Appendix A-3

Financing Guidelines

General obligation bonds

Authorization

All state general obligation debt must be authorized by a 60 percent vote by the Legislature. In addition, no bonds may be issued without prior legislative appropriation of the proceeds. Bonds are issued by the State Finance Committee under the authority granted by the Legislature. As authorized by the State Finance Committee, the issuance of bonds is administered by the Office of the State Treasurer (OST).

Consolidated Cash Flow Financing. OST manages cash flow financing for multiple projects across multiple agencies in accordance with U.S. Treasury regulations to minimize administrative tax compliance monitoring over the life of the borrowing. Bond sales are sized to fund agency and OFM estimates of expected capital expenditures over a six-month period. In estimating cash flow needs, OST also takes into account remaining bond proceed balances and seasonal spending patterns. This type of cash-flow financing ensures that funds are not borrowed until they are needed. Consolidating funding needs also produces pricing efficiencies in the sale of bonds, ensuring the state receives the lowest possible cost for all capital projects. It results in issuance amounts which meet the minimum size thresholds preferred by investors and minimizes the costs of issuance such as underwriting, legal, and rating agency fees. Bond proceeds received on the closing date are immediately transferred to the appropriate funds as directed in the capital budget.

25-Year Final Maturities with Level Debt Service. VPGO bonds are typically structured with level payments of principal and interest over a 25-year period. This serial amortization structure provides a disciplined repayment schedule which spreads the cost of the project over the life of the asset. It means that some of the bonds are repaid one year after issuance, some in the second year, some in the third year and so forth each year until the last bonds are repaid in 25 years. In an interest rate environment with higher rates at longer maturities, serial amortization is also less expensive than repaying the debt at one maturity. The true interest cost (TIC) of the entire series is a weighted average of interest rates between one and 25 years. In fact, as the average life of a 25-year bond with level debt service is approximately 12 years, the TIC of the entire series is the tax-exempt rate for that term. To meet the requirements of the federal Internal Revenue Code (the "Code"), the aggregate projects funded with each series of bonds – that is the assets being purchased or constructed – must exceed the final maturity of the bonds. For every series of bonds, OFM certifies that this requirement has been met.

Certificates of participation

The certificate of participation program uses standardized documentation, which minimizes legal and administrative costs for agencies. Once financing documents have been completed and borrowing rates set by the market, each agency receives a detailed schedule of semi-annual payments due on its outstanding leases. Funds are made available to agencies on a reimbursement basis upon receipt of detailed invoices and proof of payment. To ensure compliance with tax and legal requirements, OST periodically requests information to monitor the spend-down of proceeds and the use of the facilities that have been financed.

Authorization

The State is authorized by Chapter 39.94 RCW to enter into financing contracts for agencies to acquire real and personal property (real estate and equipment). Financing contracts are lease/purchase contracts or capital leases with a term of more than one year, which (1) provide that title to the property secures performance of the State, or (2) transfer title to the property to the State by the end of the term. Each agency financing equipment or real estate under this program pledges its budget appropriation for payment

of the lease. This is true regardless of whether it may anticipate making payments from other revenues. Additional information is available in the Lease/Purchase Program Guide.

The form of financing contracts is subject to approval by the State Finance Committee which also approves the aggregate amount of financing contracts outstanding. State Finance Committee guidelines for use of the program are shown in Guidelines for Use of Financing Contracts.

State law requires prior legislative approval of real estate financing contracts, typically in the capital budget. Most equipment financings do not require explicit legislative authorization, although OST policy requires legislative approval prior to financing major acquisitions of equipment or information systems.

Project Financings. Unlike bonds, COP borrowings are "secured" financings, i.e., in certain situations investors have rights to the underlying property if investors are not repaid on a timely basis. For this reason, COP financings are for tangible assets that could be relinquished if the Legislature chooses not to appropriate funds for lease payments. Agencies must be able to offer a security interest in the asset being acquired and must commit to maintain the property in working order and condition over the life of the borrowing. If a state agency cannot reasonably make these representations about the property to be financed, the property is not suitable for COP financing.

Borrowing Term. The term of each financing contract must be greater than one year and no longer than the expected useful life of the asset being financed. Standardized guidance on the useful life of specific assets is available in the OFM State Administrative & Accounting Manual (SAAM), Chapter 30.50, Capital Asset Class and Location Code List and Useful Life Schedules. For unique or used equipment, OST staff can provide assistance. OST's practice is to limit the maximum maturity to 20 years in order to efficiently pool multiple transactions in each COP issuance.

For administrative efficiency, OST has established a minimum borrowing threshold of $10,000 for each lease. Smaller financing requests for equipment of the same expected useful life should be combined.

Other financing contracts

Occasionally the state finances construction projects with a 63-20 financing contract. In this structure, tax-exempt lease revenue bonds are issued by a non-profit corporation on behalf of the state. The non-profit corporation causes the project to be built through a fixed price contract with a private real estate development company. The state agency makes lease payments over time to a trustee and takes title to the property at the final maturity. Costs of issuance and ongoing fees on 63-20 financings are typically higher than on COP financings and the borrower usually pays higher interest rates. Use of a 63-20 financing contract requires legislative authorization. In addition, the State Finance Committee must approve both the financing contract and the non-profit corporation issuing the lease revenue bonds on behalf of the state. For additional information, consult the State Finance Committee's Guidelines for the Use of 63-20 Financing Contracts.

Private Activity Restrictions on Tax-Exempt Financing

In general, Congress and the federal government consider the tax exemption for interest on state and local bonds to be a federal subsidy provided to state and local governments. This is because the federal government foregoes the revenues that it would otherwise receive from income taxes imposed on interest income received by taxpayers who own municipal bonds. Therefore, the provisions of the federal Code and related U.S. Treasury regulations that apply to tax-exempt obligations are intended to restrict the benefits of this federal subsidy to governmental purposes of state and local governments and not to allow benefits of the subsidy to be transferred to persons other than state and local governments.

Private business use includes: ownership by the nongovernmental person of the financed property or use of the financed property by a nongovernmental person under a lease, management contract (unless it is a "qualified" management contract under IRS guidelines), "output contract" (such as a contract to purchase

water or electricity produced by a financed facility), research agreement (with certain exceptions under IRS guidelines), a "naming rights" contract, or any other arrangement that provides similar "special legal entitlements" to a nongovernmental person to use the financed property. However, use of financed property by a nongovernmental person simply as a member of the general public or under certain, specified short-term use arrangements (involving terms of use not exceeding 50, 100 or 200 days, depending on the type of arrangement) do not result in private business use. Also, use of financed property by private individuals not engaged in a trade or business activity is not private business use.

Limits on private business use

In general, the amount of private business use of proceeds of a tax-exempt governmental financing is limited to the *lesser* of 10 percent or $15 million of proceeds of the issue. In addition, no more than 5 percent of the proceeds of the issue may be used for any "unrelated" private business use — *i.e.,* a private business use that is not functionally related to the governmental purpose of the tax-exempt financing. These limitations are measured on the basis of the average amount of private business use in each year during a measurement period generally corresponding with the overall term of the bond or COP issue.

Private payments or security

An issue of tax-exempt bonds with private business use in excess of the limits described above would not violate private activity bond restrictions *unless* the state also expects to receive payments from private business users for their use of the financed property (or payments by others in respect of property that is used for private business use) having a present value exceeding 10 percent of the present value of debt service on the bonds, regardless of whether those payments are pledged to pay the bonds. For this reason, bond proceeds used to make grants may be used for private business use so long as the state has no expectation or right to receive payments from the grantee (except only for violations by the grantee of conditions of the grant). Loans to nongovernmental persons from bond proceeds are not permitted as there would be both private use and private payments. (Moreover, use of tax-exempt bond proceeds to make loans to governmental persons also may be disallowed because of federal tax compliance issues relating to monitoring of the actual expenditure and investment of bond proceeds loaned to the governmental borrower. This is because the bond proceeds are treated as "spent" only when spent by the borrower and not when used to make the loan.)

However, for COPs, the focus is on the amount of private business use of the financed property regardless of whether the state receives any payments in respect of the financed property. This is because the financed property itself is pledged as security for the COPs, and private business use of the financed property will result in a corresponding amount of private security for the COPs. Although an issue of COPs generally would violate private activity bond restrictions if payments from private business users with respect to the financed property were to exceed the applicable limitations, the issue could violate private activity bond restrictions because of private security rather than private payments. That is, if a portion of the COP-financed property representing more than the lesser of 10 percent or $15 million of proceeds of the COP issue is used for private business use, or if more than 5 percent of the proceeds of the issue is used for any "unrelated" private business use, this would case the issue to violate the restrictions on private security as distinguished from private payments.

Strict limit on tax-exempt financing of private loans

In addition, under a separate and independent restriction, no more than the lesser of 5 percent or $5 million of the proceeds of an issue may be used, directly or indirectly, to make or finance loans to any person other than a state or local government unit. This is referred to as the "private loan financing test." Because of the size of the State's bond issues, the lower $5 million limit almost always applies.

Use of taxable obligations for private use portions of capital projects

A capital project that is expected to involve private business use in an amount exceeding the limits described above may require some or all of the financing to be executed on a taxable rather than tax-exempt basis, or require the use of funds not derived from a borrowing to pay the cost of that part of the project expected to be used for a private business use. If the project requires taxable funding, the agency may request funding from the State Taxable Building Construction Account (Account 355).

Most recent bond acts include provisions which permit the State Treasurer, on behalf of the State Finance Committee to cause bonds authorized to be issued as tax-exempt bonds instead to be issued as taxable bonds, if necessary to comply with IRS requirements. Recent bond acts also permit authorized taxable bonds to be issued as tax-exempt bonds using a similar approval process if Code requirements have been met.

Use of taxable obligations for private use portions of capital projects

Examples of Private Business Use

1. If a state agency leases excess office space in a financed building to commercial businesses, a federal agency, or a private non-profit organization, the portion of the proceeds allocated to the cost of the privately leased space is considered used for nongovernmental purposes.
2. Suppose bond proceeds are used to make a loan to a port district for the construction of an industrial building, and that the port district constructs the building and leases space in the building to various commercial tenants and uses rental income from the building to repay the state loan. In this case, the bond proceeds used to make the loan to the port district would be treated as a private business use.
3. If proceeds of a bond issue with a 25-year term are used to construct leasehold improvements for a state agency that leases office space in a privately owned building for a term of 15 years, and the estimated useful life of the leasehold improvements is 20 years, the proceeds of the bond issue allocable to the cost of the leasehold improvement that will revert to the private building owner at the end of the lease term would be treated as used for private business use.
4. If proceeds are loaned to a housing authority to build an apartment building that the housing authority leases to a separate limited partnership in which the housing authority is the general partner and private investors are limited partners, the financed apartment building is considered used for private business use, and the private loan financing test would be met.
5. If proceeds are loaned to a city to build a sewage treatment plant, but the city enters into a long-term management contract with a private company to operate the sewage treatment plant for the city, and the management contract fails to meet Internal Revenue Service requirements for a "qualified management contract," the plant is considered used for a nongovernmental purposes.

An agreement by a nongovernmental person (such as a business corporation or the federal government) to sponsor research performed by a governmental person (such as a state university) may result in private business use of the property used for the research. Consult tax counsel as it may be possible to structure research agreements with nongovernmental persons to avoid private business use of the property.