates). This would permit a fixed predetermined amount to be paid in each year and would permit more efficient monetization.⁵

The principal amount of the PILOT Bond would be the present value of the annual PILOT payments to be received by the authority, using a discount rate equal to the interest rate on the PILOT Bond. The PILOT Bond would be payable from and secured by the "tax savings" portion of "normal taxes" received by the authority from the company under the PILOT Agreement. The PILOT Agreement would need to be "bondable" (unconditional and non-terminable).

The authority would issue the PILOT Bond to a bank or group of participating banks. The interest rate would be based on negotiations between the authority (or the company) and these banks. Other conditions for the financing would also be negotiated, and might include a requirement for collateral to be provided by the company. Such collateral might be property of the company that is not otherwise encumbered, a second priority security interest in property or a letter of credit.

The proceeds of the PILOT Bond could be used by the authority as "equity" in connection with financing the project; *i.e.*, it could be used to purchase new fixed assets that would be leased to the company under the bond lease. If the company wanted to use the proceeds as working capital, the cash could be used instead to purchase some of the company's existing equipment from the company which would be included in the project and leased back to the company under the bond lease related to the Lease-Backed Bond.

In order to provide the abatement related to the Pilot Agreement, the balance of the project's assets would be conveyed by the company to the authority in exchange for the Lease-Backed Bond in a "bonds for title" transaction. Alternatively, if a financing were to be involved, the Lease-Backed Bond would be sold and the proceeds used to pay project costs, exclusive of the cost of the assets (equipment, in this example), paid for with PILOT Bond proceeds. The entire project⁶ would be leased by the authority to the company under the bond lease. The basic rent to be paid by the company under the bond lease would match debt service on the Lease-Backed Bond⁷, which would not include any debt service relating to the cost of equipment financed by the PILOT Bond.

⁵ If a fixed number is not agreed upon, there is a possibility that the actual PILOT payments may not turn out to be sufficient to pay debt service. In such case, the company would need to make up the difference under its guaranty.

⁶ If more than one capital source is used to finance the project, there would be more than one bond lease and Lease-Backed Bond.

⁷ That is, when the Lease-Backed Bond is the actual financing instrument. The structure, however, can be adapted to include the Lease-Backed Bond while accommodating other capital sources; *e.g.*, equipment leasing or a synthetic lease of real estate.

Designing the Monetization

Each monetization transaction will be unique. Below are a few of the factors that could affect the terms and conditions of a particular transaction.

An abatement schedule that provides for abatement at high percentages of normal taxes and provides for an long period of abatement will produce a larger amount of gross tax savings over the abatement period than will a shorter schedule with lower savings percentages. Because the amount of bonds which the savings will support is based on present values of the annual savings, the lower the interest rate on the bonds, the more the bond amount that can be issued.

Another factor is that the tax savings will be low during the construction period of a construction project because the tax value of the project will be low prior to completion. As a result, the PILOT payments that are to pay debt service on the bonds in the first few years may be less than the interest on the bonds that is due in such years. In such case, some of the principal of the bonds will need to be used to pay part of the interest during construction and probably for the first year after completion of the project. The result in that case would be that less than all of the proceeds of the bonds will be available to pay costs of the project.

For a variety of reasons, we would expect most PILOT Bonds to be issued as federally taxable bonds. However, under some circumstances, it is possible to structure PILOT Bonds as federally tax-exempt “governmental purposes bonds;” *i.e.*, they are not “private activity bonds”. Federally tax-exempt PILOT Bonds were the subject of two favorable federal tax rulings relating to proposed baseball venues for the New York Yankees and New York Mets. The IRS has also issued some Proposed Regulations relating to tax-exempt bonds payable from PILOT Payments.

The federal tax rules that would need to be complied with to obtain tax-exempt bond treatment are rather complex and are beyond the scope of this White Paper. For example, a guaranty of the bonds by the user of the financed facility and PILOT payments that are higher than normal tax payments would make the bonds ineligible for tax-exempt status. On request, we can provide you with extracts from the rulings, a copy of the Proposed Regulations and copies of comments on the Proposed Regulation filed with the U.S. Treasury Department by the National Association of Bond Lawyers and by the American Bar Association.

An Example of a Monetization Transaction – The “1 Bond Model”

We recently closed a transaction in which monetization of the property tax abatement made a win/win transaction with a developer (the “**Developer**”) possible for the community. The monetization paid for infrastructure that was needed for the community’s old, untenanted industrial park (the “**Site**”), which the community was able then to sell to the Developer. The Developer will assist the community in locating prospects there, and the sale proceeds will enable the community to develop another industrial park. That transaction differed from the model described above.

In that transaction, there was only one series of bonds (not two), and the initial purchaser of the PILOT Bond was the Developer (not an unrelated third party). However, in order for the Developer to attain liquidity, the transaction was designed so that the Developer could, upon compliance with applicable laws, resell the Bond. This can be called the “1 Bond Model” for monetization. A flow chart depicting the basic “1 Bond Model” is attached to this White Paper.

The community’s development authority (the “**Development Authority**”) sold the Site to the Developer for cash. The Developer then re-conveyed the Site to the Development Authority in exchange for a long-term lease (the “**Bond Lease**”) of the Site and future improvements (collectively, the “**Project**”). The conveyance of the Site served as prepaid rent for the entire lease term. The Developer purchased the Development Authority’s revenue bond (the “**PILOT Bond**”) for \$11.5 million in cash. That cash was made available to pay the costs of the necessary improvements, as well as to pay the issuance costs and to fund a debt service reserve.

The Development Authority will continue to hold title to the Site and will acquire title to any improvements as they are constructed. The transaction resulted in the Project not being subject to any actual *ad valorem* taxes during its term; thus the savings in actual taxes was 100%. Under a PILOT Agreement, the Developer will make payments in lieu of taxes on the Project (*i.e.*, PILOT payments) in an amount equal to the amount of the *ad valorem* taxes which would be payable if the Developer, rather than the Development Authority, were the owner of the property on January 1 of each tax year, using an assessment rate of 40% of actual fair market value and a stipulated millage rate. The Development Authority pledged the Project, certain funds created by the Bond Resolution (including the debt service reserve) and the revenues from such PILOT payments to repay the PILOT Bond. There is no liability for the repayment of the PILOT Bond on the part of the Development Authority, any county, any city or the State of Georgia. The PILOT Bond has a “taxable” interest rate of 8.75%, and a term of 20 years.

The Developer, of course, has to be able to deal with prospective tenants or buyers of lots (each, a “**User**”) in the industrial park with much the same flexibility as if the monetization structure were not in place. To enable this, the bond documents gave the Developer the right to acquire title to all or any of the Project in exchange for payment of a corresponding portion of the amount of the PILOT Bond, (or to do the equivalent by selling to a User a related portion of the Bond Lease). If the PILOT payments are insufficient to repay the PILOT Bond, then the Developer will provide the necessary funds or, if it then owns the PILOT Bond, it may forgive the amount of any insufficiency. When a User acquires an interest in the Bond Lease, this is the equivalent of buying a lot. In that case, the User will assume a proportionate share of the Developer’s PILOT payment obligations, and the Developer will be released therefrom.

Any payments in lieu of taxes in excess of scheduled debt service on the PILOT Bond plus amounts needed to reimburse amounts drawn from the debt service reserve fund will be paid over each year to the Tax Commissioner for distribution to the appropriate taxing authorities. The community expects to receive significant revenues as a result of that provision.

More Information

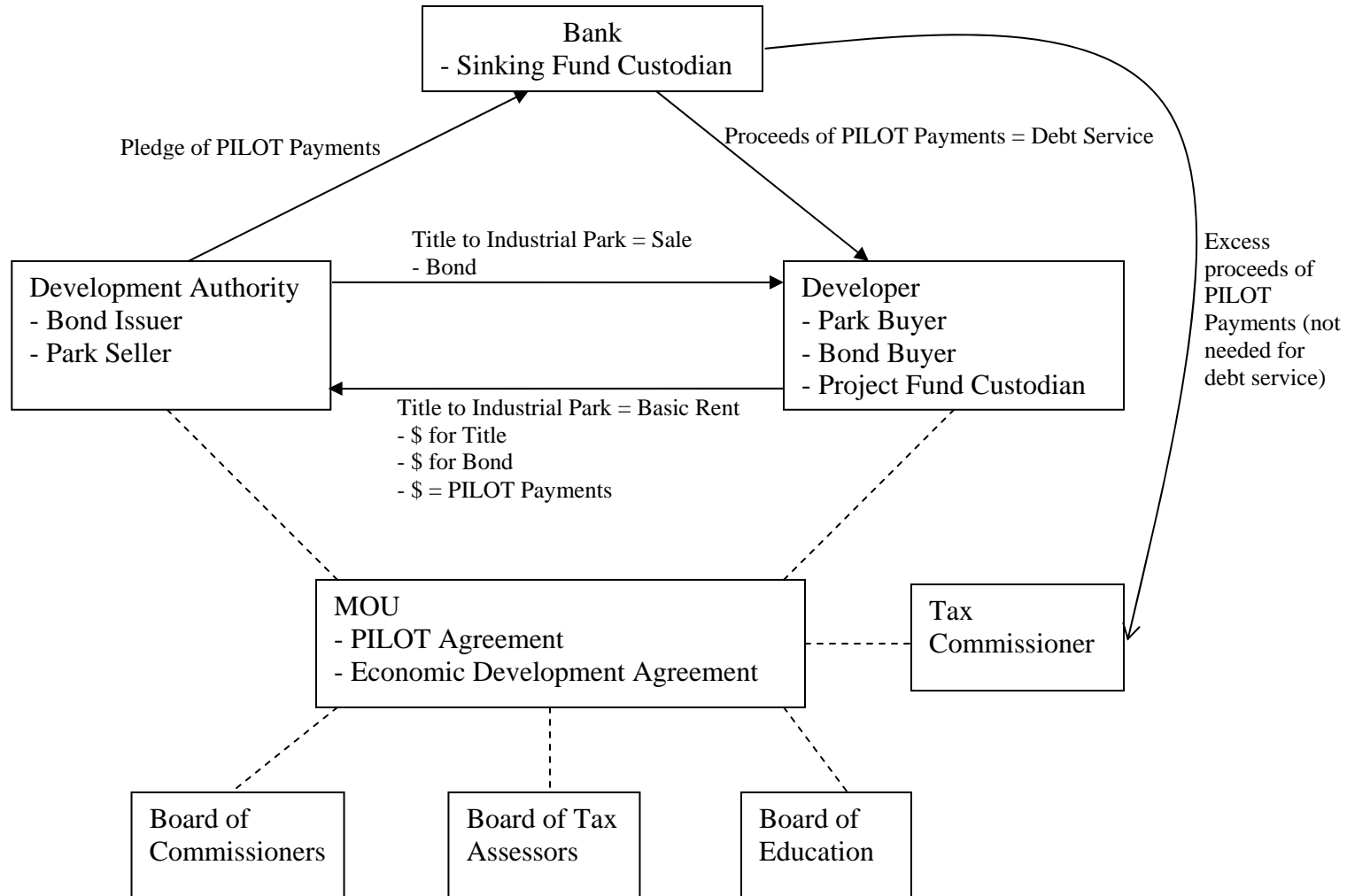
This White Paper is a high-level presentation of this incentives technique. The information in this White Paper is general in nature. Various points which could be important in a particular case have been condensed or omitted in the interest of readability. Specific professional advice should be obtained 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.)

Additional information concerning this topic, as well as White Papers and references on other topics, can be found at <http://danmcrae.info/>.

If you have any questions or comments, we would be pleased to provide more information. Please contact:

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Monetization – 1 Bond Model



Monetization – 2 Bond Model

