

STATE FINANCE COMMITTEE

Guidelines for Use of Financing Contracts To Finance State Agency Projects Under Chapter 39.94 RCW

This provides basic legal, federal tax and policy guidelines for determining if state agency projects appropriately can be undertaken with financing contracts under RCW 39.94. These guidelines are provided to help keep the state's use of financing contracts aligned with the judicial history and underpinnings of RCW 39.94. While these guidelines mainly refer to certificates of participation ("COPs"), separate, more detailed, guidance is provided for the unique conditions related to 63-20 financings. In all cases, careful consideration must be given not only to the state's ability to finance each project, but also to the cumulative effect of those financings on the state's overall ability to afford the debt, and to the effect on the state's credit ratings.

Judicial History

The use of financing contracts must be carefully restricted to those purposes and projects that substantially parallel the facts of *Department of Ecology v. State Finance Committee*, 116 Wn.2d 246 (1991) (the case in which the Washington Supreme Court upheld the issuance of COPs to finance the Ecology building in Lacey). Earlier, in *State ex rel. Washington State Building Financing Authority v. Yelle*, 47 Wn.2d 705 (1955), the Supreme Court had invalidated the use of a separate state entity to issue revenue bonds, outside the state debt limit, to finance buildings and higher education facilities that would then be "leased" to state agencies. At that time the Court said "*We cannot close our eyes to what is actually being attempted. When we strip the plan down to fundamentals, we find that it is not a leasing arrangement between landlord and tenant, but the installment purchase by the state of certain buildings and facilities with state moneys raised by taxation, far in excess of the constitutional limitation.*" 47 Wn.2d at 715.

Justice Robert Utter's lead opinion in the *Ecology* case, signed by two other justices, distinguished its facts from the *Building Financing Authority* case by stressing that an outside entity would own the leased facility, that the legislature had expressly reserved the right to discontinue making lease payments and to abandon the building, and that the risk of loss from any non-payment was clearly shifted to investors. Justice Utter emphasized that "debt only occurs when the State is *obligated* to make payments." 116 Wn.2d at 255.

A vigorous dissent signed by four justices in the *Ecology* case asserted that COPs were "merely an attempt to circumvent the debt limitation provisions" of the State Constitution 116 Wn.2d at 282. A concurring opinion by then-Chief Justice Richard Guy, signed by Justice Andersen and – significantly – by Justice Utter (the author of the lead opinion), stated that "it is important to emphasize that long-term lease agreements may not be used as a subterfuge to avoid the constitution's debt limitation" 116 Wn.2d at 261.

General Guidance

Because the *Ecology* case was so closely decided and contained multiple opinions, and especially because the lead opinion's author agreed that a COP program should "not be used as a subterfuge," the State Finance Committee concludes that it would not be prudent to expand the use of COPs beyond fact patterns that closely resemble the *Ecology* financing. This means COPs should be used solely to finance property, including improvements – and that the property should be of a nature that could be relinquished if the Legislature were to choose not to appropriate funds to make the relevant lease payments. Further, in view of the state's overall debt burden and in respect of the judicial history, care should be taken so that financing contracts are not used to avoid the constitution's debt limitation.

Specific Guidance

Prior Legislative Approval is Required for Acquisition of Real Property and Certain Personal Property. State law requires prior legislative approval of any state agency financing contract for the acquisition of real property (see RCW 39.94.040(4)). It is also a policy of the Office of State Treasurer to require prior legislative approval for state agency financing contracts used to finance major acquisitions of certain personal property such as information systems.

Financing Must Involve Acquisition of Property. RCW 39.94.030(1) provides in part that the state may enter into financing contracts for itself "for the use and acquisition for public purposes of real and personal property." RCW 39.94.020(2) also provides in part that a "financing contract" means any contract entered into by the state "which provides for the use and purchase of real or personal property by the state..." This means financing contracts may not be used to make grants or loans.

Proceeds Must Be Spent on Capital Property. For both state law accounting purposes and under federal tax rules applicable to tax-exempt obligations, the costs of property financed with COPs must be capital expenditures that can be properly charged to the capital account of the financed property. For example, the costs of purchasing, constructing and installing a property are capital expenditures. In addition, certain preliminary costs associated with a project, such as architectural, engineering, planning, permitting and legal costs, as well as direct payroll and payroll-related costs of state employees specifically allocated to project management, are capital expenditures. In contrast, proceeds of financing contracts, including COPs, may not pay current operating expenses of state agencies.

Average Maturity of COPs Must Not Exceed 120% of Average Reasonably Expected Economic Life of the Financed Property. IRS rules on tax-exempt financing provide certain direct and indirect limitations on the length of maturity of tax-exempt obligations that are issued to finance property. The IRS provides a safe harbor so that obligations issued to finance property are treated as meeting these requirements if the weighted average maturity of the obligations does not exceed 120% of the average reasonably expected economic life of the financed property, determined according to the cost of the financed property. IRS rules also provide certain guidelines that may be used to determine the useful life of property. For example, an office

building is deemed to have a useful life of 45 years. Because no financing contract under RCW 39.94 is allowed to exceed 30 years, this requirement is generally not an impediment to COP financing of real estate projects but may restrict financing for some personal property.

Timing of COP Issuance and Expenditure of COP Proceeds Must Satisfy Arbitrage Rules for Tax-Exempt Obligations. As in the ordinary tax-exempt financing of a capital project, the basic arbitrage rules for spending proceeds of tax-exempt COPs must be satisfied. Thus, COPs will be issued to finance property only if (a) the agency reasonably expects on the issue date that it will spend at least 85% of the sale proceeds on the capital project by the end of 3 years after the issue date, (b) the agency incurs within 6 months after the issue date a substantial binding obligation with a third party to spend at least 5% of the sale proceeds on the capital project, and (c) the agency proceeds with due diligence to spend the sale proceeds of the bonds and complete the capital project. This precludes issuing COPs earlier than necessary, and also precludes issuing COPs to finance expenditures over long periods of time, such as 4-5 years.

A project needs to be ready to proceed before it is financed so that it can meet these federal timing and expenditure constraints. As a result, it is the Office of State Treasurer's policy to require that a state agency has entered into a construction, design-build or general contractor / construction manager (GCCM) contract for the project prior to issuing a COP. This means the timing of a COP can be generally structured so that proceeds can be spent within either the 18-month or 24-month limits.

Financed Property Subject to Federal Tax Limits on Private Business Use. RCW 39.94 permits financing contracts be entered into for the use and acquisition of property only "for public purposes." And, to achieve the lowest borrowing costs, the state issues COPs on a tax-exempt basis. As a result, property financed with COPs is subject to federal tax limitations on the amount of private business use. In general, no more than 10% of the proceeds of any issue of COPs (or a corresponding portion of the property financed thereby) may be used for any private business use. Under federal tax rules, "private business use" means use by any person or entity other than the state and its departments and agencies or a local government unit of the state. Use by a private business corporation, nonprofit corporation, limited liability company, partnership, association, individual person engaged in a trade or business activity, or the federal government or any federal agency constitutes "private business use" for this purpose.