PILOTS & TAX-EXEMPT BONDS FOR PRIVATE BUSINESSES IN LOUISIANA: FAQS

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PILOTs

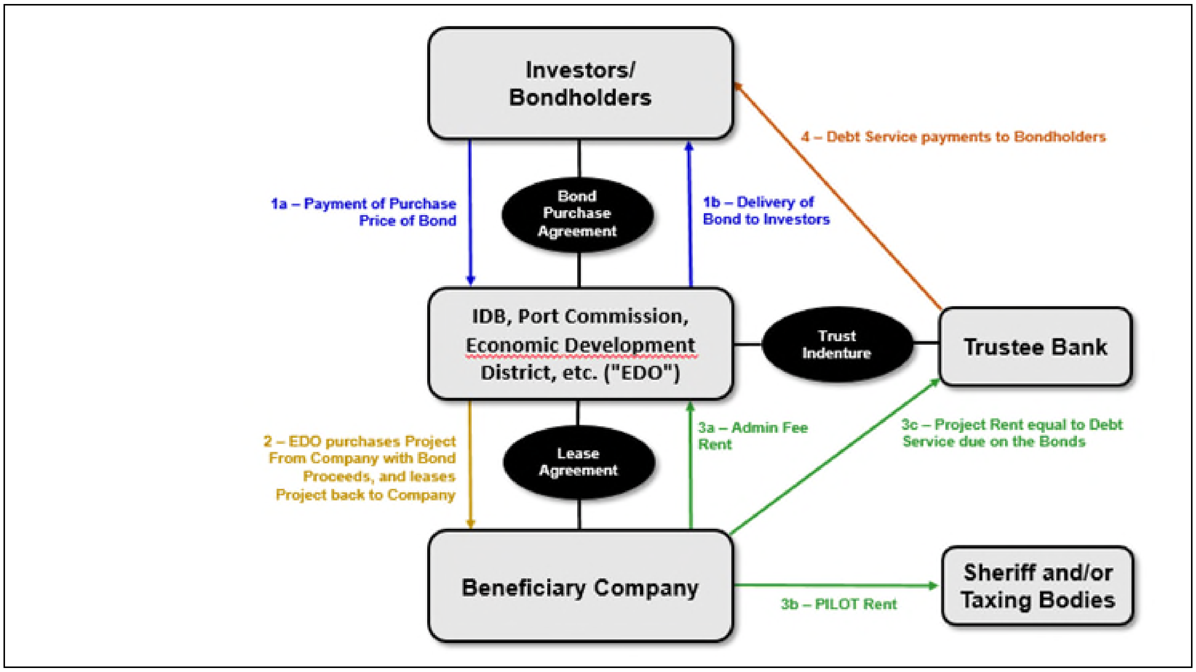
Some bond issues have a "PILOT" feature; what is that?

The term **"PILOT"** is an acronym for "Payment in Lieu of Taxes." For conduit issuers of taxable or tax-exempt private activity bonds that are either political subdivisions (such as an economic development district) or industrial development boards, it is possible to use a "sale-leaseback" arrangement whereby the conduit issuer actually holds title to the economic development project during the term of the bonds. The conduit borrower generally receives the benefits of depreciation, while being responsible for paying maintenance, operation and insurance costs on the project. However since the conduit issuer is a governmental unit, its property is exempt from property taxes. So, while the PILOT arrangement exists, the bond-financed project is not subject to property taxes.

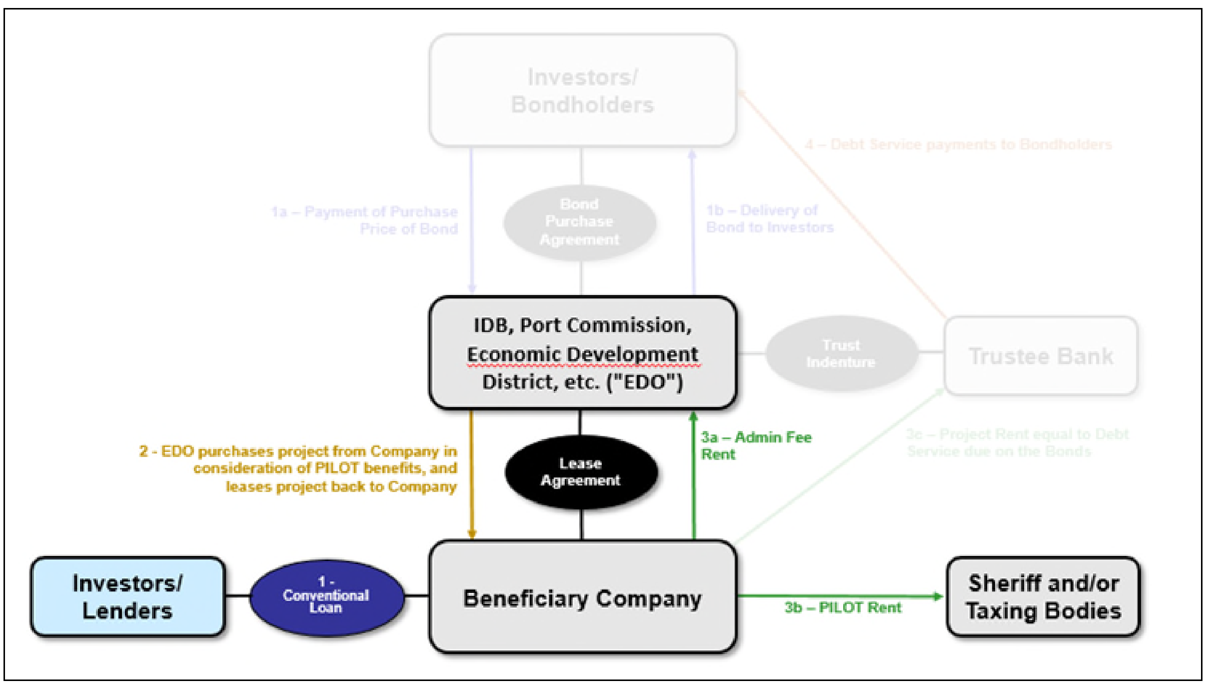
Must there be a bond issue whenever there is a PILOT?

Until recently, all PILOTs were associated with either taxable or tax-exempt bonds issued by a conduit issuer. Recently, however, a PILOT structure has evolved that does not require the issuance of bonds. In this case, there is a "PILOT Lease Agreement" but the project developer will normally structure their own conventional financing separately from the PILOT transaction. In the second, more common, case a local economic development entity (**"LEDE"**) such as an industrial development board, economic development district, port commission, city, parish or similar governmental entity will structure and implement the PILOT.

How is a PILOT structured when it is associated with a bond issue?



In contrast, how is a PILOT structured <u>without</u> an associated bond issue?



So, how does a PILOT benefit a Business Enterprise?

When a PILOT structure is utilized, the beneficiary negotiates a "payment in lieu of taxes" to the conduit issuer (if bonds are used) or LEDE, which is less than the amount of property taxes that they would pay if the property was on the tax rolls. <u>This reduced tax payment, a form of tax abatement, is the economic incentive</u>. Although PILOTs are generally used in conjunction with taxable bonds, they can sometimes be used as an additional incentive for tax-exempt private activity bonds, or they can be structured without the use of a bond issue.

Essentially, by reducing the project owner's annual tax liability, additional cashflow is created that can make a marginal project economically feasible, or allow an even larger development to be financed that might otherwise be possible without the PILOT incentive.

PILOTs will only be possible upon a showing by the project developer that the benefits to the community in the form of additional employment, sales tax revenues, etc., will equal or exceed the reduction in property tax payments.

What are some examples of PILOT use in recent years?

Over the last few years, PILOTs have been used all over Louisiana in several different ways, including:

- To provide a property tax abatement/reduction purely as an incentive to attract/retain business.
- Integrated with the State's 10-year Industrial Tax Exemption Program (**"ITEP"**) to provide a longer period of tax reduction/abatement.
- Used in lieu of ITEP to provide a longer incentive period but with structured income to local taxing bodies during the first 10 years when they would otherwise be receiving little additional tax revenues from the project under ITEP.
- To redirect local tax revenues for the purpose of financing necessary infrastructure and/or site improvements needed to attract/retain business that would otherwise be unaffordable for local government units.
- As a tool for creating a public/private partnership through a cooperative endeavor agreement whereby PILOT payments are redirected or leveraged into other economic development projects or for financing necessary infrastructure and/or site improvements.
- As a vehicle for project developers to obtain certainty regarding the amount of future tax payments, which may be necessary in order to secure financing.
- As a way for local governments to also secure assurances about minimum jobs, payroll and/or preference for local or minority/disadvantaged businesses.

How does a PILOT differ from Louisiana's Industrial Tax Exemption Program?

Although there are similarities, PILOTs and ITEP differ in several ways. While ITEP can only attach to buildings and equipment (not land) used for manufacturing, the PILOT program can be used with any kind of business property, and PILOTs can include land, buildings and equipment. ITEP is actually a private property tax exemption based on an exception in the Louisiana Constitution, while a PILOT depends on conveying the ownership of property to a public body in order to create a tax exemption that is based on public ownership. ITEP is generally limited to ten years (actually two 5-year terms) and provides on 80% tax reduction, while PILOTs can run for longer or shorter periods depending on the needs of the project developer and reason for granting the PILOT incentive, and can provide for up to 100% tax reduction. Although the State generally doesn't attach conditions once an ITEP has been approved, PILOTs can include ongoing requirements for jobs, payroll, and use of local workers; PILOTs may also have clawback or penalty provisions if such conditions aren't met. There are other differences, but these are the major ones.

How long does a PILOT arrangement run?

The term of each PILOT is negotiated between the project developer and the local conduit issuer or LEDE, sometimes with the involvement of local taxing authorities. In New Orleans, for example, the New Orleans IDB works with the Mayor's Office of Economic Development and the N.O. Business Alliance to evaluate, structure and approve PILOT proposals.

A typical commercial PILOT might run for 10-20 years, but in some cases involving the rehabilitation of public housing projects in post-Katrina New Orleans they have been approved for up to 40 years.

In some cases, the annual PILOT payment may consist of a fixed amount due each year - sometimes based on the amount of taxes being paid on the subject property prior to the development. In other cases, the amount of the annual PILOT payment may increase incrementally during the PILOT term so that at the end of the term the project owner is paying nearly the full amount of taxes that would otherwise be due. PILOT terms are always fully negotiable.

Are there other conditions imposed on PILOT recipients?

Typically, each PILOT will include certain promises by the project developer that the project will provide a certain number of construction and/or permanent jobs, and may also include a promise that the project will provide some minimum annual payroll. Failure to meet the employment/payroll targets results in a penalty payment that can be as much as the full amount of property taxes that would otherwise be payable in the absence of the PILOT.

Local conduit issuers or LEDEs may also impose additional requirements such as a "best efforts" promise to use local contractors and workers during construction, or an objective target for local, minority or disadvantaged business partners.

Are there any other innovative ways to use PILOT payments?

Yes, the use of PILOT bonds is currently one of the most cutting-edge economic development tools around. Even if a project is economically feasible without the use of a PILOT incentive, a LEDE can make use of a PILOT structure to leverage PILOT payments into targeted infrastructure or economic development projects. For example, a City might enter into a PILOT Agreement with a project developer that would effectively redirect moneys to the City in the form of a contractual PILOT; the City could then use the PILOT payments to repay bonds issued for infrastructure (either related to the project or otherwise), or in some cases to actually participate in a public/private partnership with the project developer to assist in the financing of the project itself.

Can a PILOT or a Private Activity Bond be utilized in conjunction with other incentives such as New Markets Tax Credits or Historic Tax Credits?

Yes! (although many or most of these incentives may be affected or terminated by recent "tax reform").

Can a PILOT be used if the project also qualifies for ITEP?

Under Louisiana's ITE Program, certain industrial projects may qualify for a 10-year property tax abatement (in reality, an 80% abatement for 5 years with the potential for one 5-year extension). Businesses must be classified as manufacturing in order to receive the benefits of ITEP, which is administered by the Louisiana Board of Commerce & Industry.

For qualifying projects, a PILOT may be used <u>instead of</u> ITEP.

While ITEP may be useful, they may result in a potential period where only a small amount local property taxes are paid, followed by an immediate jump up to the full amount of taxes after the exemption ends. Local taxing bodies (school boards, fire districts, parish government, sheriffs, etc.) must provide services to the new facility, but often receive little or no additional tax revenues for 10 years after project completion. To address this dynamic, a number of local government entities and manufacturing enterprises have negotiated alternative arrangements using Louisiana bond laws that may provide earlier payments to the tax recipient bodies in return for negotiated reductions over future years.

Unlike ITEP, PILOTs are not limited to manufacturing facilities and may be used for virtually any economic development project (including land). For targeted developments, PILOTs can also be used as an improved incentive by increasing the property tax abatement or reduction for a period longer than ITEP.

I may be interested in using a PILOT; whom should I contact to get more information?

Your local chamber of commerce, economic development authority or Mayor/Parish President's office may be familiar with PILOTs. The State Department of Economic Development is also a resource that you may use.

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TAX-EXEMPT BONDS

How can a private business use tax-exempt bonds?

Nationwide, a common form of corporate finance involves the issuance of tax-exempt bonds (which were once known as "industrial revenue bonds" or "IRBs") for private businesses. Since IRBs are not limited to industrial projects, they are now referred to as "private activity bonds," or "PABs." A PAB is issued by a local government, an industrial development board or an economic development authority, under state law, to finance capital improvements for private businesses. The business for which the PAB is issued is solely responsible for repaying the principal and interest on the bond. NO PUBLIC FUNDS OR CREDIT MAY BE USED TO REPAY THIS TYPE OF BOND.

Who issues Private Activity Bonds for private businesses?

In Louisiana, statewide issuers of PABs include the Louisiana Public Facilities Authority (LPFA) and the Louisiana Community Development Authority (LCDA). Also, local industrial development boards ("IDBs"), economic development districts and port commissions can issue PABs for other purposes within their jurisdiction. These kinds of issuers are referred to as "conduit issuers" since they function solely as a "conduit" to assist businesses in financing capital improvements through the issuance of private activity bonds.

The business for which the PAB is issued is sometimes referred to as the "conduit borrower."

Although PABs are issued by conduit issuers, the conduit issuer itself has no responsibility for the repayment of the bonds. In fact, many conduit issuers have no assets whatsoever. It is conduit borrower, *i.e.* the company that is building the new facility, that is solely responsible for the repayment of the bonds.

Even when PABs are issued by a city or parish government, the assets (taxes, property, revenues, etc.) of the public body can not be used to repay the bond. The bond is payable SOLELY from money that is repaid by the conduit borrower.

Do Private Activity Bonds feature any kind of government funding, or any public guarantee or grant?

PABs DO NOT include any governmental guarantee or grant. The bonds are payable strictly from moneys provided by the company for which the bonds are issued, and backed by collateral that is put up by the company.

Furthermore, conduit issuers of PABs do not act as lenders and do not purchase their own bonds. The conduit borrower, *i.e.*, the private beneficiary of the financing, must arrange for a bank or other investor to purchase the bonds for their project, and must negotiate the terms of the financing.

If there is no government guarantee or grant, then why would a business be interested in financing a project using Private Activity Bonds?

If all of the other requirements can be met, interest on some kinds of Private Activity Bonds is exempt from federal income taxes, although generally this interest WILL be subject to the federal alternative minimum tax. Like other kinds of tax-exempt bonds, PABs will have a lower rate of interest than a conventional (*i.e.* taxable) loan. So, instead of borrowing money for your business at a conventional (*i.e.* taxable) rate of interest, the interest rates on tax-exempt PABs could be two to five percent lower, depending on the creditworthiness of the borrower and the structure of the bond.

Who would invest in or purchase a Private Activity Bond?

A PAB is not like a "traditional" municipal bond, which is payable from governmental revenues like property taxes, sales taxes or utility revenues. Generally, PABs are unsuitable for investment by individuals, and are sold strictly to banks and other institutional investors.

To put it more plainly, PAB financing is essentially corporate financing rather than municipal financing. The conduit borrower and the bond purchaser negotiate the terms of the bond, and the borrower furnishes whatever collateral (mortgages, assignments of rents or revenues, personal guaranties, etc.) that they would normally furnish to their lender. Instead of receiving a promissory note from the borrower, the lender purchases a PAB from the conduit issuer, which then loans the bond proceeds to the conduit borrower to finance the improvements. The borrower enters into an agreement whereby it is obligated to make payments to the conduit issuer that match the principal and interest payments due on the bonds. Those payments flow through a bond trustee directly to the bondholder.

Purchasers of PABs are looking for the same benefits as any lender. By virtue of the interest on the PAB being exempt from federal income tax and the federal alternative minimum tax, the lender/purchaser usually benefits by getting a better "after-tax" return than they would with a normal conventional loan.

This is the sole reason that a business would consider using <u>tax-exempt</u> PABs instead of conventional financing: the lower interest rate.

What kinds of property can be financed with tax-exempt Private Activity Bonds?

The purposes for which tax-exempt PABs may be issued are limited by federal Law (Internal Revenue Code of 1986, as amended) and include the following:

(a) Manufacturing facilities (with a $10 million size limitation and other limits on capital expenditures made in the same jurisdiction as the bond-financed project);

(b) Facilities owned & operated by 501(c)(3) entities;

(c) Qualified multi-family residential rental projects, *i.e.* apartment buildings or complexes where a portion of the units must be set aside for low/moderate income tenants, EITHER 20% or more of the units for individuals whose income is less than 50% of area median gross income OR 40% or more of the units for individuals whose income is less than 60% of area median gross income.

(d) Other "exempt activity" projects such as airports, dock & wharf facilities, solid waste disposal facilities (there are other categories, but these are the most common ones)

Exceptions: The IRS Code prohibits the use of tax-exempt bonds, for the following: any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises

Can existing property be financed or refinanced with Private Activity Bonds?

An existing building (and its fixtures) can be purchased with the proceeds of tax-exempt bonds as long as the property is being purchased from an unrelated party and the borrower makes "rehabilitation expenditures" equal to at least 15% of the acquisition cost of the building and its fixtures. For structures (or equipment) other than a building, the rehabilitation expenditures must equal at least 100% of the acquisition cost.

Do Private Activity Bonds have to be secured by a mortgage or other collateral?

The security for PABs depends on who is purchasing the bonds. There is no federal or state law that requires PABs to be secured by a mortgage, guaranties, assignments or other security or collateral. It is possible, but would be unusual, for PABs to be a non-recourse issue unless the company is a very large organization with its own investment-grade credit rating.

Generally, however, there is at least a mortgage on the property that is being financed, guaranties of the owners or principals of the company, and sometimes an assignment of revenues or leases.

If the PABs are backed by a letter of credit, the collateral may be pledged to the letter of credit provider rather than to the bondholders.

Are there any size limitations on the amount of a Private Activity Bonds?

Bonds for multi-family residential rental projects and dock & wharf facilities may be issued in any amount.

Under current law PABs for manufacturing facilities are limited in size - to no more than $10 million.

However, the complexity inherent in issuing tax-exempt bonds will make tax-exempt PABs inefficient, generally speaking, for projects that are significantly less than $1 million. For projects between $1 million and $5 million, PABs Bonds will work best if the company can arrange private financing through a bank or other kind of private placement. For projects in excess of $5 million, PABs are almost always more efficient than conventional financing, since the issue is large enough to support the costs of a more complex structure and limited offering.

What steps are involved in obtaining Private Activity Bond financing?

The steps involved in obtaining tax-exempt PAB financing depend to some extent on which kind of conduit issuer is being used. While the steps may vary, there are some elements in common. Assuming a private bank placement, some or all of the following steps would need to be taken (the exact order may vary) for financings done through the an Industrial Development Board:

- Application submitted to the Conduit Issuer;
- Preliminary approval of the Conduit Issuer;
- Application for private activity bond allocation/designation from State is filed;
- Publication of a Notice of Public Hearing;

- Public hearing is held by the Conduit Issuer;
- Approval of local official (usually the Mayor or Parish President) or Attorney General.
- Preparation of Financing Documents based on term sheet furnished by lender;
- Final approval of the Conduit Issuer;
- Publication of final approval resolution (starting a 30-day protest period);
- Approval of the State Bond Commission; and
- Bond are delivered to the purchaser.

These steps would take anywhere from 3 to 6 months if the Company has lined up financing (*i.e.* a purchaser for the bonds). Depending on the complexity of the issue, there may be more steps, and the process can take longer.

Construction is already underway; is it too late to use bond-financing?

In order to use tax-exempt bonds, it is necessary for the conduit issuer to adopt a preliminary approval of the issue no more than 60 days after project expenditures begin. Most expenditures made prior to the 60-day cutoff cannot be financed or refinanced with proceeds of tax-exempt bonds. Therefore, it is important, if bond financing is being considered, to secure a preliminary approval from the conduit issuer at the earliest possible date.

What are the costs of Private Activity Bonds?

As you might expect, there are significant additional costs to issue a PAB as compared to conventional financing. A relatively simple private bank placement might involve "costs of issuance" of up to 2% of the principal amount of the loan. For larger issues ($5 million or more), the costs are in the range of 1% to 1.5% of the principal amount of the bonds. These additional costs can include:

- State Bond Commission fees;
- Issuer application & closing fees;
- Costs of publication of notices and resolutions;
- Bond Counsel fees and expenses;
- Bond Trustee fees and expenses;
- Underwriter/Placement Agent fees;
- Letter of Credit or other credit enhancement fees; and
- Rating Agency fees (for larger issues)

Generally speaking, the conduit borrower will recoup the higher costs of issuance from the interest savings that result from the lower tax-exempt interest rate on the bond.

Some bond issues have a "PILOT" feature; what is that?

The term "PILOT" stands for "payment in lieu of taxes." For conduit issuers that are political subdivisions or industrial development boards, it is possible to use a "sale-leaseback" arrangement whereby the conduit issuer actually has title to the financed project during the term of the bonds. The conduit borrower is still treated as the owner for purposes of depreciation, insurance, maintenance and operation, however since the conduit issuer is a governmental unit, its property is exempt from property taxes. So, while this kind of bond issue is outstanding, the bond-financed project is not subject to property taxes.

For projects that may already be eligible for the 10-Year Industrial Tax Exemption program offered by the State of Louisiana, a PILOT may be used to extend the benefit of a tax abatement beyond the initial ten years.

So, how does a PILOT benefit the Conduit Borrower?

When a PILOT structure is utilized, the conduit borrower negotiates a "payment in lieu of taxes" to the conduit issuer, which is less than the amount of property taxes that they would pay if the property was on the tax rolls. This reduced tax payment, a form of abatement, is the economic incentive. Although PILOTs are generally used in conjunction with taxable bonds, they can sometimes be used as an additional incentive for tax-exempt bonds.

In most cases, a PILOT will only be offered upon a showing that the benefits to the community in the form of additional employment, sales tax revenues, etc., will offset the fact that the full amount of property taxes are not being paid on the new property.

What are some examples of PILOT use in recent years?

Over the last few years, PILOTs have been used all over Louisiana in several different ways, including:

- To provide a property tax abatement/reduction purely as an incentive to attract/retain business.
- Integrated with the State's 8-year industrial tax exemption program to provide a longer period of tax reduction/abatement.
- Used <u>in lieu of</u> the State's 8-year ITE program to provide a longer incentive period but with structured income to local taxing bodies during the first 8 years when they would otherwise be receiving no additional tax revenues from the project under the ITE program.
- To redirect local tax revenues for the purpose of financing necessary infrastructure and/or site improvements needed to attract/retain business that would otherwise be unaffordable for local government units.
- As a tool for creating a public/private partnership through a cooperative endeavor agreement whereby PILOT payments are redirected or leveraged into other economic development projects or for financing necessary infrastructure and/or site improvements.
- As a vehicle for project developers to obtain certainty regarding the amount of future tax payments, which may be necessary in order to secure financing.
- As a way for local governments to also secure assurances about minimum jobs, payroll and/or preference for local or minority/disadvantaged businesses.

I may be interested in Private Activity Bond financing for my business; whom should I contact to get more information?

Contact your local Chamber of Commerce or Economic Development Foundation. Further information may also be obtained from the authors of this handout.