

Tax-Exempt Leasing

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The Workshop

OCTOBER 18–20, 2023

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The Workshop

OCTOBER 18–20, 2023

Agenda



State Law



Federal Securities Law



Federal Tax Law

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Commercial Financial Disclosure Laws

What are they?

- Federal Truth-in-Lending Act (“TILA”) and Regulation Z
 - Protects consumers from unethical lending
 - Promotes business with standardized and clear lending practices
 - Simplifies comparison of loans and credit with various lenders
 - Requires disclosure of finance charges, fees and costs
- CFDLs aim to extend consumer-like protections to businesses.
- A benefit or a burden to the market?

Commercial Financial Disclosure Laws

Enacted Legislation

- California Financial Code § 22800 *et seq.* (effective December 2022)
- Connecticut Public Act No. 23-201 (effective July 1, 2024)
- Florida House Bill 1353 (effective July 1, 2023)
- Georgia Senate Bill 90 (effective January 1, 2024)
- New York Ann. Financial Services Law § 801 *et seq.* (effective August 1, 2023)
- Utah Code Annotated § 7-27-201 *et seq.* (effective January 1, 2023)
- Va. Code Annotated § 6.2-2228 *et seq.* (effective July 1, 2022)

Proposed Legislation

- Maryland, Illinois, Kansas, Mississippi, Missouri, North Carolina, New Jersey, Texas

Commercial Financial Disclosure Laws

CFDL Requirements and Challenges Presented

- **Lack of uniformity**
 - Covered transactions
 - Principal amount (e.g., \$2.5M, \$500K, \$250K, etc.)
 - Borrower (e.g., enterprise, business, etc.)
 - Products (e.g., real estate financings, true leases, etc.)
 - Covered providers
 - Number of annual transactions (e.g., 1, 5, etc.)
 - Exemptions (e.g., depository institutions)
 - Uniform Laws Commission
- **Exacting requirements (e.g., font, column width, content, etc.)**
- **Ongoing legal challenges (CFPB 2023 and CA courts)**
- **New regulatory environment**

Commercial Financial Disclosure Laws

Why does it matter to us?

Depends on what role you play

(e.g., bond counsel, issuer counsel, bank/lender counsel)

- Civil and possible criminal penalties
 - Up to \$10,000 per violation and/or one-year jail time (CA)
- Other civil remedies (CA, CT and NY) may include restitution or disgorgement
- Is the transaction subject to CFDL compliance?
- Does non-compliance render a covered transaction void / unenforceable?
- Is CFDL compliance covered by validity opinion? Should it be?
- Is provider in compliance with applicable CFDL at time of financing?
- Responsibilities of a broker / placement agent?
- Regulatory oversight (i.e., registration regime, examination and enforcement)

Federal Securities Laws

Definition of Security

Section 2(a)(1) of the Securities Act of 1933 (“1933 Act”) defines a “security” as:

Any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a security, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

The definition of a “security” contained in Section 3(a)(10) of the Securities Exchange Act of 1934 Act (the “1934 Act”) is virtually identical to that in 1933 Act except that the 1934 Act definition does not contain the terms “evidence of indebtedness” or “guarantee” and expressly excludes short-term notes and other debt instruments.

In general, the United States Supreme Court has construed the definitions of “security” in the 1933 Act and the 1934 Act as functionally equivalent.

Federal Securities Laws

U.S. Supreme Court has attempted to clarify the definition of “security”.

SEC v. W. J. Howey Co., 328 U.S. 293 (1946)

- An investment contract involves (i) an investment of money, (ii) in a common enterprise, with (iii) the expectation of profit from the efforts of others.

Reves v. Ernst & Young, 494 U.S. 56 (1990)

- There is a presumption that a note is a security, unless the note bears a strong “family resemblance to” certain types of notes that have been previously determined not to be securities, based on the following factors:
 - (i) the motivations that would prompt a reasonable seller and buyer to enter into the transaction;
 - (ii) the “plan of distribution” of the instrument, including whether there is “common trading for speculation or investment”;
 - (iii) the reasonable expectations of the investing public; and
 - (iv) the availability of other regulatory schemes that reduce the risk of the instrument.

Federal Securities Laws

Are municipal leases securities?

- The Securities and Exchange Commission has been reluctant to take a position as to whether a municipal lease financing is a “security” as defined in the 1933 Act or the 1934 Act, as interpreted by courts.
 - “Leases” are not expressly included in the statutory definitions.
 - Municipal leases do not resemble investment contracts under *Howey*.
 - Municipal leases do not typically include a note that requires analysis under the *Reves* family resemblance test, and are easily recognized as commercial loans rather than securities.

SEC No-Action Letters

- Practitioners rely on a series of SEC no-action letters directly related to municipal lease financing structures and generally conclude that based on such prior no-action positions of the SEC, a whole municipal lease should not be considered a security.
- **WARNING:** This is not to say that a more detailed securities law analysis is not required from time-to-time, based on all the facts and circumstances, and it should not be assumed that every municipal lease financing is not a security.

Federal Securities Laws

***Itel Corporation*, SEC Division of Market Regulation Letter to Office of the Comptroller of the Currency, Investment Securities Division (Sept. 1, 1981)**

- SEC found that fractionalized participation interests in tax-exempt lease-purchase or installment sale financings were “municipal securities.”

SEC No-Action Letters (primarily regarding registration of broker-dealers)

- *Walter E. Heller & Co.*, Securities and Exchange Commission (Oct. 25, 1982)
- *Sanwa Business Credit Corp.*, Securities and Exchange Commission, (May 5, 1985)
- *James O. Hiltenbrand & Associates, Inc.*, SEC No-Action Letter (May 12, 1985)
- *Continental Heritage Financial Corporation*, SEC No-Action Letter (Sept. 10, 1987)

Federal Securities Laws

Reasonable Conclusions

- A non-fractionalized municipal lease financing, in which a single vendor or investor acquires all of the stream of lease payments (whether represented by a single certificate of participation or by the lease-purchase agreement itself) should not be deemed to constitute a “security” within the meaning of the 1933 Act, the 1934 Act, or under *Howey* or *Reves*.
- Any fractionalized municipal lease financing, including certificates of participation, are considered “securities” for purposes of the 1933 Act.

In practice

- Issuer often doesn’t care, or at least cares less, about securities law treatment of the lease than the other parties (e.g., financial advisor, placement agent, lender, etc.).
- The determination of whether a lease is a security will affect the applicability of MSRB requirements, Rule 15c2-12 requirements, etc.
- Because the issue has not been definitively determined, it is very common in single investor / purchaser transactions for the investor / purchaser to obtain an investor letter as a matter of caution.

Federal Tax Laws - Topics

- Debt Obligation (Capital Lease) or True Lease
- Exercise of Borrowing Power and Separately Stated Interest
- Qualified Stated Interest
- Registration Requirement and Leases
- Form 8038-G – “Financing Lease” or “Municipal Lease”
- Leases and Issue Price
- Escrow Fund Extensions

Capital Lease or True Lease?

Revenue Ruling 55-540

- IRS attempt to distinguish a capital lease from a true lease

Analyze the intent of the parties considering all facts and circumstances in existence at time of transaction

Factors indicative of intent to treat transaction as capital lease:

- A portion of periodic payments specifically applicable to an equity interest in asset;
- Lessee will acquire title upon the payment of a stated amount of rental payments;
- Total amount that lessee is required to pay for a relatively short period of use constitutes an inordinately large proportion of the total sum required to be paid to acquire title;

Capital Lease or True Lease? (Cont.)

Factors indicative of intent to treat transaction as capital lease:

Rental payments materially exceed the current fair rental value, which may indicate that the payments include an element other than compensation for the use of property;

Property may be acquired under a purchase option at a price which is nominal in relation to the value of the property at the time the option may be exercised, as determined at the time of entering into the original agreement, or which is a relatively small amount when compared to the total payments required; and

A portion of the periodic payments is specifically designated as interest or otherwise readily recognizable as the equivalent of interest.

Capital Lease or True Lease? (Cont.)

Have you considered how the following relate to the tax treatment of a lease?

- Annual appropriation and incentive to appropriate (economic compulsion)
- Designation of lease as UCC Article 2A Financing Lease (i.e., a true lease)
- Economic useful life of financed property in relation to term of lease
- The payment schedule (front loading payments, balloon payments, end of term options, etc.)
- Expected residual value of financed asset at end of lease term considered together with the payment schedule and end of term options
- Who holds title to the financed asset?
- Who retains tax attributes applicable to the financed assets?
 - Depreciation
 - Tax Credits

Borrowing Power and Stated Interest

Hypothetical:

City has an open account with Vendor to provide information technology (IT) equipment and software on an as needed basis. For convenience, payments for the IT equipment and software are due monthly in arrears. City fails to make timely payment on two different monthly payments. For the first late payment, Vendor charges City interest at 5% on the unpaid balance. For the second late payment, Vendor charges City interest at 5.50%. In both cases, Vendor treats the interest paid by City as tax-exempt interest.

Questions:

- Is there a written arrangement obligating City to make payments in exercise of City's borrowing power?
- Is there a written arrangement providing for interest at a stated rate on past due or deferred payments?

Borrowing Power and Stated Interest (Cont.)

Hypothetical

City signs a purchase order with Vendor followed by a lease agreement requiring monthly payments for certain information technology (IT) equipment and software. After the rental period begins, Vendor sends City a monthly rental invoice for the total payment amount.

Question:

Is there a written arrangement obligating City to pay interest at a stated rate on past due or unpaid balances?

Borrowing Power and Stated Interest (Cont.)

Hypothetical:

City enters into a lease-purchase agreement with Vendor for certain public works vehicles. Pursuant to the lease-purchase agreement, the Vendor provides City public works vehicles valued at \$1.5 million on the funding date and requires City to pay Vendor \$2 million on the 6th anniversary of the funding date.

Questions:

- Is there a written arrangement obligating City to pay interest at a stated rate on deferred or unpaid balances?
- Is the difference in value of vehicles on the funding date and amount City is required to pay in 6 years sufficient to evidence intent of agreed upon interest?

Qualified Stated Interest

Stated interest unconditionally payable at least annually at a single interest rate

- Fixed Rate Debt – A single fixed rate
 - Variable Rate Debt – A single qualified floating rate or objective rate
-

Some proposed lease transactions may contemplate a delayed first interest payment that causes interest to not be unconditionally payable at least annually

If all interest payments on the lease are not qualified stated interest payments, consider whether the debt obligation has original issue discount

If the debt obligation has original issue discount, consider:

- The impact on the timing of receipt of tax-exempt interest to the holder of the debt obligation
- Any impact to the calculation of the Stated Redemption Price at Maturity reported on the Form 8038-G

Registration Requirement

Leases like other obligations must satisfy the registration requirement for interest to be tax-exempt

Exceptions to Registration Requirement

- Not of a type offered to the public – based on whether similar obligations are in fact publicly offered or traded
 - Has a maturity of one year or less
-

Registered Form – Lease Obligation Considerations

- Perhaps lease is not a type offered to public
- Book Entry - records maintained by issuer or its agent keeping record as to entity entitled to both principal and interest on obligation

IRS Form 8038-G, Line 20

Part II Type of Issue (Enter the issue price.) See the instructions and attach schedule.					
11	Education			11	
12	Health and hospital			12	
13	Transportation			13	
14	Public safety			14	
15	Environment (including sewage bonds)			15	
16	Housing			16	
17	Utilities			17	
18	Other. Describe ►			18	
19a	If bonds are TANs or RANs, check only box 19a		► <input type="checkbox"/>		
b	If bonds are BANs, check only box 19b		► <input type="checkbox"/>		
20	If bonds are in the form of a lease or installment sale, check box		► <input type="checkbox"/>		
Part III Description of Bonds. Complete for the entire issue for which this form is being filed.					
	(a) Final maturity date	(b) Issue price	(c) Stated redemption price at maturity	(d) Weighted average maturity	(e) Yield
21		\$	\$	years	%

Instructions:

Line 20. Check this box if property other than cash is exchanged for the bond, for example, acquiring a police car, a fire truck, or telephone equipment through a series of monthly payments. (This type of bond is sometimes referred to as a “municipal lease.”) Also check this box if real property is directly acquired in exchange for a bond to make periodic payments of interest and principal. Do not check this box if the proceeds of the bond are received in the form of cash, even if the term “lease” is used in the title of the issue.

IRS Form 8038-G, Line 20

Is the term “Lease” in financing documents conclusive for checking the Line 20 box?

What consideration should be given to whether property other than cash is exchanged for the debt obligation?

- Governmental lessee takes asset from vendor in exchange for a stream of payments to vendor?
 - Governmental lessee receives cash from a lender that is subsequently used to acquire an asset from a vendor in exchange for a stream of payments?
-

Classifications of a “financing lease” as a “municipal lease”

- Does the Form 8038-G satisfy the “Good Faith Effort” standard of Treas. Reg. Section 1.149(e)-1(d)(1)?

IRS Form 8038-G, Line 20 (Cont.)

If Checking the Line 20 Box, *then*

- Stated Redemption Price at Maturity
 - Reported as “N/A”
- Weighted Average Maturity
 - Reported as the total number of years to maturity
- Yield
 - Reported as the effective interest rate being paid

Fewer calculations and perhaps easier to prepare Form 8038-G

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Leases and Issue Price

Participation Agreements - Consider impact on issue price and yield from

- Amounts paid to an “Originating Bank” from a “Participating Bank”
 - Par or premium
 - Arrangement in place on closing date?
 - Arrangement expected on closing date but not expected to occur for some period of time post-closing?
 - Participation arrangement not expected at closing but occurs a short period of time after closing?

Leases and Issue Price (Cont.)

Examples to consider whether premiums generated, or amounts paid are properly included in issue price and impact on use of proceeds and yield:

- Premium generated on lease to pay a lease broker
- Amounts paid on the issue date by an assignee of the lease originator to the lease originator
- Amounts paid some period after issue date by an assignee of the lease originator to the lease originator
- Bond counsel fee paid by lender

Leases and Issue Price (Cont.)

Principal Payment on Funding Date

- Lessee makes first principal payment on the funding date
 - Advance payment or down payment structure
- 3rd Party makes first principal payment on funding date
 - Vendor Incentive

Consider whether interest accrues on principal paid on funding date and whether the amount equal to the principal payment should be included in issue price

Escrow Fund Extensions

Facts:

Fire Department enters into a lease-purchase agreement to acquire a new fire truck and related firefighting apparatus and build a new fire house. Proceeds are deposited in an Escrow Fund (similar to a Project Fund) and expected to be spent over an 18-month period.

Hypothetical:

- At end of 18-months, fire truck has been delivered and firefighting apparatus have been acquired. Construction of the fire house has begun but due to unexpected supply chain disruptions and labor shortages, construction has not been completed.
- Unspent proceeds and investment earnings remain in the Escrow Fund. Lessor and Lessee want to extend the escrow period for an additional 6 months so the construction of the fire house may be finished.
- **Considerations? Concerns?**

Escrow Fund Extensions (Cont.)

Hypotheticals:

- After 2 years, the unexpected supply chain disruptions and labor shortages continue. Lessor and Lessee want to extend escrow for another year believing the problems will be resolved and construction of the fire house completed.
 - **Considerations? Concerns?**
- After 3 years, the labor shortages have resolved but unexpected supply chain disruptions have still not completely resolved. Lessor and Lessee are now firmly convinced that a resolution will occur within the next month or two permitting construction of the fire house to be completed.
 - **Considerations? Concerns?**

Questions

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