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TAX-EXEMPT LEASING

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Tax-Exempt Leasing Panel

This panel will cover intermediate and advanced topics in tax-exempt leasing, including topics in state law and federal securities and tax law. Commercial financial disclosure laws regulate some lessors and are now in effect in a handful of states, with new legislation introduced in several more states. Panelists will highlight the new laws, their impact on lease transactions and national efforts to create uniform disclosure laws. Panelists will also take a deep dive into the federal securities laws of lease financing and discuss the framework for analyzing leases, including a general discussion of the *Howey* and *Reves* tests, and a series of SEC no-action letters directly applicable to lease financing structures. Finally, the panel will cover fundamental, but advanced, tax topics routinely at issue in tax-exempt leasing transactions, such as distinguishing true leases from capital leases, properly completing the IRS Form 8038-G (Line 20), and dealing with escrow extensions and qualified stated interest / original issue discount.

I. INTRODUCTION

"Tax-exempt leasing" is a financing technique by which state and local governments acquire real and personal property. It may involve documents labeled variously as a "lease," a "municipal lease," a "lease-purchase agreement," an "installment purchase contract," an "installment payment contract," an "installment sale contract," a "purchase order," or simply a "contract," among others. The common elements of such agreements are (1) installment payments, characterized as rent or otherwise, that include a specified interest component, and are being made by a state or political subdivision (*i.e.*, a tax-exempt issuer for federal income tax purposes) lessee for the purpose of acquiring the use of and title to real or personal property and (2) in most jurisdictions, carefully drafted in order that the agreement does not constitute "debt" for state law purposes. In this outline, the term "lease," except when in quotes, is used as the generic term to include all the various types of agreements that make up this financing technique. Banks, leasing companies, insurance companies, other financial institutions and other private investors enter into tax-exempt leases as lessor (or purchase the lessor's interest from vendors or lease brokers) and often hold the leases for their own account during the entire term of the lease. Private parties and even other tax-exempt issuers may also act as lessors. Particularly for public market deals, leases are frequently used to provide a stream of revenues for lease revenue bond structures and leases are frequently certificated by the creation of lease certifications of participation ("COPs").

Part II of this outline examines the various forms of leasing products, from "true leases," which involve no acquisition of title by the lessee, to different types of financing leases, which pass ownership to the lessee, by describing the evolution of the lease as a financing technique and certain state law considerations relating to debt limitations.

Part III of this outline presents a general checklist of the various matters to be considered in rendering an opinion that a particular lease is duly authorized and a valid and binding obligation of a governmental lessee, and that the interest component of the payments due under the lease to be made by the governmental lessee is excluded from gross income for federal and/or state income tax purposes.

Part IV of this outline examines some special state law and tax law issues relating to COPs, which represent a fractionalized interest in a lease and the rights thereunder.

Part V of this outline raises certain other federal tax issues that may be encountered from time to time in lease financings.

Part VI of this outline provides a summary of new commercial financial disclosure laws which may be applicable to some tax-exempt leases.

This outline is not an exhaustive list of the issues that a lawyer must address in reviewing a lease or a COP transaction, but it is intended to be of assistance in identifying areas of analysis. Statements made in this outline do not necessarily reflect the views of any of the authors, nor especially of their respective law firms.

II. FORMS OF LEASES AND APPLICATION OF DEBT LIMITATIONS

A. Distinguishing a "True Lease" or Annual *Quid Pro Quo* from Lease-Purchase Agreements

True leases, sometimes called operating leases, are used by a majority of commercial and private sector entities to provide for the use of property by governmental and private lessees over a certain term without transferring the benefits and burdens of ownership. In true leases, there is no option to purchase the leased property, or the option to purchase is at fair market value at the exercise date. Although the legal analysis upholding the validity of leases varies from jurisdiction to jurisdiction (due primarily to variations in constitutional, statutory and charter provisions relating to the authority for such obligations and the applicable debt and budget limitations), true leases have often withstood challenges that they create unlawful indebtedness because the governmental lessee is only liable to pay rents during each fiscal period in an amount equal to the value of the use and possession of the leased property during that period. In this respect, the obligation of the governmental lessee is comparable to that incurred in, for example, hiring a police officer: for one day's work, one day's pay is owed. Because the true lease obligation does not create an immediate liability for all rents or other amounts scheduled to be paid during the term of the lease, but only a liability to the extent of the contemporaneous value received, it does not create unconstitutional or illegal "indebtedness" for state law purposes Unlike a financing lease, a true lease can be defended in most jurisdictions even in situations where the obligation to pay rent is not expressly conditioned on annual appropriations by the governmental unit, because under common law the lessee has no obligation to pay rent until it comes due under the terms of the lease and there is no right of acceleration of future rents upon default by the lessee. It is generally understood that a "true lease" cannot be structured as a tax-exempt obligation given the federal tax law requirement that the lessee build up equity in the leased property. *See* Rev. Rul. 55-540 and PLRs 8235056 and 8347058.

1. **Current Liability**. *City of Los Angeles v. Offner*, 19 Cal.2d 483 (Cal. 1948), involved a lease/lease-back arrangement under which the city leased a site to a contractor, the contractor built a facility on the site and leased both the site and the facility back to the city. In holding that the lease-back to the city and the installment payments therein did not violate the debt limit provision of the California Constitution, the Court stated: "if the lease or other agreement is entered into in good faith and creates no immediate indebtedness for the aggregate installments therein provided for but, on the contrary, confines liability to each installment as it falls due, and each year's payment is for the consideration actually furnished that year, no violence is done to the constitutional provision." *Id.* at 486. Additionally, contracts for the furnishing of property in the future may be upheld, but only where no liability or indebtedness came into existence until the consideration was actually furnished." *Id.*

2. **Fair Rental Value**. Although not always expressly stated in court decisions, the notion that the rents payable pursuant to a lease during each fiscal period represent fair consideration for the use and occupancy of the property during that period (*i.e.*, the concept of "fair rental value") is

implicit in the supporting state law legal analysis. *See, e.g., id.* at 487; *Dean v. Kuchel*, 218 P.2d 521, 523 (Cal. 1950); *accord City of San Diego v. Rider*, 47 Cal.App.4th 1473 (Cal. Ct. App. 1996). Thus, for example, "front-end loading" rental payments or fully-amortizing the cost of 30-year property over a 5-year lease term could raise questions concerning whether the governmental lessee is purchasing property on an installment basis, and thus has incurred debt, since such arrangements would arguably result in the payment of rent in each fiscal period greatly in excess of the value of the use and occupancy of the property during that period, with a resulting equity build-up.

Because the concept of fair rental value, where expressly recognized, is "judge-made" law, there are no precise standards for determining fair rental value.

The appraised value of leased property is not necessarily legally required to correlate to, or be higher than, the principal amount of the lease. The appraised value is one of many factors to support the lessee's determination that the rental payments payable by the lessee under the Lease do not exceed the fair rental value for the leased property that is subject to the lease. Other factors include the costs of acquisition, design, construction and financing of the leased property, replacement costs of the leased property, obligations of the lessee under the lease other than its rental payment obligation (such as use, operation and maintenance of the leased property for the public benefit), the essential or critical nature of the leased property for the lessee and its governmental operations, the uses and purposes that are served by the leased property and the benefits that will accrue to the lessee and the general public from the leased property.

B. Annual Appropriation Leases

Financing leases transfer ownership of the leased property to the lessee. An annual appropriation lease can be structured as a tax-exempt obligation. In many jurisdictions, financing leases have been upheld because the governmental unit has the option to terminate the lease at the end of each fiscal period, for example, by not appropriating the funds needed to pay the rent coming due in the next fiscal period. Therefore, like a true lease, the financing lease does not obligate public moneys in a future year and will usually be treated as a current liability, and therefore, will not constitute "indebtedness." The underlying state law concept is that a "debt" is something that binds the governmental unit to make payments in future budget years. Without a binding obligation that extends beyond the current fiscal period, there is no "debt" in the requisite sense. This concept has been the subject of a great deal of scrutiny as opponents of financing leases have attempted to have the leases declared to be "debt" and, therefore, invalid, in part, because applicable constitutional, statutory or charter procedures for the creation of "debt" were not followed.

1. **Legal Liability.** One such case, *State ex rel. Kane v. Goldschmidt*, 783 P.2d 988 (Or. 1989), involved a financing agreement whereby the state's interest in the financed property would automatically terminate at the end of each fiscal period unless the legislature appropriated the funds necessary

to pay the amounts scheduled to come due in the next fiscal period. Subject to payment of all scheduled amounts under the agreement, the state would receive title to the property at the end of the term. In sustaining the validity of this arrangement against a challenge that it constituted unconstitutional indebtedness, the Court analyzed the law as follows:

> The debates on the floor of the [constitutional] convention left little doubt as to the purpose of the debt limitation. The central concern was that future generations should not be saddled with the excessive undertakings of an imprudent legislature. The debt limitation was therefore adopted to protect against burdensome and excessive taxation. ... "Long-term obligations create a fixed charge against future revenues and can impair the flexibility of planning and the ability of future legislatures to avoid a tax increase." . . .
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> This court has looked at not less than two basic characteristics in deciding whether [the] action violates Article XI, section 7: (1) the fund from which payments on the obligation are made; and (2) the degree to which the public body is liable for repayment of the loan.
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> The state's promise of repayment is conditioned on the willingness of future legislative assemblies to appropriate the funds. The state does not promise that future legislatures will appropriate any funds. The lenders take the risk of non-payment. This aspect of the legislation does not create a fixed charge against future revenues, nor does it impair the flexibility of planning and the ability of future legislatures to avoid a tax increase. 308 Or. 573, 580-81, 586. (Citations omitted.)[1]

A similar case, *Business Computer Rentals v. State Treasurer*, 953 P.2d 13 (Nev. 1998), after analyzing the holding in *Goldschmidt* and other similar cases, determined that a lease for computer equipment containing a nonappropriation clause did not create "public debt" in contravention of the Nevada Constitution, and granted the petitioner's writ of mandamus directing the Nevada State Treasurer to make payments under the lease. Specifically, the Court determined the following:

> [T]he lease's nonappropriation provisions bring it outside the scope of Nevada Constitution article 9, section 3. The agreement's subject

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[1] *Id.* at 991-992. *See also Dykes v. North Virginia Transportation District Commission*, 411 S.E.2d 1 (Va. 1991); *Dieck v. Unified School District of Antigo*, 477 N.W.2d 613 (Wis. 1991); *State Department of Ecology v. State Finance Committee,* 804 P.2d 1241 (Wash. 1991); *In re Anzai*, 936 P.2d 637 (Haw. 1996); *State ex rel. Charleston Building Commission v. Dial*, 479 S.E.2d 965 (W. Va. 1996); *Employer Insurance Co. of Nevada v. State Board of Examiners*, 21 P.3d 628 (Nev. 2001) (supporting the proposition that nonappropriation leases do not constitute "debt"). *But see Brown v. City of Stuttgart*, 847 S.W.2d 710 (Ark. 1993) (finding that a lease constituted "interest bearing indebtedness" which was prohibited by the state constitution); *Montano v. Gabaldon*, 766 P.2d 1328 (N.M. 1989) (holding that a lease constituted unlawful indebtedness since it had not been approved by the voters as required by the state constitution).

> matter is fungible equipment, susceptible to repossession. Further, the contract clearly provides that payments are contingent on funds being appropriated by the legislature. The agreement automatically terminates if the legislature fails to appropriate sufficient funds for the payments, and in such a situation, [lessor] is entitled to repossess the equipment. Under the current revenue doctrine, no constitutionally proscribed public debt is created. Unlike the situation in *Hancock,* realism does not demand that "indebtedness ... is immediately created for the aggregate amount required by the period of the pledge." *Hancock,* 468 P.2d 333, 337. Here, the legislature is not compelled to appropriate money in the future.

2. **Compulsion to Appropriate**. Because the failure to appropriate funds necessary to pay rents coming due in the next fiscal period can have severe adverse consequences for the governmental unit, it is often argued that while the governmental unit may not be legally bound to appropriate funds for future fiscal periods, it is economically compelled to do so as a practical matter and thus, the arrangement is the functional equivalent of "debt" for state law purposes. This argument has been rejected by numerous courts; however, it has been a key argument in challenges to the validity of annually renewable/appropriated leases.

The plaintiff in *Kane* argued that the threat of loss of a credit rating in the event of nonappropriation rendered the lease in question a "debt." In rejecting this argument, the Court stated:

> Nor does the fact that the legislature may feel compelled to make payments in a future [fiscal period] out of the fiscal concern to protect its credit rating convert the state's obligation into a legal one subject to [the constitutional restrictions on the incurrence of indebtedness]. The economic and fiscal consequences of either continuing the agreements or allowing them to terminate by failing to appropriate money merely becomes [sic] a factor in the public policy calculus of a political system that automatically subjects the economic wisdom of such projects to [biennial] review by future taxpayers and their elected representatives. [Citation omitted.] These consequences are of no constitutional significance.[2]

Similarly, the court in *Colorado Criminal Justice Reform Coalition v. Ortiz*, 121 P.3d 288 (Colo. App. 2005) rejected the plaintiffs' argument that the contested lease purchase agreements would, in reality, be multiple-fiscal year obligations because the failure to appropriate would have a negative effect on the state's credit rating. Specifically, the court cited state precedent holding that "the . . . argument that nonrenewal of the lease will ruin the credit of the state . . . is a matter that may affect the legislature's exercise of its discretion, but does not commit revenues

[2] *Kane*, 783 P.2d at 995-996. *See also id*. at n. 12 (citing similar cases from other jurisdictions).

available to future legislatures to the payment of rentals under the lease." [Citation omitted.][3]

The plaintiff in *Kane* also argued that the lease created unconstitutional debt because if the state failed to renew the lease for a succeeding year, it stood to lose its entire equity in the financed property. The Court in *Kane* acknowledged that while this argument could have merit under other circumstances, the lease in question was not problematic:

> A common lease-purchase agreement generally allows the lessee to terminate the transaction without further liability if the lessee no longer needs, wants, or can afford the leased property. This does not create a debt or liability [footnote omitted]. The situation is more questionable if, upon terminating the agreement, the state stands to lose more than what remains to be paid on the acquired property, for instance, if most of the agreed price of an outright purchase, including interest, has been paid but termination will cause the state's entire valuable property (worth more than the unpaid balance) to pass into the hands of the seller or lender. In that situation, the agreement confronts future legislators with the choice between the financial cost of continued cash payments or the financial cost of losing valuable nonmonetary property. This contingency may appear to create a liability, prohibited by [the state constitution]. . . . We therefore hold no more than that the participation agreements are not on their face forbidden as a future debt or liability contrary [to the state constitution], so long as the state stands to lose property or the use of property worth no more than the unpaid balance under the agreement.[4]

On the other hand, the fact that upon default, or nonappropriation, property of the governmental unit having a greater value than the unpaid balance of the installment purchase payments could be forfeited may not to be problematic. In the case of *Wayne County Citizens Association for Better Tax Control v. Wayne County Board of Commissioners*, 328 N.C. 24 (N.C. 1991), the Court sustained the validity of an installment purchase contract where the obligation to make installment payments was subject to annual appropriation and the county's obligations under the contract were secured by a security interest in the property covered by the contract. The Court concluded that "debt," within the meaning of the state constitution, included only those obligations for which the taxing power of the governmental unit was pledged:

> What is being pledged is the constitutionally significant factor. Unlike general obligation bonds, wherein the taxing power of the

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[3] *Glennon Heights, Inc. v. Central Bank & Trust*, 658 P.2d 872, 879 (Co. 1983). *See also, Bd. Of County Comm'rs v. Dougherty, Dawkins, Strand & Bigelow Inc.*, 890 P.2d 199 (Colo. App. 1994)
[4] *Kane*, 783 P.2d at 997-998.

> governmental unit is pledged, in installment purchase contracts, only the property improved is pledged. The possibility that appropriations that might include income from tax revenues will be used to repay the indebtedness under the contract is not a constitutionally significant factor. *Id.* at 31.

In reaching this conclusion, the Court expressly noted that both the enabling statute and the contract itself barred any deficiency judgments against the county, presumably a significant fact because of the possibility that deficiency judgments could be subject to satisfaction out of tax revenues.

In jurisdictions where the constitutional concept of "debt" is not expressly linked to a pledge of the taxing power (as it was in *Wayne County, supra*) but is more broadly defined to include any obligation extending beyond the current fiscal period for which any assets of the governmental unit are at risk (as in *Goldschmidt, supra*), the logic employed by the Court in *Kane* would seem equally applicable to annual appropriation leases. Thus, in jurisdictions similar to Oregon, it may be prudent to limit the lessor/trustee's remedies in a nonappropriation situation to sale of the leased property and recovery of the balance of the scheduled rents, with any excess, *i.e.* the "equity," being remitted to the governmental unit.

C. Abatement Leases (California and Indiana)

In moving from the "true lease" considered in *Offner, supra* (where the city only had the option to purchase at fair market value), to financing leases which transfer ownership of the leased property to the lessee, the California courts have fashioned the concept of "abatement leases," which are now used as an alternative to annual appropriation financing leases to avoid violating the limitations on indebtedness included in the California Constitution. Local governments in Indiana also use abatement leases from time to time. Like annual appropriation leases, abatement leases can be structured as tax-exempt obligations. An abatement lease has the following characteristics for state law purposes:

1. **Vesting of Title at End of Term**. At the end of the lease term, upon the payment of all rents, or prior to the end of the term upon prepayment of the unpaid principal components of the lease payments and accrued and unpaid interest thereon, title to the property covered by the lease vests in the governmental unit. In sustaining this automatic vesting of title, the Court in *Dean* reasoned:

> We find no logical distinction between the Offner case and the one at the bar. It is true that [in *Offner*] there was an option to purchase [at fair market value]. . . rather than a vesting of title at the end of the term [as] in the instant case, but as far as liability is concerned, the state under the instrument here is in a better position, for it gets title without the payment of anything other than the rental. The essence of the Offner rule is that the payments are for a month to month use of the building. Here it is clearly stated that the rentals

are for that purpose. There is no substantial or logical difference between the option to purchase in the Offner case and the vesting of title at the end of the term in this case. True, the city was not bound to execute the option and thus pay the purchase price, but it was required to pay the rentals. Here the rentals also must be paid but the state need not pay any more.[5]

2. **Rental Payments Subject to Abatement**. If the property is not available for use by the governmental unit, or if there is substantial interference with the governmental unit's use or occupancy of the property, then the rents otherwise payable under the lease must be proportionately abated. As such most lessors require at least 24 months of rental interruption insurance for abatement leases, the proceeds of which would cover rent due under the lease while the financed property is being rebuilt or replaced.

a. *Abatement Generally; Use and Occupancy of the Project*. In *Starr v. City and County of San Francisco*, 72 Cal.App.3d 164, 172 (Cal. Ct. App. 1977), the Court pointed out the characteristics of the lease in question (which comply with the requirements of *Offner*, *supra*, and *Dean*, *supra*) and noted that "[t]he base rental is for specified amounts to be paid by the City to the Agency 'as rental for use and occupancy of the Project,' with rent abatement provisions if the project is not substantially completed and ready for occupancy by July 15, 1980, or if there is a subsequent substantial interference with use and occupancy of the premises."

b. *Covenant to Appropriate/General Fund Obligation*. Because this approach to holding that the lease does not constitute "debt" is based on the fact that liability for rents is confined to "each installment as it falls due and each year's payment is for the consideration actually furnished that year" (see *Offner*, *supra*), the governmental unit is obligated to make the rent payments as they come due (subject only to abatement) and can be compelled to appropriate money for that purpose. This generally results in inclusion of a covenant to appropriate money from the general fund sufficient to pay the rents due in each fiscal period. The net effect is what might be called a "general fund limited tax obligation subject to abatement," a binding and enforceable obligation payable out of any lawfully available money of the governmental unit (including general fund tax revenues) but for which the governmental unit cannot be compelled to levy taxes beyond those authorized for general purposes and that is subject to abatement to the extent of any substantial interference with use or occupancy of the property. Nevertheless, there is no right to accelerate the rents upon default. Rather, the lessor is limited to suing to collect each rental payment as it comes due.

c. *No Obligation During Construction/Acquisition Period*. In keeping with the abatement theory (*i.e.*, the municipal lessee has no liability for rent

[5] *Dean*, 218 P.2d at 523 (Cal. 1950).

except to the extent the property is available for use and occupancy), until the property subject to the lease has been acquired or constructed, the governmental unit's obligation to pay rents must be limited to sources other than its own funds or assets (*e.g.*, the capitalized interest fund and interest earnings on the acquisition/construction fund created under the financing documents and funded with the proceeds derived from the sale of the lease obligation). This aspect of the abatement lease thus incorporates an element of the special fund doctrine in terms of providing a constitutionally permissible source other than ad valorem taxes from which to pay interest during the acquisition or construction period. If permitted by state law, a governmental unit may want to enter into an "asset transfer" lease financing transaction of the type described below in order to lease property already available for use and occupancy.

D. Limited Tax Full Faith and Credit Leases

In certain jurisdictions, it is possible to structure a financing lease as a limited tax, full faith and credit obligation of the governmental unit that is not subject to annual appropriation or abatement. The availability of this financing technique is highly dependent on the interpretation of constitutional and statutory debt limitations in the jurisdiction in question, and there are often constitutional or statutory provisions that limit the amount of binding obligations that can be incurred. Generally speaking, these leases have the following characteristics:

1. **Obligation to Pay Rents**. The governmental unit is obligated to make the rent payments and can be compelled to appropriate money for that purpose. This aspect of the governmental unit's binding obligation is generally recognized by the inclusion of a provision making the obligation to pay rents a full faith and credit obligation payable out of any lawfully available source of funds, including property taxes that the unit is otherwise authorized to levy.

2. **Obligation Unconditional; No Abatement**. The obligation to pay rents is unconditional and not subject to abatement. Rather, the lease is structured as a true financing arrangement where the risk of loss, or interference with use and occupancy, is borne by the governmental unit.

3. **Right to Accelerate Rents on Default**. In some jurisdictions, the lessor can be given the right to accelerate all unpaid lease payments upon default.

E. Special Fund Leases and Related Variants

In several jurisdictions, financing leases are evolving to incorporate features such as pledges of specific revenues normally associated with the special fund doctrine. For example, the Kentucky Governmental Leasing Act § 65.942(2) allows lease payments to be secured by a pledge of revenues or taxes. Specifically, this section provides that "[A] governmental agency may pledge any revenues or taxes as security for payment under leases, and the leases may provide that the governmental agency may terminate its obligations under the lease at the expiration of each year

during the term of the lease. A governmental agency may pledge any revenue or taxes as security for payment under a lease regardless of any right to terminate." Under that section, the pledge of taxes for an annual appropriation lease would appear to give the holder of the obligation the right upon default or nonappropriation to seize the pledged taxes only to the extent needed to cover the appropriated (*i.e.*, the current fiscal year's) rents.

F. "Asset Transfer" Lease Financing Transactions

If permitted by state law, a governmental unit may wish to enter into an "asset transfer" lease financing transaction, in which the governmental unit leases or sells an existing asset that it already owns to a lessor and simultaneously leases it back. The proceeds generated from the sale or leasing of the existing asset are used for other governmental capital projects.

1. **State Law Issues**. State and local law may only allow a governmental entity to sell or otherwise dispose of property that it owns if the governing body determines that the property is obsolete, unfit or surplus property, which is no longer needed by the governmental entity, or may require that such a sale or disposition be authorized by its voters or by public auction. Other state law considerations under applicable state laws and judicial interpretations would be whether or not this form of lease purchase financing represents a type of "cross-collateralization" that constitutes invalidly incurred debt in the jurisdiction or a "mortgage" of public property that is not permitted. When an asset transfer financing is contemplated, state and local law issues should be very carefully scrutinized.

2. **Potential Advantages.** If state law issues can be resolved, the practical advantages of an asset transfer lease financing include the elimination of construction risk (because the asset securing the lease is already in existence) and the potential need for capitalized interest, having an asset to secure the lease that is potentially more essential to the governmental unit than the asset or assets that need to be financed, or being able to finance improvements to existing buildings that otherwise might be unsuitable for lease financing on a separate basis or cause a "compulsion to renew" because of "over-collateralization."

III. BASIC LEASE ISSUES

A. Is the Lease Valid?

Invalidity of a lease can mean not only the loss of future installments, but also possible recoupment of prior installments. Interest on an invalid lease is not excludable from gross income for federal income tax purposes. Yet, statutory guidance for lease financing is often not clear, and it is often possible that other statutes will unexpectedly come into play. Some of the primary issues in this regard are discussed below.

1. **Is there statutory authority for the governmental unit to enter into the lease?** Many state statutes provide only generalized language as to authority to "lease" or "purchase" or simply to "acquire" real or personal

property or to issue "obligations." Practice varies from state to state and from lawyer to lawyer as to what statutory authority is sufficient to authorize a lease financing transaction.

2. **Does the lease include provisions that are not authorized by law?** Leases and accompanying escrow agreements often include provisions for indemnification of the lessor (its assigns) and/or an escrow agent for contingencies that range from personal injury to loss of tax exemption of interest. Yet, it is the law in many jurisdictions that public bodies cannot indemnify third parties. Another provision found in some leases is the existence of a covenant precluding the lessee from acquiring similar property for some period of time after a nonappropriation, thereby potentially preventing the lessee from performing an important public function required by state law. Such nonsubstitution clauses are generally considered unenforceable and in some states may invalidate the lease. *See, e.g., Frankenmuth Mut. Ins. Co. v. Magaha,* 769 So.2d 1012 (Fla. 2000) (holding that a nonsubstitution clause invalidated a lease as debt incurred in violation of a constitutional requirement for voter approval). *Cf. Miccosukee Tribe of Indians of Florida v. South Florida Water Management. District,* 48 So.3d 811 (Fla. 2010) (affirming that the absence of a nonsubstitution clause helped render the nonappropriation clause as real and not illusory, thereby preserving the integrity of the nonappropriation clause and helping to prevent COPs from being characterized as debt). Leases that include questionable clauses are sometimes funded with the thought that invalidity is not clear or that the questionable provision can be isolated by the phrase "to the extent permitted by law" or that, in any event, a severability clause will excise the offensive provision. In this regard, consideration must be given to the basic rule that municipal entities have only those powers expressly authorized by statute (commonly known as Dillon's Rule). There have been instances where a court has invalidated a lease rather than sever the offending provision. *But see Frankenmuth Mut. Ins. Co. v. Escambia County, Fla.,* 289 F.3d 723 (11th Cir. 2002) in which the court held that the nonsubstitution clause was severable and the lease was valid.

3. **Have procurement laws been observed?** Failure to observe public bidding or other procurement laws may not affect validity of a bond issue, but could invalidate a lease. *See, e.g.*, *McBirney & Associates v. State*, 753 P.2d 1132 (Alaska 1988). Procurement codes are often a morass of requirements, observance of which will involve a fact-laden inquiry. Practice varies, but counsel will often rely on representations of the lessee, local investigation as to such compliance, or an opinion of local counsel. Public bidding laws may apply to the acquisition of the leased property and to the lease financing itself, depending on state law.

4. **Does the lease create unconstitutional or illegal "debt"?** See Part II of this outline for more detail. Despite broad use of nonappropriation clauses

and abatement lease structures, where available, there may be lingering concerns in some jurisdictions that leases might nevertheless be struck down as unvoted or otherwise unconstitutional debt. Rev. Rul. 87-116 adds to the concern with its determination that interest on an obligation found to be unconstitutional is not tax-exempt from its inception. Clauses in the lease should be analyzed as to their potential effect on the issue of debt, such as whether the lease should be subject to annual renewal or annual termination; the consequences of damage, destruction or condemnation; when the rental payment obligation may commence as to the lessee; as well as any clauses (*e.g.*, nonsubstitution clauses) that seek to penalize the lessee for exercising its option to terminate the lease annually.

5. **Does the lease violate positive requirements of state law?** It is often not clear whether usury laws or interest rate ceilings that may apply to bonds also apply to leases. At times, leases may be covered by deceptive trade practices laws. Some states have statutes that require certain specific language to be included in a lease and failure to include that language may invalidate the lease. Many states have specific requirements with respect to leases associated with renewable energy and energy conservation programs. Jurisdictions may have other statutes that unexpectedly affect validity.

6. **Has the lease been properly authorized and entered into?** *Power Equipment Co. v. U.S.*, 748 F.2d 1130 (6th Cir. 1984), holds that even interest on an enforceable lease is not exempt if a statutory step (*e.g.*, approval by city council) has been omitted. The decision in *United States Leasing Co. v. City of Chicopee*, 521 N.E.2d 741 (Mass. 1988) holding that the mayor's signature was called for by the city charter is a reminder that administrative requirements are a precondition to validity, and that the estoppel effect of the lessee counsel's favorable opinion may not be much help.

7. **Is any tax levy necessary to pay lease payments within the lessee's applicable levy limit for operating expenses or, if appropriate under state law, for capital expenditures?** Lease payments typically constitute current expenses of each fiscal year during the lease term and must be raised through a tax levy for operating expenses or capital expenditures within a levy limit imposed by state law for the particular political subdivision entering into the lease. Depending upon how the lease is drafted, the particular state law and the type of political subdivision entering into the lease, as lessee, the lessee may not be obligated to exceed any applicable levy limits in generating money to pay its lease payments without creating the risk that the lease is or may be held to be invalid debt. In addition, a comparison of the level of the required tax levy to any applicable levy limit (considered with and without the proposed additional rental payments) may suggest how likely the risk of nonappropriation may be.

B. Are the Lessor's/Owners'/Investors' Interests Adequately Protected?

1. **Is the leased property "essential"?** Lessors, assignees, and in COP and lease revenue bond transactions, underwriters and investors, generally evaluate the "essentiality" of the property to be financed with the lease. In real property transactions, the following questions may be appropriate: Is lease-financed real property essential to the delivery of critical or mandated governmental services, such as courthouses, jails and governmental offices? Or is the real property being acquired for more discretionary purposes, such as entertainment or sports facilities? Is the real property sufficiently distinct and transferable to be susceptible to lease financing? The following questions may be appropriate in equipment transactions: If the lease finances the acquisition of equipment, is the equipment subject to adequate identification and control? Is the equipment standard equipment of proven usefulness, such as school buses and fire trucks, which are unlikely to be the subject of nonappropriation and also would have value if the lease were nonappropriated? Or is the equipment "customized," "high-tech" or intangible property or systems that are subject to significant risk of not being acquired or completed on time and within budget, or that are subject to unusually fast depreciation in value or technological failure or obsolescence, with a resultant increase in the risk of nonappropriation? Is the equipment or the information stored within the equipment subject to state or federal laws (such as federal privacy laws) or prior liens, making collateral recovery difficult? Governmental lessees are typically asked to certify as to the essentiality of the property to be financed, but such certifications should not take the place of independent analysis. This is primarily a credit issue as opposed to a legal issue.

2. **Other.** The following is a non-exhaustive list of lease provisions, issues or considerations that relate to the needs and/or concerns of lessors, assignees and/or investors:

a. It may be important for credit purposes to include a lease payment schedule that reflects the expected completion date of the construction of the leased property and the expected remaining useful life of the leased property. These details have legal significance as well.

b. Leased property consisting of multiple assets or assets that are more valuable than the total principal portion of the rental payments could reduce the practical risk of nonappropriation, but may not be legally possible or feasible.

c. Protections against completion/acquisition risk include:

(1) Entering into the lease after final design and cost estimates are complete and only slightly before commencement of construction or acquisition.

(2) Requirements for the construction contract which include builder's "all risk" insurance during construction, performance and payment bonds and liquidated damages for delay.

(3) Capitalized interest through completion of construction/acquisition and acceptance by lessee.

d. Protection against loss after completion/acquisition including insurance provisions and required prepayment upon damage/destruction or condemnation.

e. Title to the property/equipment in accordance with state law (either in lessor or lessee, as required) and the grant/retention of a security interest in the property/equipment (as permitted by state law).

f. Release and indemnification of lessor (where permitted by state law).

g. Title insurance in respect of the leased property reflecting ownership or leasehold interest of lessor and mortgage loan or leasehold loan interest of lessor's assignee (which may be a trustee for the owners of COPs).

h. Analysis of appraised or insured value (replacement cost) of leased property.

i. Provisions relating to waiver of condemnation powers of lessee in respect of the leased property. Credit problems coupled with a difficult negotiation situation (*i.e.*, the inability to compromise with the lessor or the lessor's assignee) may cause a lessee to attempt to condemn the leased property at a value that is less than the principal balance of a lease.

j. Provision stating that equipment is and will remain personal property and will not become a fixture (for equipment leases).

k. Irrevocable assignment by a lessor to a bank trustee representing owners of COPs.

l. Remoteness of risk of bankruptcy of lessor to the owners of COPs.

m. Casualty and rental interruption insurance requirements, particularly for abatement leases.

n. Reserve fund relating to failure to pay or appropriate rental payments.

o. A provision confirming the lessee's/debtor's legal name and structure.

p. Provisions affording lessor ability to assign or participate the lease without prior consent of lessee (unless required by state law) or restrictions on future assignments and/or servicing.

q. Lessee covenants to properly maintain the property/equipment at its own cost and expense and to pay all applicable taxes, charges or liens.

r. For installment contracts or leases dependent upon savings (such as energy savings), whether there will be sufficient time for the lessee to realize such savings in relation to the first lease payment, and whether capitalized interest should be considered.

s. Whether a lease is subject to continuous renewal (absent nonappropriation) or whether a lease is subject to annual termination and affirmative renewal.

C. Does the lease properly match the timing and amount of rental payments to the lessee's budgetary cycle?

The budgetary cycle of a governmental lessee varies from jurisdiction to jurisdiction and within each jurisdiction as between the state, cities, counties, school districts, etc. Failure to take these considerations into account when drafting a lease may result in a lack of funds available to the lessee to make timely lease payments. The lease must be drafted with sensitivity to the particular lessee's budgetary process to ensure that the proper steps are taken so that money will be available to make lease payments in the current fiscal year and in future fiscal years if such payments are lawfully appropriated for or otherwise allowed by law. The strength of covenants relating to lessee duties with respect to budgeting and appropriations vary from jurisdiction to jurisdiction depending on how strong the obligation to budget and appropriate may be without causing the lease to become debt for state law purposes.

D. Does the lease trigger unexpected state or local taxes?

1. Ad valorem taxes. Even though the lessor is simply providing a financial service, express placement of the title in the lessor (a requirement in some jurisdictions) may trigger a real and/or personal property tax. *See, e.g.*, *University of Utah v. Salt Lake County*, 547 P.2d 207 (Utah 1976); *Pollard v. City of Bozeman*, 741 P.2d 776 (Mont. 1987). Often an equipment lessor will attempt in the lease to pass title up front to the lessee, retaining a "security interest" so the equipment may be repossessed upon early termination. In certain jurisdictions, this structure may raise "indebtedness" or other legal issues. Often, even though this procedure further undermines the lessor-lessee concept, the lessor will never have title to the equipment, asking the vendor to invoice the equipment directly to the lessee instead. On the other hand, in *First Union National Bank of Florida v. Ford*, 636 So.2d 523 (Fla. App. 1993), placement of title in a bank trustee was held not to deprive the municipal lessee of "equitable ownership" and thus preserved the property tax exemption conferred by Florida law. This same result was reached in *Leon County. Educational. Facilities Authority v.*

Hartsfield, 698 So.2d 526 (Fla. 1997), where the court held that "the project is not subject to ad valorem taxation because the Authority holds virtually all the benefits and burdens of ownership."

2. **Sales and use taxes.** Generally, sales and use taxes apply to the initial purchase from the vendor but do not apply to the lease if the lessor takes title simply to lease the equipment to a public body, provided that proper resale certificates are provided. In some states, however, municipalities are not exempt from payment of sales and use taxes.

3. **Franchise taxes.** The business of leasing may itself generate a liability. Failure to qualify to conduct business in a state might lead to invalidity of a lease. *See White Dragon Productions, Inc. v. Performance Guarantees, Inc.*, 241 Cal. Rptr. 745 (Cal. Ct. App. 1987).

4. **Covenant to Pay All Taxes.** Often the tax question is considered to be solved by a clause requiring the lessee to pay any and all taxes applicable to the leased property and the transaction. Although this clause is indispensable, its enforceability may be subject to doubt and, if not properly disclosed to the lessee, may increase the risk of nonappropriation.

E. Has the lessee formally accepted the equipment financed by a lease?

Unless provision has been made to hold lease proceeds in a fund for future release, a lessor and its counsel will want the comfort of knowing the lessee has received and accepted the leased equipment. Although this may be false comfort, as Uniform Commercial Code ("UCC") § 2-608 allows revocation of acceptance (*see Advanced Computer Sales, Inc. v. Sizemore*, 366 S.E.2d 303 (Ga. Ct. App. 1988)), it is customary to have the lessee sign an unequivocal acceptance certificate identifying the equipment and the lease. In some cases, the lease or other financing agreement may be used to fund intangibles or maybe only a portion of the financed property is subject to physical acceptance, for example, when financing software, service contracts, prepaid maintenance or other intangible property, when permitted by state and federal law.

F. Is the lessor properly secured?

1. **Is title good?** Under the UCC, an unpaid vendor retains title; accordingly, one must be satisfied that the vendor is paid. Used equipment may be subject to competing liens or security interests and, at least for expensive computer units, it may be prudent to trace title back to the manufacturer, checking to see that the serial numbers match those on the invoice. Vehicles should be accompanied by certificates of title, and title to aircraft may be searched and perfected.

2. **Does the lessor "own" the lease?** The basic protection here is, of course, to know the lessor whose paper is being examined, as a UCC search of the lessor's principal place of business will often be unavailing, and it may be that more than one original counterpart of the lease exists. Purchase of leases from a lessor-vendor in good faith and for value will generally defeat

a competing claim, but it is important that the governmental lessee acknowledge the assignment. Some lessors will continue to receive the rental payments to "service" the account for the investor; but the risks of confusion (should the lessor become insolvent or reassign the paper) call for extreme confidence in the lessor's financial stability and integrity.

3. **Is the security interest in the leased property perfected as against the lessee?** In some, but not all, states, Article 9 of the UCC applies to the creation of security interests by state and local governments. Unless a state has adopted a non-uniform amendment, Article 9 governs security interests created by a state or governmental unit of a state except to the extent another statute of the state expressly governs the creation, perfection, priority or enforcement of such security interest. Whether or not Article 9 applies, the practice is to file UCC financing statements to have the benefit of the public notice that such filing provides. For motor vehicles, applications for certificates of title are typically made with the lessee listed as the "registered owner" and the lessor, as the lienholder.

4. **Is the investor's security interest perfected vis-a-vis its assignor?** Generally, the assignment is considered an outright sale of all of the assignor's right, title and interest in the lease (and the underlying leased property), rather than an assignment for security, and the investor in any event takes physical possession of the original counterpart of the lease (chattel paper). Article 9, however, specifically applies to the sales of accounts and chattel paper. UCC financing statements covering such sales, therefore, must be filed.

5. **Does the assignment insulate the assignee from the risks associated with the bankruptcy of the assignor, at least for the applicable bankruptcy period?** The answer to this depends upon whether the assignment is absolute or is intended as collateral security for performance of obligations by the assignor. The assignment document for the lease should be drafted carefully to resolve this question in favor of protecting the investor.

6. **Is the lease unsecured or effectively unsecured?** In some cases, the lease or other financing agreement may be used to fund intangibles, for example, software, service contracts, prepaid maintenance or other intangible property, when permitted by state and federal law. This presents credit issues (i.e., the lessor must get comfortable with the nonappropriation risk in the absence of essential equipment) and potentially federal tax issues (i.e., is there an obligation under Section 103 of the Code), but UCC questions also come up with some regularity when financing other than goods. One question that may arise in a lease financing transaction financing software-as-a-service (SaaS) agreement or a software license, for example, may be whether a security interest can actually be taken in and perfected in the non-goods financed. Or, when a lease grants a lessor a security interest in an agreement or a license held by the lessee, is it properly treated as a secured

financing of the general intangible type perfected by a financing statement, or does the granting of a security interest create issues with the underlying agreement or license being financed? The purchase money security interest (PMSI) exception is the centerpiece of the equipment leasing and finance industry (without it most financed assets would be subject to a prior lien with an "after-acquired" collateral provision) and a PMSI can only exist in goods and software acquired with goods. If no PMSI can be taken when financing non-goods with a lease, then of what value is the security interest taken by a lessor, or is the lease effectively unsecured? Such questions and many others of this type will require a careful analysis under Article 9 of the UCC as adopted in the governing jurisdiction. The UCC analysis required to answer these questions is beyond the scope of this publication, as are the applicable state law issues (e.g., does the applicable state law financing authority permit the financing of non-goods?).

G. Do Federal or State Securities Laws Apply?

1. **Are leases and participations (*e.g.*, COPs) "securities" and if they are "securities," are they exempt from registration and other securities law requirements?** Section 2(a)(1) of the Securities Act of 1933 (the "1933 Act") and Section 3(a)(10) of the Securities Exchange Act of 1934 (the "1934 Act") define "security." The 1933 Act defines the term as follows:

> The term 'security' means 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 1934 Act is virtually identical to that in Section 2(a)(1) of the 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, however, the United States Supreme Court has construed the definitions in the 1933 Act and the 1934 Act as functionally equivalent.

Two Supreme Court decisions are also central to the question of whether a financing instrument, such as a lease, should be considered a security. In *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946), the Court considered whether

a particular financing arrangement constitutes an "investment contract," which is included in the definition of a "security" under the 1933 Act. Under *Howey*, as modified by its progeny, the Court has held that an investment contract involves (i) an investment of money, (ii) in a common enterprise, with (iii) the expectation of profit primarily from the efforts of others. *See also United States Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975). The paragraphs below apply the *Howey* test to municipal lease financings. Then, in 1990, the Court set forth a "family resemblance test" for determining whether a note should be considered a security for purposes of the federal securities laws. *See Reves v. Ernst & Young*, 494 U.S. 56 (1990). Per *Reves*, 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. Tax-exempt leases do not typically include a note that requires analysis under the *Reves* family resemblance test, and most tax-exempt leases are easily recognized as commercial loans rather than securities.

The tax-exempt leasing industry does not routinely evaluate municipal lease financings under the fact-specific *Howey* or *Reves* tests. Instead, practitioners rely on a series of SEC no-action letters directly related to municipal lease financing structures (the "No-Action Letters").[6] 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. In fact, in the No-Action Letters, the Securities and Exchange Commission (the "SEC" or the "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 (or a "municipal security" as defined in Section 3(a)(29) of the 1934 Act). In the *Walter E. Heller & Company* no action letter, the SEC Division of Market Regulation said that it would not recommend any enforcement action to the Commission if a firm engaged in arranging municipal lease financings (but retaining no interest therein after the sale of the financing interest to a sophisticated individual or financial institution) did not register as a broker-dealer under Section 15(b) of the 1934 Act. The Commission staff, however, specifically took "no position as to whether these lease-purchase transactions are securities as defined in Section 2(1) of

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[6] SEC No-Action Letters (1978-1982), *Walter E. Heller & Co.*, Securities and Exchange Commission (Oct. 25, 1982); SEC No-Action Letters (1983 - 2003), *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).

the 1933 Act or Section 3(a)(10) of the [1934 Act], or municipal securities as defined in Section 3(a)(29) of the [1934 Act].”

Prior to the *Walter E. Heller* no-action letter, the SEC created considerable uncertainty in the municipal lease financing industry when it released an inquiry from the Office of the Comptroller of the Currency regarding Itel Corporation and the SEC’s response to that inquiry. *Itel Corporation*, SEC Division of Market Regulation Letter to Office of the Comptroller of the Currency, Investment Securities Division (Sept. 1, 1981). The SEC Division of Market Regulation concluded in *Itel Corporation* that fractionalized participation interests in tax-exempt lease-purchase or installment sale financings were “municipal securities” within the meaning of Section 3(a)(29) of the 1934 Act.

The *Itel Corporation* letter was widely reported in the municipal finance and municipal lease finance industries. The publication of *Itel Corporation* raised the prospect that vendors, other financial intermediaries and persons not customarily subject to securities regulation might find themselves subject to the 1933 Act or the 1934 Act as a result of their participation in municipal lease financing transactions.

The uncertainties created by the *Itel Corporation* letter were gradually resolved, largely as a result of the SEC’s no-action position in *Walter E. Heller* and similar requests with respect to the registration of brokers/dealers under the 1934 Act. What has emerged from the series of similar no-action requests and the favorable SEC responses is the practical view that if the conditions described in those letters are followed, the transfer of a whole lease on a non-recourse basis to a sophisticated investor experienced in municipal lease financing investments may not constitute the transfer of a security for purposes of the 1933 Act or the 1934 Act, whereas the fractionalization of that lease interest into COPs will undoubtedly give rise to the issuance of securities for purposes of both the 1933 Act and the 1934 Act.

In requesting the No-Action Letters, each of the firms involved made similar arguments that a tax-exempt lease financing is not a security or a municipal security. First was the argument that the municipal lease financings at issue did not fit expressly within any of the specific statutory definitions set forth in the 1933 Act or the 1934 Act. Transactions not specifically covered by the statutory definitions will generally not be deemed to be securities unless they are “investment contracts” under *Howey*. Thus, the second argument made by the firms was that the municipal lease financings at issue did not create securities or municipal securities in that such financing arrangements could not be considered investment contracts.

The firms requesting the No-Action Letters argued to the SEC that municipal lease financings generally do not involve an "investment" of funds, but rather are commercial transactions excluded from the definition of security. In the transactions described in the No-Action Letters, the lessor or assignee of a whole municipal lease financing merely served as a lender to a municipality which enabled the municipality to purchase property on credit, therefore not involving any common enterprise. The municipality was required pay the lessor or its assignee under a fixed schedule of payments which, when coupled with the municipality's option to purchase the property for a nominal sum at the end of the term of the municipal lease financing, were essentially principal and interest payments. The agreement entered into restricted the municipality's use of the underlying property and required the municipality to maintain, protect and insure the property at its own expense. Although the lessor or assignee could retain title to the property for the term of the lease, the lessor also retained a security interest in the property which served as collateral. The existence of collateral is also strongly suggestive of a commercial rather than an investment transaction. Moreover, the fact that a municipal lease financing finances one or more items of property rather than being a general extension of funds to the municipality also indicates that the transaction is a commercial loan. In addition, the lessors or assignees in the transactions described in the No-Action Letters were not within the class of persons the United States Congress meant to protect under the securities laws. The lessors or assignees described in the No-Action Letters were always sophisticated investors who routinely engaged in financing commercial transactions and were knowledgeable about such transactions. Each lessor or assignee had access to sufficient information and had the experience and financial sophistication necessary to make an informed economic decision.

In the transactions described in the No-Action Letters, the municipal lease financings did not involve "profits," derived from the efforts of others, one of the indicia of an investment contract under *Howey*. The United States Supreme Court has defined "profits" as either capital appreciation resulting from the development of the initial investment or a share of the earnings created by the use of the investor's funds. In the transactions described in the No-Action Letters, the return on a lessor's or assignee's investment could come only from the payments of the municipality under the terms of the lease or the municipality's exercise of its option to purchase the property covered by the agreement. The rental payments represented a fixed stream of revenues that did not depend on or vary with any capital appreciation in the underlying project or the services of a third party. The municipality's option to purchase at the end of the lease term was for a nominal sum or upon payment of all rent due, and hence the lessor's or the assignee's investment had no potential for appreciation. While the receipt of rental payments required that the municipality remain capable of making such payments, this inheres in any lease or commercial loan. Similarly, the lessor's or assignee's rights in the event of default, primarily repossession

of the financed project, was typical of any lease and did not represent anticipated capital appreciation of the lessor's or assignee's investment.

In the transactions described in the No-Action Letters, a lessor could assign, or an assignee could reassign, its interest in the municipal lease financing to a third party, but would only realize revenues consisting of the discounted value of the remainder of fixed rental payments. Such reassignment is closely analogous to that of commercial loans, and the amounts realized do not represent profits. None of the revenues received by assignees were shared with the assignor. In addition, no lessor or assignee had an expectation of profits from the managerial efforts of others. A municipality's obligation as lessee to make its rental payments did not constitute the entrepreneurial efforts required for an investment contract. Courts have held that the assignee of a lease does not anticipate profits from the efforts of others even though its revenues depend solely upon the continued solvency and viability of the lessee. Although the municipality was required to keep the financed property in good condition and insure it, this was merely to preserve the assignee's collateral and not to enhance its value. Assignees did not depend on any managerial or entrepreneurial efforts from prior assignees to realize its expected return. An assignment by a lessor or subsequent assignee was made without recourse, and thereafter the assignor did not retain any interest in the municipal lease financing and was in no way connected with the stream of rental payments (other than in its role as servicer, if any, which ministerial service was not entrepreneurial in nature).

One may reasonably conclude, based upon the No-Action Letters, that 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 COP 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*. Because the issue has not been definitively determined, however, it is very common in single investor / purchaser (as opposed to single vendor) transactions to obtain an investment letter from the single investor / purchaser to the effect that (i) the investor is an "accredited investor" within the meaning of Rule 501 of Regulation D promulgated under the 1933 Act (or some similar indication of financial suitability), (ii) the investor has obtained and reviewed certain documents or summaries of documents, including particularly the municipal lease financing documents, (iii) the investor has obtained, or has had the opportunity to obtain, all such financial and other information as such investor has desired from the governmental entity/lessee, and (iv) the investor is experienced in investing in municipal lease transactions.

Any fractionalized municipal lease financing, including COPs, are considered "securities" for purposes of the 1933 Act, but the question is whether they are governmental securities exempt from registration under

Section 3(a)(2) of the 1933 Act. COPs are usually created by assignment of the lessor's interest in the tax-exempt lease, the assets financed and the rental payments under the lease to a trustee under a trust indenture pursuant to which the interest in the rental payments, assets financed and legal rights are fractionalized to multiple investors. More discussion of COPs is set forth in Part IV of this outline. Since 1977, the SEC, in a series of no action letters has provided guidance that the typical fractionalized municipal lease financing will constitute a governmental security of the underlying governmental lessee if certain conditions are met. *See Smith, Barney, Harris, Upham & Co., Inc.,* SEC No-Action Letter (Jan. 7, 1977). In *Smith Barney*, counsel to Smith Barney argued that the governmental entity should be considered the "issuer" of the certificates, and that the nominal role of the seller of the equipment (as lessor or seller) and the ministerial role of the trustee in the financing should be disregarded in determining the availability of an exemption under Section 3(a)(2) of the 1933 Act. Based upon the facts presented in *Smith Barney*, the SEC agreed not to recommend any enforcement action if the COPs in the financing agreements were offered and sold to the public by the company without compliance with the registration requirements of the 1933 Act in reliance upon the exemption provided by Section 3(a)(2) of the 1933 Act.

Counsel for the State of New Jersey, in the *State of New Jersey* (May 21, 1984) no-action request, relied upon the SEC's conclusions in *Smith Barney* and summarized the factors noted by the Commission staff in *Smith Barney* as being important to a determination that no registration would be required under the 1933 Act in the case of state and municipal equipment lease or conditional sale programs. The relevant factors in *Smith Barney* include the following:

a. the obligation of the public body must be a direct obligation in respect of which a certificate holder would have recourse without the necessity of joining a third party;

b. the obligation of the public body must not be subject to set-off or counterclaim as a result of any dispute between the public body and a third party (*e.g.*, the trustee, lessor or vendor);

c. the obligation of the public body cannot be dischargeable as a result of damage to, or the destruction of, the subject property;

d. the public body must be required to maintain the property at its own expense and to make all payments in respect of insurance premiums;

e. the public body may not be permitted to sell or encumber the property without the consent of certificate holders;

f. the trustee or fiscal agent acting on behalf of a certificate holder may provide only ministerial services as part of the financing transaction; and

g. the rights of certificate holders [can] not be adversely affected by any insolvency proceeding to which the trustee or fiscal agent might become subject.

2. **Do state blue-sky laws apply?** The comfort available at the federal level that whole leases are not securities often is not available under state securities laws. State level securities commissioners may simply not have thought of the question *vis-a-vis* leases. However, in some jurisdictions, statutes and/or case law supports the general position that state securities laws are to be interpreted in accordance with federal law, except as otherwise provided. A separate analysis of applicable state securities laws is advisable in each case.

3. **Are there Dodd-Frank Act issues?** The *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub.L. 111-203, H.R. 4173 (approved July 21, 2010) (the "Dodd-Frank Act"), which amended the 1934 Act, requires a "municipal advisor" to register under the 1934 Act if such municipal advisor (a) provides advice to or on behalf of a municipal entity or an obligated person with respect to (i) "municipal financial products" or (ii) the "issuance of municipal securities," or (b) undertakes the solicitation of a municipal entity or obligated person. The application of these requirements to a lessor of municipal lease obligations presents questions that are similar to the questions facing banks, leasing companies and other investors that purchase municipal obligations for their portfolios.

4. **Does SEC Rule 15c2-12 apply?** Whole leases (unparticipated in the form of COPs or otherwise) are generally not treated as securities as discussed above and thus, a lessor is under no obligation to comply with securities laws as they relate to the offer and sale of the lease. COPs and other fractionalized leases, however, are securities and therefore, Rule 15c2-12 will apply in such instances as it does in the case of other municipal securities transactions (*i.e.*, underwriters will be required to require a continuing disclosure agreement and the lessee will be required to comply therewith). Even where a whole lease is involved, the lease should be considered a financial obligation for purposes of events 15 and 16 under Rule 15c2-12 such that an issuer party to an outstanding continuing disclosure agreement may be required to disclose the incurrence of the lease obligation and any changes thereto.

H. Have Federal Income Tax Considerations Been Addressed?

All the questions that apply to bonds also apply to leases, but with specific nuances and considerations. It is generally assumed, correctly, that the federal tax analysis applicable to tax-

exempt bonds is also applicable to tax-exempt leases, as the arbitrage rebate requirements, private activity bonds tests, and additional rules apply to any debt obligation the interest on which is intended to be exempt from gross income for federal income tax purposes.

New or well-seasoned tax-exempt financing practitioners participating in the tax-exempt leasing sub-industry should be sure to remember the fundamentals of tax-exempt financing and begin any transaction intended to be tax-exempt by focusing on whether a proposed lease is structured as a true lease or operating lease for federal tax purposes or whether the proposed lease is structured as a financing lease or capital lease as only capital leases will have interest eligible to be excluded from gross income for federal income tax purposes. Practitioners should next consider whether and how the entity desired to be the lessee qualifies as a valid issuer of a tax-exempt debt obligation under the state or local bond requirements of Section 103 of the Code and Treas. Reg. Section 1.103-1 thereunder. Practitioners should also consider whether the expenditures proposed to be financed constitute capital or working capital expenditures for federal tax purposes and, if any of the proposed expenditures constitute working capital expenditures, the extent to which those expenditures are eligible to be financed on a tax-exempt basis. Practitioners should also consider how the assets desired to be financed are expected to be used in context of compliance with the private activity bond tests and plans for compliance with the remaining rules applicable to tax-exempt debt obligations under Code Sections 103 and 141-150 and the related Treasury Regulations, rulings and decisions thereunder. The following outline highlights certain of these requirements and provides some discussion of provisions of particular importance but should not be relied upon as a thorough or complete discussion of all federal tax requirements applicable to tax-exempt debt obligations.

1. **Is the Lease a Financing or Capital Lease for Federal Tax Purposes?** A financing or capital lease is treated as a debt obligation for federal tax purposes and only interest on a financing or capital lease is eligible to be excluded from gross income for federal tax purposes. One of the first pronouncements by the IRS that attempted to distinguish true leases and conditional sales contracts for federal tax purposes was Revenue Ruling 55-540. The IRS ruled that whether an agreement is in substance a conditional sales contract or true lease for federal tax purposes depends on the intent of the parties as evidenced by the provisions of the agreement, considering facts and circumstances in existence at that time. Absent compelling persuasive factors of contrary implication, for federal tax purposes, the IRS would infer an intent to treat a transaction as a purchase and sale rather than as a lease or rental agreement if one or more of the following conditions are present: (1) a portion of the periodic payments are made specifically applicable to an equity interest to be acquired by the lessee; (2) the lessee will acquire title upon the payment of a stated amount of rentals required under the agreement; (3) the total amount that the 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; (4) the agreed rental payments materially exceed the current fair rental value, which may indicated that the payments include an element other than compensation for the use of property; (5) the 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 (6) some portion of the periodic payments is specifically designated as interest or otherwise readily recognizable as the equivalent of interest. Revenue Ruling 55-540 further clarified that, for federal tax purposes, agreements are usually indicative of an intent to rent equipment if the rental payments are at an hourly, daily or weekly rate, or are based on production, use, mileage, or similar measure and are not directly related to the normal purchase price, provided if there is an option to purchase, that the price at which the equipment may be acquired reasonably approximates the anticipated fair market value on the option date.

a. **Is the lessee building up equity in the leased property as required by Rev. Rul. 55-540 (see e.g., PLRs 8235056 and 8347058)?** Often, the dollar or nominal purchase option or automatic passage of title at the end of the lease term satisfies this test, but at times lessors will ask for a greater purchase option price, raising the Rev. Rul. 55-540 question of whether the lease is a true lease. The economic useful life of the financed property, the term of the lease financing and other factors (e.g., the payment schedule) should also be considered to ensure that the lease is properly treated as a financing or capital lease for federal income tax purposes rather than a true lease for use of the leased property. In many cases, the build-up of equity in a tax-exempt lease subject to non-appropriation is accomplished through a financing term substantially shorter than the useful life of the equipment.

b. **Is the interest component of the rentals sufficiently distinct and described as required by Rev. Rul. 72-399?** Tax-exempt leases should include either a schedule setting out the principal and interest components of each rental payment, with yet another column setting out any permitted prepayment schedule, or include language permitting ready calculation of such schedules. For instance, some leases may use a formula for expressing interest. In such cases, it is important that the formula enable an investor to demonstrate to the IRS the amount of the interest component of each installment payment.

c. **Is the lease an "obligation" under Section 103(c)(1) of the Code?** In Private Letter Ruling 7821068 (February 23, 1978), the IRS found that an "obligation" existed for purposes of Section 103 of the Code, in the context of an annual appropriation lease even though the lessee's obligation was limited to funds appropriated annually and the lessee was entitled to terminate the lease from year to year. Where a lease is subject to non-appropriation, the build-up of equity in the equipment through a financing term substantially shorter than

the useful life of the equipment (*see* Rev. Rul. 55-540) is also often considered important to create an economic compulsion for the lessee to continue making payments even where the lease arguably does not otherwise rise to the level of a debt obligation for federal income tax purposes. Where no tangible assets are financed it may be appropriate to consider the lack of traditional remedies (e.g., repossession of real or personal property) in the event of a non-appropriation or default, when determining whether an "obligation" exists for federal tax purposes.

Notwithstanding treatment of tax-exempt leases as debt obligations for federal income tax purposes, most leases are structured to avoid treatment as debt under state law (see Part II of this outline).

2. **Is the Lessee an Eligible Tax-Exempt Issuer?** Lease financings present unique legal and practical challenges related to the status of the lessee as a valid issuer of a tax-exempt debt obligation under Section 103 of the Code. Despite such challenges, vendors, lessors and others routinely initiate and consummate tax-exempt lease financing transactions without consulting qualified legal counsel. Practitioners invited to participate in such financings should review the relevant provisions of the Code, Regulations and rulings carefully. On occasion it is necessary that the lease be restructured so that the lessee is a more clearly established political subdivision in order to ensure that the lease constitutes an obligation (i.e., a "state or local bond") eligible for tax-exempt treatment for federal income tax purposes.

a. **States and Political Subdivisions and "Integral Parts" of States and Political Subdivisions.** Recall that tax-exempt debt falls into two general categories: (a) those issued by a state or political subdivision; and (b) those issued "on behalf of" a state or political subdivision.

"State" is defined in Section 103(c) of the Code to include the District of Columbia and any possession of the United States. Under applicable rules, a State includes, agencies, boards and commissions which are considered an "integral part" of a state. The term "political subdivision" for purposes of Section 103 of the Code is defined in Treas. Reg. Section 1.103-1(b) and denotes any division of a State or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of that unit, and includes, agencies, boards and commissions which are considered an "integral part" of a political subdivision. Treasury Regulation Section 1.103-1(b) notes that political subdivisions may or may not include special assessment districts (road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port, etc.) and similar districts and

divisions if such districts or divisions have not been delegated the right to exercise sovereign powers. Practitioners should become familiar with the sovereign powers tests and IRS guidance on the topic. The sovereign powers referred to in the regulations have been interpreted to be the power to tax, the power of eminent domain, and the police power (s*ee, e.g.,* Rev. Rul. 77-164; *Philadelphia National Bank v. United States*, 666 F.2d 834 (3d Cir. (Pa.) 1981).

It is usually clear when an issuer is a "State" as the term is used in Section 103 of the Code; however, questions do arise as to whether an entity qualifies as a "political subdivision" of a State for purposes of Section 103 of the Code and whether a particular agency, board, commission or body within a State or political subdivision is an "integral part" of the State or political subdivision for these purposes. Entities (*e.g.*, joint planning agencies, library boards, joint powers entities, state senators, justices of the state supreme court and sheriffs) which are not authorized to issue bonds and entities which may have bonding authority but would not likely consider issuing bonds, sometimes find themselves leasing equipment, and when dealing with such uncommon lessees, the threshold question for federal income tax purposes is usually whether the entity enjoys sufficient sovereign powers to qualify as a political subdivision or can be otherwise be treated as issuing "on behalf of" a state or local governmental unit (*see* Rev. Rul. 57-187).

b. **Constituted Authorities and 63-20 Corporations.** Under IRS rulings and interpretations, the rules have evolved into two general classes of entities which generally qualify as issuers acting "on behalf of" a State or political subdivision: (a) entities formed under state law for the express purpose of issuing bonds to effect a public purpose (i.e., "constituted authorities"); and (b) entities formed under applicable state nonprofit corporation law which comply with the requirements of Rev. Rul. 63-20.

(1) *Constituted Authorities.* Constituted authorities are entities specifically authorized by state law to issue bonds on behalf of political subdivisions of a State, among other specific powers granted to such entities in order to further public purposes. The IRS has described the "criteria" which must be present for an entity to be treated as a constituted authority empowered to issue tax-exempt debt on behalf of a political subdivision. *See* Rev. Rul. 57-187 and Rev. Rul. 60-248; *see also* PLRs 8912008, 8906058, 8419029, 8405131, 8232044, 8215025, 8207036, 8139121, 812503, 7911022. In summary, the criteria are: (i) the issuance of debt must be authorized by a specific state statute; (ii) the debt issuance must have a public purpose (which includes promotion of

trade, industry and economic development); (iii) the governing body of the authority must be controlled by the political subdivision; (iv) the authority must have the power to acquire, lease, and sell property and issue bonds in furtherance of its purposes; (v) earnings cannot inure to the benefit of private persons; and (vi) upon dissolution, title to all debt financed property must revert to the political subdivision. Published guidance includes a number of related factors which may also be applicable depending on the specific nature of the proposed lessee and all the facts and circumstances.

(2) *63-20 Corporations.* 63-20 corporations are typically used where applicable state law has not specifically authorized the formation of public corporations which would qualify as constituted authorities under Rev. Rul. 57-187. The criteria required for constituted authorities under Rev. Rul. 57-187 and the five requirements for 63-20 corporations are substantially the same. The most significant difference is the type of authorizing statute under which each is organized.

Rev. Proc. 82-26 identifies circumstances in which the five tests in Rev. Rul. 63-20 will be deemed to have been met and, consequently, the IRS will issue a favorable advance ruling. For example, the requirements that the sponsoring political subdivision have a beneficial interest in the 63-20 corporation while its bonds are outstanding and that it obtain full legal title to the 63-20 corporation's property upon retirement of the bonds will be deemed met under Rev. Proc. 82-26 if (among other requirements): (i) the [sponsoring governmental] unit may not agree or otherwise be obligated to convey a fee interest in the property to any person who was a user of the property or a related person ... within 90 days after the unit defeases the obligations...; (ii) reasonable estimate of a fair market value of the property on the latest maturity date of the obligations ... is equal to at least 20 percent of the original cost of the property financed by the obligations ...; and (iii) a reasonable estimate of the remaining useful life of the property on the latest maturity date of the obligations ... is the longer of one year or 20 percent of the originally estimated useful life of the property financed by the obligations." *See also* PLRs 8649072, 8643050, 8628081, 8615013, 8601045, 8542104, 8506112, 8402026, 8351040, 8340067, 8334081, 9322006, 9335040 and 200019023.

c. **Entities Treated as States and Political Subdivisions for purposes of Section 103 of the Code.** In addition to states and political subdivisions, including "integral parts" thereof, and "on behalf of" issuers (i.e., constituted authorities and 63-20 corporations), the Code allows certain other entities to be treated as eligible tax-exempt issuers.

(1) *Indian Tribal Governments.* Federally recognized Indian tribal governments are permitted to enter into tax-exempt leases for governmental and qualified purposes. Section 7871(a)(4) of the Code provides authority for Indian tribal governments (or a subdivision thereof) to be treated as a State for purposes of Section 103 of the Code if substantially all of the proceeds of the debt obligation are to be used in the exercise of any essential governmental function. Indian tribal governments (or a subdivision thereof) are not generally permitted to issue private activity bonds although Section 7871(c)(3) provides an exception for certain qualified small issue manufacturing bonds. A subdivision of an Indian tribal government is treated as a political subdivision of a State if (and only if) the Secretary of the Treasury determines after consultation with the Secretary of the Interior that such subdivision has been delegated the right to exercise one or more of the substantial governmental functions of the Indian tribal government. Revenue Procedure 2008-55 simplified the process of identifying qualifying tribal governments by recognizing the Federal Register's annually updated Department of the Interior list of tribes as the official list of Indian tribal governments that are to be treated as States for purposes of Section 103. The essential governmental function test is of particular significance since it relates to the status of the entity as a valid issuer of the tax-exempt debt obligation. Section 7871(e), Treas. Reg. Section 305.7871-1(d) and rulings thereunder define and set forth the scope of activities constituting an essential governmental function for this purpose. When reviewing and documenting lease financings for Indian tribal governments, it is important to consider the proper identification of the lessee and the essential governmental functions being financed, waivers of sovereign immunity, tribal authority to enter into the lease and access to tribal lands when exercising remedies under the lease and issues of jurisdiction and governing law.

(2) *Qualified Volunteer Fire Departments.* Section 150(e) of the Code provides authority for debt obligations of certain volunteer fire departments to be treated as a debt obligation

of a political subdivision of a State. Under Section 150(e), an obligation of a volunteer fire department may be treated as tax-exempt if: (1) the fire department is a "qualified volunteer fire department" (usually a nonprofit corporation) organized and operated to provide firefighting or emergency medical services in an area (within the jurisdiction of a political subdivision) which generally is not provided with any other firefighting services (disregarding any other services if they are also provided by a qualified volunteer fire department with which the qualified volunteer fire department borrower has been working together continuously since January 1, 1981), which is required by written agreement to provide firefighting services with the political subdivision; (2) 95% or more of the net proceeds of the tax-exempt issue are used for the acquisition, construction, reconstruction or the improvement of (a) a fire house (including land functionally related and subordinate thereto) or (b) a fire truck to be used by the qualified volunteer fire department; and (3) the public approval (TEFRA) requirements of Section 147(f) are satisfied. It should be noted that the special treatment of debt obligations issued by "qualified volunteer fire departments" as debt obligations of a political subdivision of a State for purposes of Section 103 is only available if the proceeds of the debt obligation are used as provided in Section 150(e) and Treas. Reg. Section 1.103-16. The Regulations provide an example of an obligation issued by an ambulance and rescue squad that is a qualified volunteer fire department but substantially all the proceeds of the obligation are used to provide emergency medical services rather than a fire house or fire truck. The Regulations conclude that the obligation is not treated as an obligation of a political subdivision of a State for purposes of Section 103. This concept may initially seem straightforward but in practice can pose significant challenges.

3. **Is the lease financing capital expenditures?** The allocation and accounting regulations under Section 148 of the Code, generally do not permit a lessee to allocate proceeds of a tax-exempt obligation to any cost that is not a capital expenditure, subject to certain *de minimis* and extraordinary expenditure exceptions, and except in the case of an issue that qualifies for restricted working capital financing. For this purpose, a "capital expenditure" is "[a]ny cost of a type that is properly chargeable to capital account (or would be so chargeable with a proper election or with the application of the definition of placed in service under § 1.150-2(c)) under general Federal income tax principles." Accordingly, with limited exceptions, lease proceeds may only be spent on expenditures that could be

capitalized under general federal income tax principles. Vendors, lessees and lessors may, on occasion, seek to finance property or costs which do not clearly qualify as capital expenditures, such as costs for certain software, maintenance or service contracts, product training, extended warranties, etc. See Part V of this outline for additional discussion of capital expenditure issues becoming increasingly common in the tax-exempt leasing industry.

4. **Is the lease in registered form?** Section 149(a) of the Code requires that a tax-exempt obligation be in registered form, but implementing a registration system can be awkward in the leasing context. It is generally possible to have the lessee agree to keep copies of all assignments with its leasing records to serve as a record of the lease owners. Any participation or division of interests in a lease, however, leads to multiple owners, whose identity the lessee (or its assignee fiduciary) may not always know. The solution has at times been to have the lessor agree to carry out the registration function. The announcement in 26 CFR § 5f.103-1 that the functionary must do so as "agent" of the issuer has led to confusion, as it may appear anomalous to a lessee that a lessor can be its "agent" for anything.

   In PLR 9128034, the IRS ruled that tax-exempt installment sale contracts with governmental entities accepted by the seller of products (or a financing affiliate) in a private placement for the exclusive benefit of the seller and that would not be sold to third parties or pledged as security in financing arrangements of the seller were "not of a type offered to the public" and did not have to be registered. Of course, publicly-offered COPs must comply with the registration requirement.

5. **Private activity obligations.** It is imperative to inquire as to the lessee's intended use of the leased property and customary for the lessee to make certain representations and covenants in the lease which demonstrate that the lease is not and will not become a private activity bond. Covenants against subleases to any nongovernmental entity should be included in the lease to prevent the private business use test from being met. If the lease-financed property meets the private business use test, the "private security" test of Section 141(b)(2) of the Code will be met when the financed property serves as "security" for the lease obligation.

   If the governmental lessee defaults under the lease or does not appropriate base rentals and, therefore does not renew the lease, then federal tax issues will arise concerning continued tax exemption for interest components of the lease payments (that may be evidenced by outstanding COPs) if the real estate or equipment that is the subject of the lease is then subleased to other users that are not governmental entities, thus causing a change in use to "private business use." The special (lease) counsel's opinion on the tax exemption for the interest component of the lease payments should contain an appropriate exception for this situation, and if there is official statement

for the COPs, it should contain appropriate disclosure of the risk of taxability in that situation.

Notwithstanding the private activity considerations described above, it should be noted that leases can be structured and issued as tax-exempt qualified private activity bonds under the Code where private use may be acceptable. For example, a lease might be structured as a qualified 501(c)(3) bond under Section 145 of the Code. Structuring a lease as a qualified private activity bond may require several changes to the provisions of the lease (e.g., to accommodate sublease(s) by the governmental issuer to 501(c)(3) organizations) and of course, it would require compliance with the various tax rules related to qualified private activity bonds (e.g., TEFRA requirements).

6. **Reporting.** A lease may require the filing of IRS Form 8038 (where the lease is structured as a private activity bond), 8038-G or 8038-GC. IRS Forms 8038-G and 8038-GC have instructions specifically applicable to leases. A lease financing may present unique reporting issues that will need to be addressed for purposes of tax reporting requirements. Some of the unique reporting issues a practitioner may encounter are described below. Note, however, that lessees often do not engage counsel to assist with smaller municipal leases, and lessors generally refuse to assist with preparation of the forms in an effort to avoid being treated as a paid preparer (paid preparer requirements have applied to the series 8038 forms since 2009). This can make accurate reporting a challenge in some cases. Lessees should be advised regularly to exercise caution when reporting lease transactions without the involvement of bond counsel or the lessor, as paid preparer.

The instructions for Line 20 of IRS Form 8038-G (and for Line 9 of IRS Form 8038-GC) refer to "municipal leases" as financing structures where property other than cash is exchanged for the lease obligation. For example, the acquisition of a police car, fire truck or other equipment may be accomplished by execution of a lease financing and exchange of the vehicle or equipment for a series of monthly payments. However, not all vehicle and equipment leases should be treated as bonds exchanged for property (i.e., not all leases should be designated as a "municipal lease" for purposes of the series 8038 forms). Local counsel and lessees often improperly designate a lease as a municipal lease when the lease is exchanged for cash rather than property. Where proceeds of a lease are received in the form of cash, as is often the case when an escrow account is established and funded for future spenddown at closing, the lease should be treated as issued for cash. The determination of whether a lease is exchanged for property or for cash should be made taking into account all the facts and circumstances, and the series 8038 form should be completed accordingly.

The instructions to IRS Form 8038-G provide certain special rules with respect to leases satisfying the requirements of Line 20 for completing certain lines calling for computed quantities. Stated Redemption Price at Maturity is not to be reported for such leases ("NA" should be put in its place). In place of reporting the weighted average maturity, one just reports the total number of years that the lease will be outstanding. Instead of reporting the yield on a lease, one reports the effective interest rate. The entire Part IV (used to show a breakdown of the uses of proceeds) for a lease may be omitted with just the insertion of NA in the appropriate place. These special rules generally make it easier to complete an IRS Form 8038-G for a lease that qualifies as a municipal lease exchanged for property under the rules of Line 20.

Also, from time to time, the named lessor may not actually be financing the equipment. For example, the named lessor may be assigning the lease upon closing in a pre-arranged sale to an assignee. That assignee may actually provide the financing. Treas. Reg. § 1.1273-2(e) of the Treasury Regulations states that in determining issue price, sales made to placement agents and similar intermediaries are ignored. Treas. Reg. § 1.148-1(f) similarly ignores purchases by "underwriters." The payment schedule and language of an assigned Lease should make it clear that the named lessor is not financing the equipment itself, but rather is assigning the lease to an assignee that is financing the equipment. In such cases, the lease should appropriately be treated as issued for cash, even if no cash escrow is funded. If the lease is treated as issued for cash, as opposed to property, the issue price should be the price paid by the assignee. It may be necessary to consult with tax counsel to ensure tax reporting is done accurately.

Lease financing transactions sometimes require the lessee to make its first lease payment on the issue date or funding date of the lease (*e.g.*, an advance payment structure or down payment). In other lease financing transactions, a third party (such as a vendor) makes an initial principal payment on the issue date or funding date (a financial incentive from the vendor). In each of these examples, the principal payment on the issue date or funding date results in a reduction of the issue price reported on the appropriate series 8038 form. Original issue discount may also be found in certain lease arrangements where a lease is assigned at closing at a discount.

Some lease financing transactions are facilitated by lease brokers, who introduce potential funding sources to potential lessees in exchange for a fee. The broker is often compensated by the lessor on behalf of lessee out of proceeds of the lease. Generally, the lessor and lessee determine the cost of the equipment or other improvements to be financed with lease proceeds and set this amount as the par amount of the lease. Next, the lessor and lessee agree upon an interest rate and amortization schedule for the lease that is based upon the par amount of the lease. Then, the broker's fee is added as an additional premium on the lease over the par amount of the

lease. When the transaction closes, the lessor pays this amount on behalf of the lessee to the broker as compensation for introducing the lessor to the lessee. The premium generated on the lease must be reported on the appropriate series 8038 form. The premium is included in the issue price of the lease reflecting the additional proceeds generated on the lease. The amount of the broker's fee should be reflected on the series 8038 form as a cost of issuing the lease. As a result of the premium generated on the lease, the lessee in effect has borrowed additional proceeds and used these additional proceeds to pay costs of issuance but the amortization schedule and interest rate on the lease have not changed. This requires the person preparing the series 8038 form to calculate the yield on the lease reflecting the true total proceeds generated based upon the agreed upon amortization schedule. The result is the lessee in effect pays a reduced interest rate to the lessor and the yield on the lease is lower than the interest rate agreed upon between the lessor and borrower. The same concept may apply where the lessor agrees to pay other fees not included in the par amount of the lease.

7. **Is the lease federally guaranteed under Section 149(b) of the Code?** Even if the lease does not mention it, many leases are in fact paid with moneys derived from federal grants or other assistance, such as grants or aid provided for a welfare department's computer, for a state's Medicaid program or for a university's lab. Whether the receipt of a federal grant or other assistance in amounts determined in whole or in part by reference to the lease payments constitutes a federal guaranty is a factual question determined by analyzing the terms of the federal program.

8. **Is the lease an arbitrage bond?** The same basic arbitrage rebate and yield restriction requirements that apply to tax-exempt bonds must be met for tax-exempt leases, but participants in lease financing often lack understanding and expertise in this area and believe the amounts involved are not great enough to merit paying for the expertise needed to comply with the arbitrage rebate and yield restriction requirements. To obtain an exception to the rebate requirement for both equipment and real property lease financings, reliance often is placed on the small issuer (under $5 million with a larger limit for school construction) exception or the 6-month spending exception.

   The arbitrage regulations also contain an 18-month spending exception for any financing eligible for a 3-year temporary period for unrestricted investment of proceeds (generally, where proceeds are used to finance capital purposes or projects, including acquisition of property as well as construction), if all of the gross proceeds are spent according to a required spending schedule over three 6-month spending periods.

   Similarly, in a lease financing of a construction project (including "constructed" personal property), the "available construction proceeds" may be eligible for the 2-year spending exception from the rebate requirement for a "construction issue" (an issue in which at least 75% of the

available construction proceeds will be used for construction expenditures), if all of the available construction proceeds are spent according to a required spending schedule over four 6-month spending periods.

If any gross proceeds are held in a reasonably required reserve or replacement fund for the tax-exempt lease or an issue of COPs therein, those gross proceeds are not required to be spent to satisfy any applicable spending exception, but generally will be subject to the rebate requirement from the issue date. Reference should be made to other outlines on arbitrage-related topics for the specific requirements applicable to rebate exceptions and arbitrage requirements generally.

9. **Is the transaction an "investment trust with multiple classes"?** See discussion of special issues relating to COPs in Part IV below.

10. **Has the lessee properly designated the lease as a "qualified tax-exempt obligation" for purposes of Section 265(b)(3) of the Code?** If a governmental lessee is eligible to designate its lease obligation as a "qualified tax-exempt obligation" for purposes of Section 265(b)(3) of the Code (because the lessee does not reasonably anticipate issuing more than the current maximum threshold allowed of tax-exempt obligations in that calendar year under Section 265(b)(3)) of the Code, it is generally beneficial to the lessee to do so because the designation makes the lease more attractive to banks and other financial institutions which is, in turn, taken into account in pricing. Counsel may be asked to give an opinion that the lease is a "qualified tax-exempt obligation" for banks and other financial institutions. Depending on the circumstances, however, that opinion may be difficult to provide because of the extent of due diligence that may be required to determine the amount of outstanding tax-exempt obligations of the lessee and the basis for the "reasonable expectations" of the lessee regarding its eligibility to designate obligations in any particular calendar year. In most cases, a certification by the lessee should be sufficient for this purpose. In addition, if the issuer of the tax-exempt obligation is an "on behalf of" issuer, it is important to remember that such issuer must take into consideration other tax-exempt obligations (and reasonable expectations) of the state or local government on behalf of which the obligation is being issued, when making a determination as to whether a tax-exempt obligation is a "qualified tax-exempt obligation."

IV. SPECIAL ISSUES RELATING TO COPS

A. Fractionalized Interests.

COPs represent for an investor (the "COP Investor") a fractionalized interest in a lease and rights thereunder, the rental payments and the security for said lease (collectively, the "Assigned Lease"). The mechanism used for such fractionalization of the Assigned Lease is assignment of the lessor's interest in the Assigned Lease by the original lessor to a trustee pursuant to a trust

indenture. The trust indenture establishes the rights of the COP Investors in the Assigned Lease and mechanisms and procedures for enforcement of rights under the Assigned Lease by the trustee for the benefit of all of the COP Investors. The fractionalization of the Assigned Lease can be either vertical, whereby the COP Investor is acquiring rights in the stream of rental payments over the life of the Assigned Lease (for example, purchasing 50% of the rental payments coming due on each and every rental payment date) or horizontally, whereby the COP Investor is purchasing the rights in the principal component of rental payments for just certain rental payment dates, as well as the interest component of rental payments that accrues on the purchased principal component payable on each of the rental payment dates. COPs representing vertical fractionalization usually have one interest rate attributable to each principal component of rental payments (but are not required to), while COPs representing horizontal fractionalization usually have separate interest rates for each principal component maturity date (to avoid large premiums on early maturity COPs and deep discounts on late maturity COPs). Care must be taken to make sure that interest accruing on one principal component of rental payments is not allocated to principal component with a differing maturity date. Doing so creates a separate security for both federal tax and federal securities law analysis with the probable result of loss of tax-exempt status of interest and loss of security law exemptions.

For federal income tax purposes, COP structures should be reviewed to ensure the transaction does not create an "investment trust with multiple classes." In the May 2, 1984 Federal Register, the United States Treasury proposed amendments defining "trusts" for federal tax purposes; the final regulations were published in the March 24, 1986 Federal Register. As the Treasury proposal was originally worded, it was feared that a certificated tax-exempt lease (i.e., COPs) with serial "maturities" bearing different interest rates would be treated as a "trust" with multiple classes of interests, such that the trust would be taxable as a corporation. A press release at about that time relating to a State of New Jersey lease transaction substantiated that fear. The final regulations made it clear that pass-through treatment as a grantor trust would result if the interest rate or rates on the COPs matched those formally set out in the underlying certificated lease.

B. Characterization of the COPs.

Inasmuch as COPs are executed and delivered by a trustee to whom the Assigned Lease has been assigned by virtue of a trust indenture and evidence a direct and proportionate interest of the owner thereof in the rental payments under the Assigned Lease, several questions are raised as to what the COPs are and what they should be to preserve the tax-exempt treatment of distributions which represent the interest component of the underlying lease payments and to maintain the exemption from registration for the COPs under Section 3(a)(2) of the 1933 Act.

1. **Should the lessee be a party to the trust agreement between the lessor-assignor and the trustee and also appear in some fashion as a signatory (whether by authentication or otherwise) on the face of the COPs?** Practitioners differ as to the desirable level of lessee involvement to demonstrate its participation in the COPs process, particularly in light of the paucity of statutory authority as to what actions the lessee is authorized to take in this respect under state law. Generally, it would be advisable to have the issuer-lessee approve, or at least acknowledge, the trust agreement.

It does not appear to be common practice for the issuer-lessee to sign or authenticate the actual COPs and such a practice may cause state law problems in respect of the creation of debt.

2. **Is specific legislation required for COPs transactions?** While specific legislation may be of comfort to those practitioners who render approving opinions with respect to COP transactions, particularly depending upon the nature of the lessee's participation in the certification process, the number of such transactions in a variety of jurisdictions suggests that the lack of specific legislation is not an impediment to these transactions. If achievable, however, specific legislation supporting the lessee's participation in the COPs process would be desirable.

3. **What opinions should counsel render in COPs transactions?** The practice differs widely as to the opinions that counsel should render in a COPs transaction beyond those opinions that are customary as to the validity of the lease and the tax-exempt treatment of the interest component of lease payments. For example, what opinions should special counsel render as to distributions with respect to the certificates or the due authorization, execution and delivery of the trust agreement by the lessor or the compliance of any continuing disclosure undertaking with local law? What, if any, opinions of trustee's counsel should be requested with respect to the due execution and delivery of the COPs themselves.

4. **Does interest payable only from earnings on proceeds from the sale of COPs constitute interest on an obligation of a state or local government?** COPs transactions are often structured so that interest accruing during a construction or installation period is paid from capitalized interest or from interest earnings on the proceeds from the sale of the COPs. In states like California, a lessee generally cannot be obligated to make lease payments before the property is available for the lessee's use. Leases in those states frequently provide that the lessee's obligation to make lease payments during the construction or installation phase is limited to the amount of the capitalized interest or to earnings on the proceeds from the sale of the COPs.

Technical Advice Memorandum (PLR 9721003), dated January 24, 1997, described a transaction in which several local governments (the "Districts") participated in a pool designed to provide funding to meet cash flow needs. Each District executed a promissory note obligating it to pay the principal amount of the note plus interest at a specified rate, but not more than the District's "Payment Obligation," which was defined in the COPs documents. A corporation pooled the notes and assigned them to a trustee. The trustee executed and delivered COPs evidencing undivided interests in the aggregate payments due under the notes. The COPs proceeds were used to purchase an investment agreement at a yield sufficient to pay the interest accruing on the COPs until the Districts drew down the funds to meet operating expenses.

The IRS held that the proceeds of the COPs were not received by the Districts until they were withdrawn from the investment agreement and that prior to the withdrawal the notes were not deemed to be issued. The practical effect of the IRS' conclusion is that interest accruing on the COPs prior to withdrawal of the funds from the investment agreement is not interest on an obligation of a state or local government. The IRS based its position on a determination that prior to a withdrawal from the investment agreement, the notes represented only a right to draw on the funds rather than an interest in the funds themselves. This determination was based on the fact that each District's Payment Obligation, and, thus promise to pay under its promissory note, was equal to zero unless a draw was made. The IRS further supported its conclusion that the Districts did not have an interest in the funds by the fact that the trustee for the COPs was directed to invest the COPs proceeds in an investment agreement, which would not have been a permissible investment for the Districts.

Many lease transactions utilize a structure very similar to the one described in the Technical Advice Memorandum. To avoid the adverse results mandated by the Memorandum, the transaction documents should make it very clear that the proceeds of the COPs are the funds of the lessee from the date the proceeds are received and that the lessee has an unequivocal obligation to make the lease payments. In carefully drafted documents, it should still be permissible for the payment obligation to be satisfied only from specified sources of funds, such as accrued interest or investment proceeds. Consistent with the concept that the proceeds of the COPs are the funds of the lessee, proceeds derived from a COP should be invested only in obligations which are permitted investments for the lessee.

V. CERTAIN OTHER FEDERAL TAX ISSUES IN LEASING

A. Tax-Exempt Financing of Intangibles.

Financing intangible assets (e.g., service contracts, maintenance contracts, support, software licenses, cloud services, software-as-a-service (SaaS) agreements, etc.) on a tax-exempt basis requires careful analysis of all the facts and circumstances surrounding each financing, including, but not limited to, the nature and description of the financed assets, the financing structure and the financing terms. While not unique to leasing, this issue is a common part of the tax due diligence process for tax-exempt lease transactions as vendors, lessors, tax-exempt issuers and others are increasingly seeking to finance myriad types of intangibles using traditional lease and installment sale structures, sometimes revised to eliminate collateral and leasing concepts as the same are not often compatible with financing intangibles.

As stated previously in prior sections, the allocation and accounting regulations under Section 148 of the Code generally do not permit an issuer to allocate proceeds of a tax-exempt obligation, including a tax-exempt lease, to any cost that is not a capital expenditure, subject to certain *de minimis* and extraordinary expenditure exceptions, and except in the case of an issue that qualifies for restricted working capital financing. For this purpose, a "capital expenditure" is "[a]ny cost of a type that is properly chargeable to capital account (or would be so chargeable with a proper election or with the application of the definition of placed in service under § 1.150-2(c)) under general Federal income tax principles." Accordingly, with limited exceptions, tax-exempt proceeds may only be spent on expenditures that could be capitalized under general federal income tax principles.

As of the date hereof, general guidance concerning the capitalization of intangible expenses is available, but practice varies widely among practitioners as to whether or not intangibles can be financed as capital assets on a tax-exempt basis. Some practitioners are comfortable financing only *de minimis* amounts of intangibles on a tax-exempt basis, while others have undertaken a more complete analysis of direct and analogous tax guidance and concluded that a prepayment of expenses for intangibles (e.g., computer software or related maintenance and services) that does not constitute a "purchase" can still be treated as a created intangible and a capital expenditure for purposes of the arbitrage rules applicable to tax-exempt obligations.

In most cases, when it is determined that an intangible can be financed on a tax-exempt basis, the intangible is prepaid. Practitioners should note that the payment of expenses before goods or services are received typically implicates two separate, but similar, rules applicable to tax-exempt obligations: the prohibition on private loan financing and the arbitrage rules applicable to investment-type property. For a further description of these rules, see "Prepayment of Vendors" below.

Federal tax considerations relating to the financing of intangibles are in addition to any state law considerations raised by the financing of intangibles (e.g., whether the applicable state law authority actually permits the financing of intangibles as personal property, whether alternative statutory authorities allow the prepayment of and/or acquisition of intangibles, whether a security interest can be taken and perfected in intangibles under the UCC).

B. Prepayment of Vendors.

Tax-exempt lease proceeds may be used to prepay certain items not provided until a later date. If certain requirements are not met, the Internal Revenue Service may treat any such uses of lease proceeds (for example, but without limitation, the prepayment of intangibles) as investment-type property subject to the arbitrage yield restriction and rebate rules under Treas. Reg. §1.148-1(e), or as a private loan prohibited by the private activity bond rules of Treas. Reg. §1.141-5.

1. **Investment Type Property**. For interest on State or local bonds (including tax-exempt leases) to be excluded from the gross income of the bondholder under Section 103 of the Internal Revenue Code of 1986 (the "Code"), the bonds must satisfy various eligibility requirements, including a requirement that the bonds not be arbitrage bonds as defined in Section 148 of the Code. Section 148(a) generally defines an "arbitrage bond" as any bond issued as part of an issue any portion of the proceeds of which are reasonably expected to be used or are intentionally used to acquire "higher yielding investments" or to replace funds so used. Section 148(b)(1) defines the term "higher yielding investments" as any "investment property" that produces a yield over the term of the issue that is materially higher than the yield on the issue. Section 148(b)(2) defines the term "investment property" to include any security, any obligation, any annuity contract, certain residential rental property, and any "investment-type property." In general, except as otherwise provided in Treas. Reg. §1.148-1(e), a prepayment for property or services, including a prepayment for property or services that is

made after the date that the contract to buy the property or services is entered into, gives rise to investment-type property under the Code if a principal purpose for prepaying is to receive an investment return from the time the prepayment is made until the time payment otherwise would be made.

2. **Private Loan**. Treas. Reg. §1.141-5 provides that bonds of an issue are private activity bonds if more than the lesser of 5 percent or $5 million of the proceeds of the issue is to be used (directly or indirectly) to make or finance loans to persons other than governmental persons. In determining whether the proceeds of an issue are used to make or finance loans, indirect, as well as direct, use of the proceeds is taken into account. In general, any transaction that is characterized as a loan for federal income tax purposes is a loan for purposes of the private loan financing test. In addition, a loan may arise from the direct lending of bond or lease proceeds or may arise from transactions in which indirect benefits that are the economic equivalent of a loan are conveyed. Thus, the determination of whether a loan is made depends on the substance of the transaction rather than its form. Under Treas. Reg. §1.141-5(c)(2)(ii), "[e]xcept as otherwise provided [in the regulation], a prepayment for property or services, including a prepayment for property or services that is made after the date that the contract to buy the property or services is entered into, is treated as a loan for purposes of the private loan financing test if a principal purpose for prepaying is to provide a benefit of tax-exempt financing to the seller."

3. **Avoiding "investment-type property" and private loans in tax-exempt leasing**. The federal tax requirements that must be satisfied to ensure that using tax-exempt lease financing proceeds for prepayments will not result in arbitrage under Treas. Reg. §1.148-1(e), or private activity bond status under Treas. Reg. §1.141-5, are effectively identical, so compliance with one test resolves the concern of compliance with the other. As a result, the concerns raised by prepayments are often conflated when discussing the issue, notwithstanding the fact that two separate tax rules are implicated.

   Treas. Reg. §1.141-5(c)(2)(ii) states that "Except as otherwise provided, a prepayment for property or services, including a prepayment for property or services that is made after the date that the contract to buy the property or services is entered into, is treated as a loan for purposes of the private loan financing test if a principal purpose for prepaying is to provide a benefit of tax-exempt financing to the seller."

   Treas. Reg. §1.141-5(c)(2)(ii) and Treas. Reg. §1.148-1(e)(2)(i)(A), state, respectively, that "a prepayment is not treated as a loan for purposes of the private loan financing test" and "a prepayment does not give rise to investment" if any of the following three tests can be satisfied:

a. Prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing (the "Customary Prepayments Test");

b. The prepayment is made within 90 days of the reasonably expected date of delivery to the issuer of all of the property or services for which the prepayment is made; or

c. The prepayment meets the requirements of §1.148-1(e)(2)(iii)(A) or (B) (relating to certain prepayments to acquire a supply of natural gas or electricity).

The third test is rarely, if ever, applicable to tax-exempt lease financing transactions and the second test is limited in applicability to prepayments made within 90 days of final delivery of the property or services (in practice, most prepayments are made more than 90 days in advance, limiting the applicability of this provision), requiring the majority of tax-exempt lease financings where proceeds are used to prepay vendors or contractors to meet the Customary Prepayments Test.

Whether a prepayment satisfies the Customary Prepayments Test is generally made based on all the facts and circumstances; however, the regulations provide safe harbors for certain prepayments. See Treas. Reg. §1.141-5(c)(2)(iii)(A) and Treas. Reg. §1.148-1(e)(2)(ii)(A). The Customary Prepayments Test is deemed satisfied under the safe harbors if the prepayment is:

a. made for maintenance, repair, or an extended warranty with respect to personal property (for example, automobiles or electronic equipment), or updates or maintenance or support services with respect to computer software; and

b. the same maintenance, repair, extended warranty, updates or maintenance or support services, as applicable, are regularly provided to nongovernmental persons on the same terms.

Where the facts preclude application of the safe harbor, a practitioner must ensure that prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer of the tax-exempt lease, but who are not beneficiaries of tax-exempt financing.

Note that when a tax-exempt lease financing transaction involves a prepayment it is common for bond counsel or special tax counsel to request a certificate from the vendor or contractor who is the recipient of the prepayment. In the certificate the vendor or contractor makes representations about the terms on which it offers other buyers who are not

beneficiaries of tax-exempt financings, and, where applicable, specific representations can be requested to ensure the terms of the Customary Prepayments Test safe harbor apply to the transaction.

VI. COMMERCIAL FINANCIAL DISCLOSURE LAWS

Commercial financial disclosure laws (each a "CFDL" and together, "CFDLs"), first enacted in 2019, are becoming more common across the nation. CFDLs generally seek to require lenders to provide consumer-type disclosures in commercial loan transactions to allow small businesses to make more informed borrowing decisions. Lessors and lenders, and their counsel, and bond counsel delivering validity opinions in municipal financings, should be aware of any applicable CFDLs. The extent to which CFDLs apply to municipal lease financing transactions varies in each particular jurisdiction where a CFDL has been enacted. As of October 2023, seven states have CFDLs on the books (in some cases, with future effective dates), namely (1) California (California Financial Code, Section 22800, et. seq., and California Code of Regulations, Title 10, Sections 900-956); (2) Connecticut (Public Act No. 23-201); (3) Florida (House Bill 1353); (4) Georgia (Senate Bill 90); (5) New York (Consolidated Laws of New York Annotated Financial Services Law, Section 801, et. seq.); (6) Utah (Utah Code Annotated, Section 7-27-201 et. seq.); and (7) Virginia (Virginia Code Annotated, Section 6.2-2228, et. seq.).

Lenders subject to those laws and regulations are likely required to make compliant disclosures, unless they can avail themselves of certain exceptions. A short summary of enacted CFDLs follows, but practitioners should refer to the referenced statutes and laws for a more complete description of each CFDL and a description of the disclosures actually required:

The California CFDL applies to commercial loans in a principal amount of $500,000 or less, but at least $5,000, and includes certain lease financings. Depository institutions, loans secured by real property, true leases and lease financings subject to termination by the lessee are exempted from the California CFDL.

The Connecticut CFDL requires providers of sales-based financings to provide certain disclosures. Sales-based financings include transactions where repayment is tied to revenues or sales. Banks and certain credit unions are excepted from the Connecticut CFDL. Commercial financing transactions that are secured by real property, that constitute a lease, that involve a provider that consummates no more than five transactions in Connecticut during a twelve-month period or that exceed $250,000 are exempted from the Connecticut CFDL.

The Florida CFDL requires persons who consummate more than five commercial financing transactions in any calendar year to provide disclosures. The commercial financings subject to the Florida CFDL include commercial loans, the proceeds of which are provided to a business or are intended to be used to carry on a business (including a corporation and potentially municipal corporations) and not to be used for personal, family, or household purposes. Providers that are federally insured depository institutions or subsidiaries or service corporations owned and controlled by federally insured depository institutions are exempted from the Florida CFDL, as are financing transactions that are secured by real property, that constitute a lease, that involve a provider that consummates no more than five transactions in Florida during a twelve month period or that exceed $500,000.

The Georgia CFDL requires persons who consummate more than five commercial financing transactions in any calendar year to provide disclosures. The commercial financings subject to the Georgia CFDL include commercial loans to a private enterprise carried on for the purpose of gain or economic profit. Tax-exempt lease financings may not involve a loan to a private enterprise such that the Georgia CFDL may not be applicable.

The New York CFDL applies to loans, leases and other forms of financing in a principal amount of $2,500,000 or less. Certain financial institutions are exempted from the New York CFDL, as are true leases, financings secured by real property, persons lending infrequently (no more than five financings in a 12-month period).

The Utah CFDL is very similar to the Georgia CFDL, but includes a registration requirement, subjecting certain lenders to oversight by state regulators.

The Virginia CFDL is narrow and applies only to sales-based financings, transactions which apply only to merchant cash advance providers.

In addition to the states described above, several other states have proposed and even seen CFDLs progress through the law making process. For example, Maryland's proposed CFDL (Senate Bill 496) has been referred to committee and may be in effect on October 1, 2023. In addition, the following states have proposed various forms of CFDLs: Illinois (Senate Bill 2234 and House Bill 3064), Kansas (Senate Bill 245), Missouri (Senate Bill 187 and House Bill 584), North Carolina (Senate Bill 539), and Mississippi (Senate Bill 2619 and House Bill 1271, both of which have since failed). New Jersey's CFDL remains pending during the carry-over session (Senate Bill 819 and House Bill 2150). Other proposals are expected to be forthcoming.

In 2022, the Consumer Financial Protection Bureau ("CFPB") received a request from an industry trade association to determine whether New York's CFDL is preempted by the Truth in Lending Act ("TILA"). The CFPB's preliminary determination was that the New York law is not preempted by TILA because the New York law regulates commercial financing transactions rather than consumer-purpose transactions. On March 28, 2023, the CFPB announced it had determined that CFDLs in California, New York, Utah, and Virginia are not preempted by TILA. TILA is intended to ensure that credit terms are disclosed in a meaningful way to consumers, so they can better compare lending options. The California, New York, Utah, and Virginia CFDLs require lenders to include disclosures in their commercial financing transactions with businesses. Commercial financing transactions, according to the CFPB, are not covered by TILA.

The Uniform Laws Commission is currently studying the need for and feasibility of a uniform or model act providing for standardization of CFDLs across the states. As with other uniform laws, even if a uniform law is drafted, states are free to choose whether to adopt the uniform law, and whether to customize the law.

To determine whether a particular CFDL relates to a specific financing and the lender or lessor in such transaction, practitioners should carefully review the defined terms, exemptions and/or exceptions, and the regulatory reach of the particular CFDL. To the extent disclosures are required, practitioners representing lenders and lessors should be aware of the requirements, and

practitioners representing the recipient of the financing should evaluate the effect of compliance, or more importantly, non-compliance with any applicable CFDL.

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