Chapter 4

Financing Guidelines

4.1 METHODS OF FINANCE

Capital projects are paid with cash balances, revenues received over time, or with proceeds of financings. Most financing is provided through general obligation bonds or with lease/purchase financing contracts that are sold to investors as certificates of participation (COPs). Both general obligation bonds and COPs are typically issued by the state several times a year in the public securities market.

State financings are typically tax-exempt (i.e., the interest paid to investors is exempt from federal income tax), as borrowing rates are lower than taxable rates. Tax-exempt financings are subject to federal tax regulations regarding the types of projects to be financed, the pace at which proceeds are spent, and the use of the asset during the financing term.

General obligation bonds

Various purpose general obligation (VPGO) bonds are the traditional form of government debt financing for non-transportation capital projects. General obligation bonds are payable from general state revenues and backed by the state's pledge of its full faith, credit, and taxing power. Unless specifically exempted, VPGO bonds are subject to a state constitutional debt limit which requires that the maximum annual payment of principal and interest on debt subject to this limit not exceed a specified percentage of average general state revenues for the six preceding fiscal years. Typically, VPGO bond sales are scheduled semiannually to provide funding for six months of expenditures on a variety of capital projects across the state.

Program parameters

Proceeds of tax-exempt bonds must be spent on capital expenditures, in accordance with state accounting guidelines and under federal tax laws applicable to tax-exempt obligations. Proceeds of tax-exempt bonds may be spent on grants, but loans to entities besides state or local government units – including non-profit organizations, the federal government or federal agencies – are not allowed under federal tax laws. Certain upfront costs such as design, delivery and setup, and training may qualify for financing. Expenditures for sales and use tax on purchases of equipment and construction of capital projects also may be financed. More detailed information on the allowable uses of tax-exempt financing is provided in Chapter 4.2. All property financed on a tax-exempt basis is subject to federal tax restrictions regarding private business use (see Financing Guidelines Appendix).

Certificates of participation

The lease/purchase program provides agencies with an alternative way to finance essential real estate and equipment over a multi-year period. The program is structured to ensure agencies benefit from economies of scale and the state's low tax-exempt financing rates when financing contracts are consolidated or "pooled" and sold to investors as COPs. COPs offer investors ownership interests or participation in the lease payments made by State agencies.

This 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 provided 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.

Program parameters

Proceeds of tax-exempt financing contracts must be spent on capital expenditures, in accordance with state accounting guidelines and under federal tax laws. All property financed on a tax-exempt basis is subject to federal tax restrictions regarding private business use (see Financing Guidelines Appendix). Financing contracts may not be used to provide funds for grants or loans. Proceeds of financing contracts must be spent on assets serving an essential public purpose. Agencies must represent that the property is essential for carrying out its functions and responsibilities.

Certain upfront costs such as design, delivery, setup, and some training qualify for financing. Expenditures for sales and use tax on purchases of equipment and construction of capital projects may also be financed. Note that design costs may not be financed before equipment is acquired or construction begins because design, by itself, does not create a tangible asset. More detailed information on the allowable uses of tax-exempt financing is provided in Chapter 4.2.

A real estate project must be ready to proceed before it is financed. For acquisitions, agencies must first acquire the building or land and obtain title to the property prior to issuing the COP. For new construction, OST requires agencies to have entered into a construction, design-build, or general contractor/construction manager (GCCM) contract for the project prior to issuing a COP. Construction projects are subject to public works requirements. Generally, proceeds must be spent within 18 months.

4.2 LONG-TERM TAX EXEMPT FINANCING RESTRICTED TO CAPITAL PROJECTS

Regulations adopted by the Internal Revenue Service (IRS) restrict the purposes for which tax-exempt bonds and COPs may be issued. IRS regulations severely limit the ability to issue long-term tax-exempt obligations to finance current operating expenses. The use of long-term tax-exempt financing for capital projects or purposes is treated relatively more favorably because the proceeds of the obligations are used to pay capital expenditures for capital projects that have useful lives reasonably commensurate with the maturities of the obligations being issued to finance the expenditures. The information below distinguishes allowable capital purposes from non-allowable operating expenses.

Agency administrative and staffing costs

Proceeds of tax-exempt bonds or financings are intended for the acquisition, construction and renovation of capital assets. They should not be used to subsidize operating costs such as ordinary maintenance or administrative staff expenses. IRS tax rules relating to staffing costs are very restrictive.

Allowed:

- Project administrative costs for tasks directly related to a financed project, including project support services such as processing agreements, contracts, and change orders; managing bid processes, and verifying invoices. Project-related administrative costs must be identified as such in accounting records.
- Project management fees for project design, land use applications, environmental impact statements and other environmental assessments, hazardous material assessments, and building code plan review. This also covers project management costs related to consultant selection, contract negotiation, administration of consultant agreements and public works contracts for individual capital projects. These costs must be identified as such in accounting records.
- Staff costs for the time and expenses directly related to coordinating and delivering a project. Project-related staff costs must be identified as such in accounting records.
- Tasks associated with the support of project management operations for multiple projects including staff management, staff support, accounting, and management of public information regarding the capital project.

Not allowed:

- Regular staff operating costs.
- Agency administrative costs related to capital budget development, capital facility development, long-range budget planning, and policy initiatives.
- Non-project specific tasks associated with regulation and policy development, contract development, interagency initiatives or legislative oversight.
- Non-project specific tasks associated with overall general comprehensive planning for facilities and infrastructure, the identification and prioritization of capital projects, and the preparation of agency capital requests.
- The provision of emergency services and infrastructure management.

Additional COP financing restrictions: As part of the reimbursement process, OST requires detailed accounting records to document staff time or other labor charges. Contact OST for further information on the requirements.

Acquisition – land and buildings

Allowed:

- Expenditures for the acquisition of real property, whether obtained by purchase or condemnation under the applicable eminent domain laws of the state, including expenses directly and necessarily related to such purchase or condemnation.
- The cost of improvements to real property, such as buildings, structures, land improvements, roads, and bridges. Costs may include land and improvement costs, appraisal fees, title opinions, surveying fees, real estate fees, title transfer taxes, easements of record with an extended term, condemnation costs, and related legal expenses.
- Relocation costs that are payments made to owners or occupants of property that the state is acquiring. These costs may be financed long-term when paid pursuant to federal or state statutes.

Planning and consultant services for predesign and design work

Allowed:

- Preliminary technical studies developed from program statements that reflect the functional characteristics and architectural requirements of a specific capital improvement project (predesign).
- Architectural and engineering services, such as schematic design, design development and construction documents.
- Reimbursable expenses provided in an executed contract for professional and technical services.
- Fees for construction management and observation.
- LEED certification fees as part of a construction project.

Not allowed:

- Expenditures for general long-range development plans, master plans, historical or archeological research, feasibility studies, statements, energy audits, or other similar expenditures which are not associated with a specific capital project.
- Unpredictable or unusual legal expenses (other than those associated with land acquisition) which are not ordinarily provided in the budget for a capital project.

Additional COP financing restrictions: Design costs for a capital project may not be financed with a COP before construction begins because design, by itself, does not create the tangible asset which is necessary to secure the financing. Once construction contracts are executed and COPs are issued, certain upfront costs such as design, delivery, setup, and some training may be reimbursed from COP proceeds.

Construction

Site improvement costs

Allowed:

- Site improvement such as demolition of buildings and structures; construction or replacement of sidewalks, bridges, ramps, curbs, pedestrian bridges and tunnels, building terraces, retaining walls, and exterior lighting surface parking areas; removal of trees and plant material; grading; rerouting of utilities; and erosion control may be financed if they precede a financed project to be undertaken on the same site.

Not allowed:

- Routine maintenance of land improvements.
- Expenditures to acquire or construct temporary facilities or for facilities where abandonment or replacement is imminent. This does not include temporary facilities required by a contractor during construction.

Road work

Allowed:

- Expenditures related to the construction, extension, replacement, reconstruction or upgrading of a new road or parking lot. The following are considered part of roadwork costs: all necessary signing, landscaping, erosion control, drainage, lighting, bridges, safety, and control structures.

Not allowed:

- Repairs or resurfacing of existing roads to temporarily extend useful life are not allowed.

Facilities preservation

Allowed:

- Expenditures for the reconstruction, preservation, and improvement of existing buildings or structures that materially extend their useful lives, including:
  - Site developments necessarily required or related to the preparation of a site for reconstruction purposes (see "Site Improvement Costs").
  - Required built-in, special purpose or other fixed equipment where such equipment is permanently affixed or connected to real property in such a manner that removal would cause damage to the real property to which it is affixed.
  - Expenditures for the installation or replacement of water control structures such as dams, culverts, aqueducts, drainage systems, locks, spillways, reservoirs and channel improvements.
- Interior work including: demolition, moving walls, new carpet or floor surfaces, new finishes, replacement of electrical and plumbing facilities, and installation of new fixed or movable equipment.

Not allowed:

- Normally recurring expenses.
- Labor fees associated with moving equipment between facilities.

- Ordinary maintenance such as patching, painting, caulking, weatherproofing, insulating, adding storm windows, replacing doors, replacing gutters and shingles, repairing vandalism or cleaning. An aggregation of ordinary maintenance does not create a long-term financed capital project.

Utilities, safety, and codes

Allowed:

- Expenditures for the acquisition, construction, replacement, modification or extension of utility systems, including construction or replacement of utility lines between buildings, replacement or installation of utilities to off-site supply systems, and replacement of complete boiler or central air conditioning or ventilation systems.

Not allowed:

- Minor replacement of corroded or leaking pipes inside a facility; replacement of unsafe or undersized wiring; repairs to stop leaks; replacement of heating or cooling coils; replacement of radiators, fans or motors; re-tubing of boilers; addition of controls or valves for energy conservation; or replacement of thermostats, timers and other items that are consumed or worn out in the ordinary course of use of a capital facility.

Equipment

Allowed:

- *Built-in equipment* permanently attached to the building or improvement and considered to be an integral part of the structure, without which the building or improvement will not function. Built-in equipment is generally included in the base construction budget and estimate. Examples include plumbing fixtures, heating, ventilation and air-conditioning equipment, electrical equipment, elevators, and escalators.
- *Fixed equipment* attached to the building or improvements for purposes of securing the item and contributing to the facility's function. Fixed equipment is generally included in the base construction budget and estimate. Examples include shelving, cabinets and bolted furniture.
- *Some movable equipment* may be allowed if it is necessary for the functioning of the building or improvement and remains with the facility in support of a program, even though it is not attached to the building or improvement. Movable equipment is generally included in a separate equipment budget and estimate. Examples include desks and computers. Check with your OFM capital analyst if you have questions.
- Some costs of purchasing or developing *information/software systems* may be allowed. For additional information, consult with your OFM capital analyst.

Not allowed:

- *Consumable inventories*, as defined in the State Administrative and Accounting Manual (SAAM), are supplies consumed in the course of an agency's operation or incidental items held for resale. Examples include office, janitorial and chemical supplies, and laboratory glassware.
- *Spare or replacement parts for equipment.*
- *Temporary equipment* that is planned to be used for a period less than its useful life. For example, research equipment for a short-term project.

Additional COP financing restrictions: Agencies considering COP financing for IT projects should contact OST early in the planning process and be aware that prior legislative approval is required for major acquisitions. Agencies are also required – without exception – to receive explicit vendor permission to grant a security interest in information system property. More information about financing IT projects can be found in OST's Lease/Purchase Program Guide.

4.3 PRIVATE ACTIVITY RESTRICTIONS ON TAX-EXEMPT FINANCING

All agencies planning to finance capital projects with bonds or COPs and who anticipate engagements with nongovernmental entities on their projects are strongly encouraged to consult with OST and OST's tax counsel early in the process.

Private business use

IRS regulations restrict the amount of proceeds of any tax-exempt issue of bonds or COPs that are permitted to be used for any private business use. For this purpose, the term "private business use" means use by any person other than the state or another local government unit of the state, and includes use by any private for-profit or nonprofit corporation, limited liability company, general or limited partnership, association, or an individual person engaged in a trade or business activity. It also includes use by the federal government or any federal agency.

For more information, see the Financing Guidelines Appendix.