

**GOVERNMENT FINANCE OFFICERS ASSOCIATION
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TAX-EXEMPT LEASING OUTLINE

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1. WHAT'S IN A NAME?
 - a. These agreements use several different names, *i.e.*, Installment Purchase Contract, Lease Purchase Agreement, Lease Agreement.
 - b. Need to look at the provisions of the agreement itself to determine the legal effect of the document, whether it is a true lease or a purchase.
 - c. These agreements will generally be sales of the equipment. Title will pass to the purchaser either by operation of law or by agreement.

2. STATE LAW/FEDERAL LAW
 - a. State law and federal tax law treat these agreements differently.
 - b. State Law
 - i. These agreements are either a sale or a lease, depending on which entity has title during the term of the agreement.
 - ii. These agreements are usually not considered "debt" for state law purposes.

- (1) Obligations to make payments or otherwise provide funding in any future fiscal year constitute "debt" for state law purposes.
- (2) If the agreement does not obligate the public entity to provide funds for any fiscal year other than the current one and the conditions set forth in (b) below are met also, it does not constitute "debt".
- (3) These agreements contain clauses granting the public entity the right not to appropriate funds for any future fiscal year to meet this "current budget year obligation only" condition.
- (4) In order to have a valid non-appropriation right, the following aspects must be reviewed:
 - (a) Does the agreement contain an obligation to appropriate? If there is language in the document obligating the public entity to use its "best efforts" or "good faith" efforts to appropriate, this is considered an obligation to appropriate and not a valid non-appropriation clause.
 - (b) Does the agreement provide for a "penalty" in the event of non-appropriation? The agreement cannot require the payment of money in return for the right to non-appropriation. Also, the agreement cannot have such a short term that the value of the equipment in a given year far exceeds the remaining amount to be paid under the agreement.
 - (c) Does the agreement prohibit the public entity from purchasing substitute equipment if terminated due to failure to appropriate? Non-substitution provisions are prohibited. The public entity must have the right to purchase additional equipment.

c. Federal Law

- i. For federal law purposes, these agreements are financing documents and the transaction is an "obligation" under Section 103 of the Internal Revenue Code, since the public body is building up equity in the equipment over time and either owns the equipment or will own it at the end of the term for nominal consideration. The public body's right not to appropriate in future years does not affect this conclusion. An existing appropriation when the agreement is executed is sufficient.
- ii. The payments under the lease must be broken down into a principal component and an interest component.

- iii. Provided that the lessee/purchaser is a public body allowed by federal tax law to issue tax-exempt debt, the interest component of the rental payments is tax-exempt interest to the lessor/seller.
- iv. Opinion as to tax-exempt status of the interest component of the payments is provided by counsel to the lender (lessor). Local counsel opinion as to tax exemption is not required – only other state law issues.
- v. To comply with federal tax laws, tax counsel to the lender will require that certain provisions be in the agreement:
 - (1) What will the equipment be used for? The agreement will require that the public body not sell or lease the equipment or otherwise allow the equipment to be used by another entity. This ensures that the public body will use the equipment and it therefore will have a public purpose.
 - (2) What interest rate will be earned on any funds escrowed to purchase equipment? Sometimes not all of the equipment will be purchased when the lease is signed and there will be funds deposited into an account and used to pay for equipment from time to time. Federal tax law requires that the moneys in this account either be spent within a certain time period or that the interest earned on this money be either restricted or paid to the treasury.
 - (3) There will be an informational IRS Form 8038-G executed by the public body and filed with the IRS. This will be prepared by the lender's attorney.
 - (4) The agreement will require that the public body keep a record of any assignments of the agreement made by the lender. This is because federal tax law requires that tax-exempt debt be in registered form. Since the agreement is considered a loan for federal purposes, there must be a register kept showing who owns the right to the payments under the agreement.
 - (5) Is the lease a "qualified tax-exempt obligation" (bank qualified) under federal tax law? If the public body does not reasonably anticipate that it will issue more than \$10 million of tax-exempt obligations in the calendar year, then certain financial institution lenders (banks) may be allowed to deduct a portion of their interest expense allocable to tax-exempt loans.

This will result in a reduced interest rate under the agreement. The agreement may contain a certification as to the amount of obligations the borrower plans to issue in the then current calendar year to establish bank qualification.

3. REMEDIES UNDER THE AGREEMENT

- a. Why would anyone enter into an agreement where the other party has the right not to pay? Generally, the public body will state in the agreement that the equipment is necessary to its operations. The lender is convinced that since the public body needs the equipment and has the money to pay for it over time, it will continue to pay for the equipment. It is willing to help the borrower keep the loan off the books under state law (it is considered an operating expense) and no regulatory approval is required.
- b. What if the public body defaults? The only time there would be a default is if the public body breaches a covenant in the Agreement or fails to make a payment which it has appropriated funds to pay. If there were some problem, it is likely that the public body would just non-appropriate, which is not a default.
- c. What if the public body non-appropriates?
 - i. Usually, there is no right to seize property belonging to a public entity. This prohibition would not apply if the lender retained title to the equipment.
 - ii. Agreements generally will provide that the public body return the equipment if there is a non-appropriation (or default, for that matter). New changes to lease of moveables law allows return of property and title flexibility.

4. MISCELLANEOUS LEASE PROVISIONS

- a. These agreements will contain various provisions which need to be reviewed for compliance with state law.
 - i. Insurance. The public body will be required to insure the equipment for the term of the agreement. Generally, whatever insurance the public body already carries will be sufficient (self-insurer and/or commercial). Some evidence of insurance coverage will usually be required.
 - ii. Maintenance and Repairs. The public body generally will be required to maintain the equipment and keep it in good working order.
 - iii. Indemnity. Some agreements may contain language requiring indemnity in circumstances when it is against public policy, such as indemnifying a third party

against some other entity's actions. These provisions should be reviewed to ensure they are acceptable.

- iv. Severability Clause. There should be a provision saying that if for any reason any provision in the agreement is unenforceable, the remainder of the agreement remains enforceable.

5. PROCUREMENT MATTERS

- a. Since the equipment is being procured by the public body, the public bid laws will usually apply.
- b. Once the procurement of the equipment has been bid in compliance with the bid laws, the agreement can be entered into. There is usually no requirement that the agreement itself be bid as long as the equipment being acquired under the agreement has been properly bid.