

Quick Takes: A Primer on PILOT Bonds

This issue of *Quick Takes* is a quick reference on PILOT Bonds, a “primer”, if you will. But probably the word “primer” itself needs some explanation first, since that’s not a term that’s heard much anymore. According to Merriam-Webster’s On-Line Dictionary, a primer is “a short informative piece of writing.” That’s what I want to do here- briefly provide much needed information to clarify this financing technique.

In the last issue of *Quick Takes*, we looked at TAD, or tax allocation district, financing. (TAD bonds are called TIF, or tax increment financing, in most states). I explained that when property taxes are “monetized”, TADs are just in the middle of the spectrum of choices.

At one end of the extreme, potentially all of the property taxes can be monetized when PILOT Bonds (repayable out of payments in lieu of taxes) are used.

TAD bonds are in the middle of the spectrum. This is because TAD bonds only monetize a “positive tax increment”, and only the positive tax increments of the property taxes of the jurisdictions that can, and do, participate.

At the other extreme, when special tax districts or Community Improvement Districts (“CIDs”) are used, only the additional tax or assessment is used.

Now, let’s take a closer look at these PILOT Bonds.

PILOT Bonds are revenue bonds, and the revenue that is the intended source for their repayment is “payments in lieu of taxes”, or “PILOT payments”. In order for these to be payments in lieu of taxes, normal property taxes have to be eliminated or reduced. This elimination or reduction is usually referred to informally as “abatement.”

However, in Georgia, the circumstances in which the term “abatement” can be used formally and accurately are very limited. Examples include state enterprise zones, and a handful of local Constitutional amendments that exempt specified investments from property taxation within certain parameters.

So, in order to create a situation where a private developer can have cash invested in its project instead of paying property taxes, how do we eliminate or reduce these taxes? We have to design the project along the lines of one scenario or another so that either-

Scenario 1. There is no tangible property interest that is in the hands of the developer to be taxed. Result – taxes are eliminated.

Scenario 2. The tangible property interest has less value for tax purposes in the hands of the developer. Result – taxes are reduced.

As an example of Scenario 1, I don’t own the 17th Street Bridge, so I don’t pay any taxes on it. If I were to receive a lease of the 17th Street Bridge, and the lease were designed so as not to convey to me a tangible property interest, then I still don’t pay taxes on the bridge. (If there is no property interest that is taxable in a lease, it is said to create a “usufruct”.)

As an example of Scenario 2, suppose I received a lease of the 17th Street Bridge and the lease conveyed to me a tangible property interest. Then the lease would be taxable, and I would have an “estate for years.” But what’s the value of that lease? It depends. If that lease were taxed at a level different from normal taxes on outright ownership, this would be the result of “lease valuation” by the Board of Tax Assessors.

It is this potential for leveraging what otherwise would be normal property tax payments that opens the door to PILOT Bonds. However, PILOT Bonds themselves are not new. All that it takes to have a PILOT Bond is someone willing to make payments in lieu of taxes in light of normal taxes being reduced or eliminated.

In fact, PILOT Bonds resemble South Carolina’s Special Source Revenue Bonds. In South Carolina, Special Source Revenue Bonds can be used to finance infrastructure or a prospect’s land and buildings in a multicounty park. Fees in Lieu of Taxes (FILOT) payments that the county receives are the sole source for repayment of the Special Source Revenue Bonds.

Of course, there needs to be a legal basis for the reduction or elimination in property taxes. In South Carolina, this is provided by statute.

In Georgia, for many years development authorities have provided property tax “abatement” to projects through a bond-financed sale-leaseback structure. The

“abatement” is conferred either on a usufruct or lease valuation basis (or, in the case of some “Constitutional” development authorities, because the leasehold under the bond lease is exempt from taxation). The legal title to the project that is held by a development authority is also potentially subject to taxation, but this is regulated by statute and the Constitution.

Many Georgia communities have adopted policies regarding the use of property tax “abatement” as an incentive for prospects. Viewed solely from a legal perspective, the question is whether or not property taxes have been legally reduced or eliminated in a transaction. If the answer is “yes” and the policy has been followed, then the transaction can be said to be “**on policy**”. If the answer is “yes” but the policy has not been followed, then the transaction can be said to be “**off policy**.” Of course, access to the “abatement” is through a bond-financed sale-leaseback structure, so the cooperation of a local development authority (or other appropriate bond issuer) is needed. In any event, being on policy or off policy does not change the governing law applicable to the transaction.

A lot is at stake with PILOT Bonds, especially when a transaction is “off policy.” A recent case, *Diversified Golf*, went to the Georgia Court of Appeals on the issue of taxability. In *Diversified Golf*, the Court of Appeals found that there was no taxable interest in a project where a city recreation authority “...entered into several agreements relative to [City property that had been transferred to it], including a fifty-year lease agreement with Diversified; a “Waste Water Effluent Spraying and Operating Agreement” with Diversified; three construction contracts in which Diversified agreed to build a golf course, clubhouse, wastewater distribution facility, and wastewater storage ponds; and an intergovernmental contract between the City and the authority.” If you would like to have a copy of the *Diversified Golf* case, please let me know.

A PILOT Bond transaction that is off policy will be more complex, and will go to particularly great lengths to eliminate any vestige of a taxable property interest. One implication of this is that, if land and buildings are being financed, a bond investor will need to get comfortable with having as security for its investment something other than normal real estate collateral.

In many PILOT Bond transactions, in order for the bonds to be marketable, the bond issuer’s parent local government has to enter into an intergovernmental agreement (“**IGA**”) with the bond issuer. In the IGA, the local governmental agrees, to the extent allowed by governing law and needed for the financing, to impose property taxes, on all of the taxable property within its jurisdiction. The IGA is then used as security for the PILOT Bonds.

Many PILOT Bonds are issued as federally taxable bonds. When the benefit of tax-exempt financing is needed, the Internal Revenue Code imposes further requirements.

The U.S. Treasury Department just released new final Regulations to modify and clarify, effective October 24, 2008, the standards for treating PILOT payments as “generally applicable taxes” for purposes of the “private payment or security test” of Section 141 of the Internal Revenue Code. For tax-exempt PILOT Bonds, among other things, either (a) the PILOT payments must be an “eligible PILOT”, or (b) “private business use” of the property being financed must not exceed 10%.

PILOT Bonds have already been used in Georgia to finance, for example, infrastructure for an industrial park, hotels, and the renovation of a convention center. I expect the trend towards the use of PILOT Bonds only to intensify in Georgia if a Constitutional amendment affecting TADs does not pass this November. This Constitutional amendment would restore the option to a Board of Education for it to consent to include its educational millage increment as a source for the payment of redevelopment costs in a TAD.

Meanwhile, you can think of PILOT Bonds as representing a “**synthetic TAD**” or a “**backdoor TAD**.”

If you have any questions or comments on this technique for monetizing property tax “abatement”, please do not hesitate to let me know.

NOTE- This issue of *Quick Takes* preceded the 2009 PILOT Restriction Act and should be read in conjunction with it. The text of the Act follows:

O.C.G.A. § 36-80-16.1. PILOT Restriction Act; terms

(a) This Code section shall be known and may be cited as the “PILOT Restriction Act.”

(b) As used in this Code section, the term “payments in lieu of taxes” means payments made directly or indirectly:

(1) Primarily in consideration of the issuance of revenue bonds or other revenue obligations and the application by the issuer of such bonds or other obligations of the proceeds of such bonds or other obligations to finance all or a portion of the costs of acquiring, constructing, equipping, or installing a capital project; and

(2) In further consideration of the laws of the State of Georgia granting an exemption from ad valorem taxation for such capital project,

to or for the account of the issuer of revenue bonds or other revenue obligations or the public bodies whose consent would otherwise be required, in the case of the separate payments provided for under subsection (d) of this Code section. Payments in lieu of taxes shall be deemed to be payments in lieu of taxes for educational purposes in the same proportion that property taxes for educational purposes would bear to total property taxes on such capital project if the project were subject to ad valorem property taxation. The term “payments in lieu of taxes” shall not include payments made primarily in

consideration for the use or occupancy of property, including but not limited to lease payments or rent paid under a lease, regardless of whether or not the lessee or tenant holds an interest that is taxable for property tax purposes.

(c)(1) No local government authority, as defined in Code Section 36-80-16, shall be authorized to issue revenue bonds or other revenue obligations to finance, in whole or in part, any capital project if the terms governing such revenue bonds or other revenue obligations provide for such capital project to be used primarily by a nongovernmental user or users that have no taxable property interest in any portion of such capital project and provide for such revenue bonds or other revenue obligations to be repaid, in whole or in part, through payments in lieu of taxes made by a nongovernmental user or users, unless:

(A) Each of the local governments that have property tax levying authority in the area in which such capital project is located consents by ordinance or resolution to the use of payments in lieu of taxes for such purposes; and

(B) In the case of payments in lieu of taxes for educational purposes, a consent is obtained that covers the use for such purposes of such payments in accordance with subsection (d) of this Code section, except that the terms governing such revenue bonds or other revenue obligations may provide for one or more of the public bodies, whose consent would otherwise be required, instead to receive, in such capacity, separate payments in lieu of taxes at least equal to the property taxes that such public body or bodies would have received if the capital project were subject to ad valorem taxation or in such other amount or amounts as may be agreed to by such public body or bodies.

(2) No such revenue bonds or other revenue obligations may be so issued without compliance with the requirements of paragraph (1) of this subsection.

(d)(1) When a capital project is located within the boundaries of a municipality with an independent school system, a consent by the municipality under subparagraph (c)(1)(B) of this Code section shall cover the use of payments in lieu of taxes for educational purposes, provided that, if the board of education of the independent school system is empowered to set the ad valorem tax millage rate for educational purposes and the legislative body of the municipality does not have the authority to modify such rate set by the board of education, the requisite consent shall be that of the board of education of the independent school system rather than that of the legislative body of the municipality.

(2) For those municipalities which do not have an independent school system, a consent by the municipality under subparagraph (c)(1)(B) of this Code section shall cover the use of payments in lieu of taxes for educational purposes if the county board of education or the local legislative body of the county, whichever is authorized to establish the ad valorem tax millage rate for educational purposes, consents to such coverage by resolution duly adopted by said board of education or local legislative body, as appropriate.

(3) The use of payments in lieu of taxes levied for county school district purposes shall be covered by a consent under subparagraph (c)(1)(B) of this Code section if the board of education of the county school district or the local legislative body of the county, whichever is authorized to establish the ad valorem tax millage rate for educational purposes, consents to such coverage by resolution duly adopted by said board of education or local legislative body, as appropriate.

(4) The use of payments in lieu of taxes levied for school district purposes within the boundaries of a consolidated government shall be covered by a consent under subparagraph (c)(1)(B) of this Code section if the board of education of such school district or the local legislative body of the consolidated government, whichever is authorized to establish the ad valorem tax millage rate for educational purposes within the school district, consents to such coverage by resolution duly adopted by said board of education or local legislative body, as appropriate.

(e) This Code section shall not affect revenue bonds or other revenue obligations which any local government authority has issued or which have been judicially validated on or before April 22, 2009. Each county board of tax assessors shall continue, notwithstanding this Code section, to exercise its powers and discharge its duties and is specifically authorized, without limitation, to use a method or methods of valuation for leases related to revenue bonds or other revenue obligations issued by a local government authority for a capital project or projects to be leased primarily to a nongovernmental user or users, based on assessments of the increasing interest of the nongovernmental user or users in the real or personal property, or both, over the term of the lease, or to use a simplified method or methods employing a specified percentage or specified percentages of such leasehold interests. Each local government authority that is authorized to issue revenue bonds or other revenue obligations secured by a taxable property interest, such as a taxable lease of a capital project, shall continue, notwithstanding this Code section, to exercise its powers and discharge its duties, including, in the case of development authorities, the development of trade, commerce, industry, and employment opportunities. Any local government or local government authority which directly or indirectly receives payments in lieu of taxes shall be authorized to use the same for any governmental or public purpose of such local government or local government authority.

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General note: This issue of *Quick Takes* is a quick-reference guide for economic

developers, community developers, participants in the real estate and financial industries, company executives and managers, and their advisors. The information in this issue is general in nature. Various points that could be important in a particular case have been condensed or omitted in the interest of readability. Specific professional advice should be obtained before this information is applied to any particular case. Any tax information or written tax advice contained herein (including any attachments) is not intended to be and cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer. (The foregoing legend has been affixed pursuant to U.S. Treasury Regulations governing tax practice.)

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