Lease/Purchase Program Guide

For State Agencies

Office of the State Treasurer

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The Lease/Purchase Program of the Office of the State Treasurer provides convenient, cost-effective financing for state agencies, colleges and universities for real estate projects and equipment purchases.

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Lease/Purchase Program Guide

Table of Contents

I. Overview

The Lease/Purchase Program provides convenient, low-cost financing for state agencies.

The Lease/Purchase Program provides state agencies with an alternative way to finance essential real estate and equipment over a multi-year period. The program is structured to ensure state agencies benefit from economies of scale and the State's low tax-exempt financing rates.

Pooling agency financings and standardized legal documents help keep borrowing costs low.

Legal and administrative costs for each agency are minimized through the use of standardized documentation. All necessary tax and legal analysis and opinions are provided by counsel through the Office of the State Treasurer (OST). 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. OST also monitors refunding opportunities.

The Office of the State Treasurer manages the administration and regulatory compliance of the program.

To ensure compliance with tax and legal requirements, OST periodically requests information to monitor the spenddown of proceeds and the use of the facilities that have been financed.

Authorization

The form of financing contracts must be approved by the State Finance Committee.

The State is authorized by Chapter 39.94 RCW to enter into financing contracts for state and local 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. Financing contracts do not include operating leases.

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

The State Legislature must approve proposed real estate financing contracts.

State law requires prior legislative approval of real estate financing contracts. Real estate projects and contracts are typically authorized in the Capital Budget. Most equipment financings do not require explicit legislative authorization, although OST policy requires prior legislative approval for financing major acquisitions of certain personal property such as information systems.

Standardized documents allow agency financing contracts to be pooled and sold to investors as Certificates of Participation (COPs).

The Lease/Purchase Program uses standardized documentation which allows the contracts to be consolidated or "pooled" periodically and sold to investors as Certificates of Participation (COPs). COPs offer investors ownership interests or participation in the lease payments made by state agencies. By pooling financing requests in the name of the State of Washington, OST provides individual state agencies access to economies of scale and the lower tax-exempt interest rates available to the State.

Agencies pledge their budget appropriations to lease payments.

When an agency enters into a lease under this program, it pledges its budget appropriation for payment of the lease. This is true regardless of whether it may anticipate making payments from other revenues.

Program Parameters

Funds must be spent on capital expenditures.

Proceeds of financing contracts must be spent on capital expenditures, in accordance with state accounting guidelines and under federal tax laws applicable to tax-exempt obligations. All costs to be reimbursed through the financing must have been determined by OFM and the agency to be capital expenditures that will be properly chargeable to the capital account of the financed property. (See Appendix 1: Tax Exempt Financing Restrictions).

Assets to be financed must serve an essential purpose.

Funds must be spent on assets serving an essential public purpose. Agencies must represent in their financing contracts that the property to be financed is essential for carrying out its functions and responsibilities.

Certain upfront costs such as design, delivery and setup, and some training do qualify for financing. Expenditures for sales and use tax 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. Additionally, proceeds of financing contracts cannot be used to pay operating expenses. Maintenance and insurance are operating expenses and cannot be financed.

Financing contracts may not be used to provide funds for grants or loans.

COP financings are for tangible assets that could be relinquished if the Legislature chooses not to appropriate funds for lease payments. Also, COP borrowings are "secured" financings, i.e., investors have rights to the underlying property in certain situations when investors do not receive payment on a timely basis. 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.

Finance terms must be at least one year and not extend beyond the useful life of the property.

It is always possible to finance for a term that is shorter than the useful life.

The minimum threshold for borrowings is $10,000.

Financing contracts may not be used to provide funds for grants or loans.

State agencies should acquire equipment in accordance with State law and internal agency procurement policies. Construction projects are subject to public works requirements.

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, and online here. For unique or used equipment, OST staff can provide assistance. OST practice is to limit the maximum maturity to 20 years in order to efficiently pool multiple lease/purchase transactions in each COP.

For administrative efficiency, OST has established a minimum borrowing threshold of $10,000 for each lease. Consider combining smaller requests for equipment of the same expected useful life or purchasing assets with available funds.

All property financed on a tax-exempt basis is subject to federal tax restrictions regarding private business use.

A real estate project needs to be ready to proceed before it is financed. The financing cannot be executed until the construction contract has been awarded or the acquisition completed. 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. Generally, proceeds must be spent within 18 months.

II. Financing Process for Equipment Purchases

1. Submit a Notice of Intent
2. Purchase, accept and install the equipment. Request a Certificate of Insurance.
3. Submit two sets of signed documents (original and one copy) before the COP cut-off date.
4. COP Sale

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1. Submit a Notice of Intent (available on the OST website)

Submit a Notice of Intent as soon as possible *after* selecting the equipment and deciding to finance its acquisition, and *before* taking delivery. To comply with IRS reimbursement requirements, expenditures made more than 60 days prior to the date of the Notice of Intent cannot be reimbursed.

Provide purchasing and accounting contacts on the Notice of Intent. The Purchasing contact should be able to provide information regarding equipment details and scheduling, and the Accounting contact is important for disbursements and lease payments. Some agencies delegate responsibility for lease/purchase transactions to one individual.

Briefly describe the type of equipment to be financed, such as vehicles or computers. More specific information is required later in the process.

Estimate the dollar value to be financed. Provide a high estimate as an amendment to the Notice of Intent is required for any revision that increases the amount to be financed. The minimum size for each financing is $10,000. Consider combining smaller requests for equipment of the same expected useful life.

Request a repayment term in years. Remember that the finance term may not exceed the useful life of the equipment. Agencies may request a shorter term. OST can provide estimates of payment schedules for alternative terms.

Estimate when the equipment will be delivered and installed.

Indicate which account your agency will charge when lease payments are made.

Sign the Notice of Intent. The Notice of Intent must be signed by the agency director or by an authorized representative. Note that submitting a Notice of Intent does not obligate the agency to use the Lease/Purchase Program.

OST will assign a lease number that will be referenced throughout the financing process and acknowledge acceptance of the financing application to the purchasing contact identified on the Notice of Intent.

If an agency subsequently decides NOT to finance the equipment, please notify the OST Lease/Purchase contact.

2. Purchase Equipment

Select the equipment to be purchased in accordance with agency procurement and approval regulations. For example, financing for computers or telecommunications equipment for amounts in excess of the agency's delegated authority may require approval from the Office of the Chief Information Officer. Similarly, energy conservation projects may require approval by the Energy Program in the Department of Enterprise Services.

Inspect the equipment and install it before submitting final financing documents. The COP pledges a security interest in all financed equipment. Agencies should list themselves as both legal and registered owners on titled assets.

Insure the equipment for both liability and property damage. Check with OFM's Office of Risk Management to determine if the equipment is covered by the self-insurance pool for liability or requires a commercial policy.

The equipment serves as collateral for financing and must be maintained in good working order. If equipment becomes unusable, the equipment must be repaired or replaced with equipment of equal value and useful life. If not, the agency must immediately prepay the lease.

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3. Submit Financing Documents

Two sets of financing documents (original and one copy) should be submitted after the equipment has been delivered and installed. OST reviews financing documents to confirm they are complete, signed and accurate. Financing documents include:

a. <u>Agency Financing Contract</u>

The Agency Financing Contract specifies the details of the agency's lease, establishes the contractual obligations of the agency and confirms the intent of the agency to make lease payments. It is signed by (1) the agency director or a designated representative and (2) the Deputy State Treasurer for Debt Management.

Definitions of the terms used in the Financing Contract are found in Appendix I to the Contract.

b. <u>Notice of Intent</u>

The agency should include a copy of the previously submitted Notice of Intent.

c. <u>Personal Property Certificate</u>

The Personal Property Certificate describes the equipment, the vendor(s), and the amount to be financed and specifies directions for disbursement of the financing proceeds.

Specific details regarding the property are necessary to describe the property as collateral. It is important to list all equipment related to the disbursement amount being requested. A spreadsheet can be attached if necessary.

Disbursement directions indicate if the funds received on the COP closing date are to be distributed by OST as a reimbursement to the agency or held until a later reimbursement request(s) is submitted.

Attach the following to the Personal Property Certificate:

i. Copies of Invoices — Copies of all invoices for the equipment listed on the Personal Property Certificate for which the agency is requesting reimbursement.

ii. Proof of Payment – Proof of payment for each invoice submitted can be in the form of a remittance advice or payment register from an official payment system, an expenditure activity report from Enterprise Reporting, or a cancelled warrant. Each vendor must receive payment before reimbursements are made.

iii. Certificate of Insurance – If the equipment is covered by the State's self-insurance pool, submit the written Certificate of Insurance from OFM's Office of Risk Management demonstrating liability and property damage insurance coverage and stating that insurance will be automatically renewed annually. If the equipment is not covered, you must submit evidence of a separate commercial insurance policy.

d. Certificate Designating Authorized Agency Representatives

This Certificate authorizes certain individuals to execute and deliver Financing Contracts for each agency. It must be signed by the agency director and notarized. Once an original Certificate is on file with OST, photocopies may be submitted for subsequent transactions.

4. COP Sale

Generally twice a year, OST "pools" agency requests for equipment and real estate financings. Interests in this consolidated pool of lease/purchase contracts are sold to investors as Certificates of Participation (COPs). The borrowing rates for each agency are set based on the interest rates resulting from the COP sale.

For each COP sale, OST has established a "cut-off" date by which documents must be received. Dates and deadlines for equipment financings are typically as follows:

	NOI & Credit Approval (Forms A-B) Cut-Off	All Documents (Forms C-L) Cut-Off	First Payment (Interest Only)
Late February	November 15	December 8	December 1, year of issue
Mid/Late August	May 15	June 20	December 1, year of issue

On the COP sale date, OST executes a competitive market sale which sets the borrowing costs for the financing. On the COP closing date (approximately two weeks following the sale date), proceeds are received and distributed to agencies in accordance with the agencies' disbursement directions. Typically funds are distributed to the agency as a reimbursement.

Additional Instructions for Energy Efficiency Equipment

As in all equipment financing contracts, the maximum term of energy equipment financing contracts is set by the expected useful life of the equipment as shown in the OFM (SAAM), Chapter 30.50, Capital Asset Class and Location Code List and Useful Life Schedules. The term may also be shortened for market efficiencies as lease/purchase contracts are pooled into COP transactions.

Occasionally, energy equipment acquisitions cannot be fully completed and installed by the cut-off date for each COP sale. In certain cases, the financing nonetheless may be able to proceed if additional documentation is provided by the cut-off date. This includes:

- A signed energy services contract with a guaranteed final price;
- A documented project timeline with a definitive completion date;
- Written proof that at least 30% of the total finance amount will have been spent by the COP closing date;
- A cover letter indicating the total finance amount, the requested reimbursement amount, and certification that the remaining balance will be spent within 18 months after the closing date; and
- A detailed list of equipment purchased to date.

At closing, the agency will be reimbursed for funds spent prior to the COP sale, for those expenses in which appropriate documentation was submitted by the cut-off date prior to closing. The remaining proceeds will be held temporarily by OST in the LGIP and disbursed as project expenditures are made and reimbursements are requested. Each request for disbursement must be supported with a Personal Property Certificate with a detailed list of equipment, copies of invoices with proof of payment.

Additional Instructions for IT Equipment

It is challenging to finance IT projects within the State's Lease/Purchase program. As noted above, COP financings are for tangible assets that could be relinquished if the Legislature were to choose not to appropriate funds for lease payments. In addition, agencies must be able to offer a security interest in the asset being acquired as the assets serve as collateral for investors.

Agencies considering lease/purchase financings for IT projects should contact OST early in the planning process and anticipate the following factors:

Legislative Approval: Legislative approval is required for state agency financing contracts used to finance major acquisitions of information systems.

Acquisition of Property: The financing must involve the acquisition of property and the awarded vendor contract must be signed prior to the issuance of the financing.

Capital Expenditures: All components of the project being financed must have been determined by OFM and the agency to be capital expenditures that will be properly chargeable to the capital account of the financed property. The cost of computer software, applicable licenses and hardware, as well as the cost of implementing imbedded software templates and modeling and design of such software may be capitalized. Certain expenditures for technical consulting costs may be capitalized depending on the nature of the work performed by the consultants. Technical consulting costs incurred for installation and modification of software necessary to make the software compatible and operable may be capitalized as part of the underlying cost of purchasing software, particularly if the consultants have contractual responsibility for making the software operational and compatible with the agency's needs. Costs of agency employees involved in the process may be capitalized until the system is operational. Agency employee training costs incurred after the system is operational cannot generally be capitalized.

Security Interest: Agencies are required – without exception - to receive from vendor(s) explicit permission to grant a security interest in information system property. System purchase or license documents must include explicit provisions that permit the state agency to grant the required security interest and permit assignment by the COP trustee to another user notwithstanding any other provisions in the system purchase or license documents to the contrary. OST is willing to provide sample language to address this requirement.

Standard Equipment: Evidence that the product being purchased is an "off the shelf" product with proven industry acceptance is useful in demonstrating the asset has value as collateral for the security. Evidence may include documented references of users with similar products and the functionality of those systems. If the product is not "off the shelf," evidence must be provided showing that the equipment and software are customarily used by like users for similar programs and purposes, and demonstrate a history of successful implementation by other users.

IT projects with Multiple Components: Because of the security and legal structure of COPs, each separately financed component of an IT project must be a discrete capital project, representing completed modules that would be fully functional and valuable even if the additional projects were not completed. Separate legislative authorization is necessary for each financing. In addition, the Legislature should be briefed on the outcome should future portions of the project not receive legislative authorization or if it is not financed (and therefore not implemented) for any reason. It is critical to inform the Legislature that there is no guarantee the full project will be completed, as problems with budget, timing and completion of projects in earlier phases may mean that future financing cannot proceed. IT projects with multiple components carry more non-appropriation risk (for investors) than usual due to the long rollout and multiple authorizations potentially spanning several biennia. The complete project timeline including the project description of each component along with the desired schedule of COP issuance should be provided to OST prior to any COP issuance.

Term: The term of each financing contract is limited by the expected useful life of the asset being financed. IRS rules also provide certain guidelines that may be used to determine the useful life of the property. For IT systems, the maximum financeable term is typically 7-12 years. The agency must provide supporting documentation demonstrating the useful life of the system.

Contract Review: Service contracts associated with acquisition of software should be made available to OST for review to confirm compliance with regulatory requirements, including any applicable federal tax requirements for tax-exempt financing.

III. Process for Financing Real Estate Projects

1. Legislative Authorization
2. Submit a Notice of Intent and Project Overview Form.
3. Preliminary review of proposed financing with OST and counsel.
4. Submit all agency documents noted on the Checklist before the cut-off date.
5. COP Sale

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1. Legislative Authorization

All financing contracts for real estate projects must be authorized by the Legislature, typically in the capital budget or in the transportation budget. Note that authorizations lapse at the end of the biennium. Accordingly, financing contracts must be completed and the financing closed by the last day of the biennium, otherwise reauthorization will be necessary.

Agencies pledge their appropriations to make their lease payments even if they intend to use another revenue stream for payments. Agencies should provide for lease payments in their operating budget.

Authorizations should request authorization for the amount needed for acquisition or construction costs. This figure need not include financing expenses.

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2. Submit a Notice of Intent and Project Overview Form

Submit the Notice of Intent and completed Project Overview forms when a project has been authorized and acquisition and/or construction is expected to occur within six months.

Agencies may not be reimbursed with COP proceeds for expenditures made more than 60 days before the Notice of Intent is submitted.

OST will assign a lease number that will be referenced throughout the financing process and acknowledge acceptance of the financing application to the purchasing contact identified on the Notice of Intent.

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3. Preliminary Review with the Finance Team

Real estate projects and complex acquisition projects often require a minimum of 90 days lead time before a financing can take place. Expect to consult with OST staff and the state's counsel at several points during the financing process.

The finance team (comprised of OST staff, certificate counsel and OST's financial advisor) will discuss the COP financing process in a preliminary review with agency representatives and seek information on several aspects of the project. Agency project leaders should be prepared to provide an overview of the project, including the estimated cost of acquisition and/or construction and timing. Any special budget and financial issues will also be discussed.

Following the meeting, OST staff will provide a summary of the discussion including a list of contacts and a checklist of information and documents required from responsible parties.

The finance team will then develop a schedule for the transaction, working toward a sale and closing date for the COPs. OST must be alerted if the project timeline changes. The financing cannot be executed until a construction contract has been awarded or the acquisition completed and closed. For new construction, OST requires agencies to have entered into a construction contract, design-build or general contractor/construction manager (GCCM) contract with a guaranteed maximum price prior to issuing a COP. For acquisitions, agencies must first acquire the building or land and obtain title to the property prior to issuing the COP. Generally, proceeds must be spent within 18 months.

Any ancillary legal agreements with outside parties related to the project must be reviewed by OST's certificate counsel prior to execution to ensure that requirements of the COP program have been met. This includes documents drafted by the agency's assistant attorney general. Ancillary legal agreements include purchase and sale agreements, construction contracts, property management or other service agreements and any lease agreements between the agency and current or prospective tenants.

Sub-leases or management contracts with private businesses, non-profit organizations or agencies of the federal government may impact the tax status of the borrowing. Agencies should discuss their plans with OST prior to the execution of those sub-leases or management contracts to avoid unintended tax consequences.

Additional legal review is necessary for projects located on land that will not be owned by the State of Washington or a state agency. Lease/purchase financing within the COP program may not be possible unless specific structural and legal criteria are met.

The selection of contractors, construction plans and purchase negotiations are the responsibility of the agency and DES. Construction projects financed through the COP Program must be built as public works projects.

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4. Submit All Required Documentation

OST's finance team takes responsibility for completing the financing transaction with the issuance of the COPs in coordination with the agency's acquisition and construction schedule. The agency is responsible for submitting the documentation specified below or other materials requested by the finance team. Some of the documentation will be provided by OST for execution by the agency. The agency is also responsible for informing OST of any material changes in the expected timing of the acquisition and/or construction.

Documentation required for a real estate lease purchase financing includes two primary lease documents which are prepared by OST and its certificate counsel. Other required documentation is shown in the Real Estate Financing Checklist (Appendix 2).

State Agency Financing Lease

The State Agency Financing Lease commits the agency to make lease payments to be able to use the specific land or facility being financed. Lease payments are made to a non-profit corporation appointed by the State Treasurer (currently the Washington Finance Officers Association, or WFOA) which then assigns its rights under the lease to the state's fiscal agent, currently US Bank.

Site Lease

The site lease – an agreement between the agency, OST and WFOA – commits WFOA to lease the land and the facility for a period of time that extends 5 years beyond the financing lease. WFOA prepays its lease commitments with the proceeds received with the issuance of the COP. WFOA assigns its rights to the land and facility to the state's fiscal agent.

The site lease effectively provides a type of back-up to the financing lease. Should the agency fail to make lease payments under the financing lease, the site lease allows the fiscal agent to assume control of the property on behalf of investors. The trustee may determine that it is in the best interests of investors to rent the facility to another entity to repay investors. In all cases, however, the property reverts to the state agency at the end of the term of the site lease. If the agency makes its lease payments on a timely basis, the site lease terminates at the end of the financing term.

5. COP Sale

As noted above in the section on equipment financings, OST periodically consolidates or "pools" several lease/purchase financings and sells interests in the portfolio to investors in the form of COPs. Real estate financings may be pooled with equipment financings. This sale of COP securities sets the borrowing rates for each agency lease/purchase financing.

To efficiently consolidate the financings, OST establishes "cut-off" dates by which all documents must be received. Dates and deadlines for real estate projects are typically as follows:

	NOI & Credit Approval (Forms A-B) Cut-Off	All Documents (Forms C-L) Cut-Off	First Payment (Interest Only)
Late February	November 1	December 4	December 1, year of issue
Mid/Late August	May 1	June 1	December 1, year of issue

On the COP sale date, OST executes a competitive market sale which sets the borrowing costs for the financing. On the COP closing date (approximately two weeks following the sale date), proceeds are received and distributed to agencies in accordance with the agencies' disbursement directions. Most funds are distributed to the agency as a reimbursement.

If the real estate project has not been completed, proceeds are temporarily held by OST and invested in the Local Government Investment Pool (LGIP). Subsequent disbursements are made following OST's receipt of a *Request for Release of Proceeds* form certifying that the project costs have been incurred, along with invoice(s) and proof of payment(s). Proceeds must be spent only on the project described in the Notice of Intent and in accordance with IRS spenddown rules.

IV. Disbursement Procedures

Fund Disbursement Procedures

On the COP closing date, the underwriter wires the sale proceeds to OST. As noted above, most of these proceeds are immediately released as reimbursements to agencies. However, there are occasions where an agency has not yet taken possession of equipment, or a project has not been completed. In these cases, the proceeds are deposited and held in the Local Government Investment Pool (LGIP) until the agency has received and paid for the goods or services and seeks reimbursement. Reimbursement requests can be submitted at the will of the agency; however, it is imperative that all proceeds be spent according to IRS spenddown rules.

Following is a more detailed description of the forms that must be submitted for either reimbursement on the COP closing date or for later reimbursement(s):

Request for Release of Proceeds (real estate only) – This form provides the essential information needed in order to begin the reimbursement process. It also provides certification that the goods or services have been received or project costs have been incurred.

Personal Property Certificate (equipment only) – This document serves as the collateral document for OST. It identifies the agency and the designated signer. It also describes the equipment, the vendor(s), the amount to be reimbursed, and directions for disbursement. It is important to list all equipment related to the reimbursement amount being requested. A spreadsheet can be noted and attached if necessary.

Copies of Invoices – Copies of all invoices for which the agency is requesting reimbursement. The invoice amounts must be equal to, or greater than the total requested amount on the request form.

Proof of Payment – Proof of payment(s) for each invoice submitted can be in the form of a remittance advice or payment register from an official payment system, an expenditure activity report from Enterprise Reporting, or a cancelled warrant. It is imperative that each vendor has received payment in advance of your reimbursement submittal.

On occasion, there might be labor charges that are associated with the work being performed on real estate projects and with certain special equipment financings. Because the lease/purchase program is intended to finance capital expenditures - not operating expenses - prior review and approval by OST is necessary. Contact our office for further information on the requirements.

V. Lease Payments

Lease Payments

OST provides payment schedules to the purchasing contact at each agency following the COP sale. Lease payments are due to OST semi-annually on June 1 and December 1.

OST will send a payment notice to each agency accounting contact by May 15 and November 15. The notice will provide an itemized list of payments due for all outstanding lease/purchase transactions and a summary of the total due.

Instructions for remitting payment can be found on the payment notices. If you have questions or concerns regarding your agencies' lease payment, contact OST prior to the payment due date.

Prepaying Lease/Purchase Financings

Most COPs are issued for relatively short maturities and cannot typically be restructured to take advantage of lower interest rates over the life of the financing.

Occasionally, agencies need to prepay lease/purchase financings for other reasons. In this case, the agency prepays both principal and interest due over the life of the financing. The funds are used to purchase a portfolio of U.S. Treasury securities to be held in an escrow account.

OST generally discourages using prepayments for budgetary reasons. Prepayments will only be arranged for exceptional circumstances. Agencies requesting prepayments must cover all associated costs of the transaction including escrow fees. A minimum of 30-days notice is required to complete a prepayment request. OST cannot schedule prepayments in the month of June.

OST will provide an initial estimate of escrow costs. <u>Once the decision to proceed with prepayment has been made, it is irrevocable</u>. OST will commit to the purchase of the escrow securities and advise the agency of the amount due. Funds must be remitted as scheduled.

VI. Regulatory Post-Issuance Compliance

OST is responsible for monitoring overall compliance with all Internal Revenue Service (IRS) regulations governing tax-exempt finance. Also, each agency is responsible for monitoring its own compliance with these rules with respect to its project. If one lease in a pooled COP financing fails to meet these regulations, the tax exempt status of the entire pooled transaction may be compromised.

Disbursement of COP Proceeds

Disbursement requests will be reviewed in detail to confirm that proceeds are used only for qualified capital expenditures and that requests are supported by invoices and the appropriate proof of payment.

Proceeds must be spent in accordance with IRS spenddown rules, typically within 18 months, with at least 15 percent of the total in 6 months and at least 60 percent in 12 months. Monthly statements from OST will show the minimum spenddown requirements for each lease. OST will contact agencies to monitor the expected spenddown. OST will also confirm that reimbursements are requested for expenditures made no more than 60 days prior to the date of the Notice of Intent.

If spenddown requirements are not met, the agency will be responsible for the cost of any required arbitrage calculations and/or payments to the IRS.

Private Activity

COPs are almost exclusively issued as tax-exempt securities, which means their interest is excluded from gross income for the investor. If it is determined that a security no longer qualifies for tax-exemption, the interest becomes taxable for the COP investor, negatively impacting the value of the COPs.

COPs may be treated as "private activity" bonds and lose their tax-exempt status if they meet the IRS "private business use test" AND the "private payment test".

> *Private Business Use Test* – Private business use is established if a certain percentage – usually above 10 percent - of the proceeds of the COP issue is used for a private company, a non-profit corporation by or any agency of the federal government. Private business use does not include "general public use" such as private drivers on state highways. To avoid unintended tax consequences, agencies considering rental agreements or management contracts with private entities should discuss their plans with OST prior to the execution of contracts.

> *Private Payment Test* – This test is met if debt service on more than 10 percent of the COP issue is secured by (or could be sourced from) private payments or security. This may be a concern if COP-financed facilities are rented to a private company, a non-profit corporation or a federal government agency. The rent-free use of a state facility by one of these entities would not meet the test.

The obligation to monitor private activity continues for the life of the financing, i.e. until the COP has been fully repaid. COPs that may have originally qualified as tax-exempt can become taxable if there is a "change in use" of the financed facility or equipment which includes private use and private payments. For example, if an agency finances the construction of a building with a COP and then later sells the building before the COP has been paid off, the COP may meet both the private business use test and the private payment test. Remedial actions to correct a change in use are sometimes available, but these options are not guaranteed. It is critical that the agencies notify OST as private business use arrangements such as new rental agreements, management contracts or property sales are being considered

Excerpted from: "2017-27 Capital Budget Instructions"
(http://www.ofm.wa.gov/budget/instructions/capinst/17-27capinstr/default.asp)

Chapter 4: Financing Guidelines

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.

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 notassociated 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 and 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, 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.

Real Estate Financing Checklist

REQUIRED DOCUMENTS	ACQUISITION	RENOVATION	CONSTRUCTION
Notice of Intent & Project Overview	✔	✔	✔
Legal description of land	✔	✔	✔
Phase 1 environmental report	✔	✔	✔
Phase 2 environmental report, if required	✔	✔	✔
Service contracts or management agreements	✔	✔	✔
State Agency Financing Lease*	✔	✔	✔
Site Lease*	✔	✔	✔
Acquisition Project			
Title report and title insurance	✔		
Purchase and sale agreement	✔		
Affidavit regarding nationality of seller (FIRTPA)	✔		
Copies of any building warranties or guarantees	✔		
Construction Project			
Construction schedule		✔	✔
Bid documents		✔	✔
Executed Construction Contract		✔	✔
Payment and performance bonds		✔	✔
Site lease if land is leased from third party		✔	✔
If personal property is included in the project:			
Schedule of personal property	✔	✔	✔
UCC search	✔	✔	✔
Equipment leases, if applicable	✔	✔	✔
Use tax affidavit, if applicable	✔	✔	✔
For properties with non-state agency tenants			
Percentage of space occupied by non-state agencies	✔	✔	✔
Copy of proposed leases for non-state agencies	✔	✔	✔
For facilities with continuing tenants:			
Copies of leases	✔	✔	
Assignment of leases to state agency	✔	✔	
Estoppels from tenants	✔	✔	
Security deposits and prepaid rents	✔	✔	

**Indicates document provided by OST to agency for completion/execution.*