

PENNSYLVANIA FINANCING INCENTIVES

UNDERSTANDING WHAT IS INVOLVED BEFORE YOU APPLY

The Commonwealth of Pennsylvania, primarily through the Department of Community and Economic Development (DCED) but through other state agencies as well, administers financial incentive programs for a wide variety of business purposes. These financial assistance programs exist to encourage businesses to locate or expand operations within the state and to create or retain jobs. For businesses, access to state incentive programs can help reduce the cost of financing for capital projects and, in the case of tax credits and tax abatements, lower the state or local tax burden of the business.

However, some businesses attempt to take advantage of state financing programs without a full understanding of the conditions that may be placed upon the use of state funds. In such cases, unanticipated transactional costs and other unintended consequences may outweigh the benefits of obtaining low-cost capital.

State financing programs are not for the unprepared. There truly is no such thing as “free money.” However, with proper planning and a full understanding of what the acceptance of state funds will mean, successful access to and use of state financing programs can be readily accomplished.

The following is a brief overview of some circumstances that businesses may encounter when applying for state financial assistance.

I. Types of State Financial Assistance

Financial assistance offered by Pennsylvania generally takes one or more of the following forms: grants, loans, loan guarantees, bond financing, tax credits, tax abatements and equity-like investments.

II. Conditions Generally Applicable to All State Financial Assistance

Most Pennsylvania financial assistance programs require that a certain number of jobs be created or retained when a company seeks state financial assistance, and that the company itself must make a financial investment (either through company equity or with funds obtained from other non-state sources). If the business fails to create or retain the specified number of jobs, or to make the required amount of financial investment, the business may be assessed a “clawback.” A clawback requires the business to repay all or part of the state assistance received, or, in the case of a loan, the interest rate on the balance of the loan may be increased to market rate or

higher for the remainder of the loan term. A clawback may also apply if the business closes or downsizes within a certain period of time after receiving the state assistance.

Pennsylvania usually allows the business to provide a justification as to why it was not able to fulfill the job or investment conditions under which the assistance was provided. If the justification is acceptable to the state, the clawback may be reduced to a percentage of the state assistance provided or waived entirely. Justifications that are currently accepted by the state relate to the occurrence of a natural disaster, a declining industry trend, a lack of available labor force and the loss of a major supplier.

III. Grants

Everyone wants grant money because it is generally viewed – incorrectly – as “free money.” While repayment of grant money is not anticipated, most grants come with conditions that could result in repayment if the conditions are not met. These include the job creation/retention and financial investment conditions described above.

Grant awards can have tax and accounting consequences for a business. The award of grant money may be considered as income to the business and be subject to local, state and/or federal taxation. Recent changes in accounting standards may also require grants that are subject to specified conditions be treated as contingent liabilities until those conditions are satisfied. Any business seeking to obtain grant funding should consider potential tax and accounting consequences before accepting a grant award.

IV. Loans

State loan programs generally carry below-market interest rates and more favorable terms and conditions than may be available from a commercial lender. In some cases, a state loan program will accept a subordinated lien position. As a general rule, state loans may not finance the entire cost of a project; therefore, businesses either have to obtain complementary financing from traditional lending sources or finance the balance of the project with company funds.

As with a commercial lender, the state requires sufficient collateral to secure a loan and proof of the business’ financial ability to repay. Company-prepared financial statements and projections may not be acceptable, in which case the business may need to have financial statements or projections prepared by an independent certified public accountant.

The state will want to know the identity of all individuals who own 20% or more of the company (this applies not just to loan financing but to other forms of financial assistance as well). The state may also request to see personal financial statements and require that personal guarantees be provided.

Many loan programs require that applications be submitted through local economic development organizations, which are usually county-based or regional economic development

agencies. Most of these organizations charge the business a fee for the preparation and submission of a loan application and require the business to cover closing costs for the loan. (Some state programs also charge an application fee or a commitment fee.) The business should discuss fees and other charges at the outset with these intermediary organizations.

If a borrower fails to repay a loan, the state will exercise all rights available to it as a creditor, including foreclosure and obtaining a judgment against the borrower. However, the state is usually more willing to enter into a workout agreement or alternative payment plan with a financially troubled business, particularly if it means the difference between the business' remaining open or closing its doors. Likewise, the state is also more willing to allow debt owed to the state to be reaffirmed as part of a reorganization plan filed by a business restructuring in bankruptcy.

V. Loan Guarantees

The state administers a small number of loan guarantee programs. They are generally for small loans made by banks to small businesses. The guarantees are limited to a percentage of the total loan amount. The state also operates a tax increment financing (TIF) guarantee program, whereby all or a portion of TIF debt may be guaranteed by the state in the event the primary source of security proves to be insufficient.

For the most part, the state relies on the underwriting performed by the lender rather than re-analyzing the creditworthiness of the business and the collateral provided. However, if the state finds deficiencies with the lender analysis, it may perform its own evaluation and require additional collateral to be provided.

VI. Bond Financing

Instead of obtaining a traditional bank loan, a business may find it to be more cost-effective to borrow money through the issuance of tax-exempt or taxable bonds using a local or statewide bonding authority. (The terms "tax-exempt" and "taxable" refer to whether or not the interest paid on those bonds will be subject to payment of federal income tax.) The use of tax-exempt bond financing is limited by federal law and is principally applicable to manufacturers, certain energy producers, private water companies, businesses that utilize certain waste byproducts, and non-profit 501(c)(3) corporations.

The Pennsylvania Economic Development Financing Authority (PEDFA) is a statewide bond financing authority that issues tax-exempt and taxable bonds and other forms of debt. There are three potential advantages to using PEDFA. First, if the business wants to fund projects in more than one county, working with one statewide issuer rather than two or more county issuers simplifies the process and reduces costs. Second, PEDFA may "pool" two or more unrelated projects as part of a single bond issue, thereby reducing transactional costs. Finally, as a state entity, PEDFA is given preference in obtaining tax-exempt "volume cap," a federal mandate designed to limit the amount of private activity tax-exempt bonds that are issued each year.

Notwithstanding these benefits, a small- to modest-sized project may prefer to use a county or local authority for a bond issue. For smaller projects, the PEDFA process can be rigid and inflexible. If structural freedom is a concern, a county authority may be more appropriate. Projects that require a large amount of volume cap must utilize PEDFA.

The key to pursuing a bond issue is “crunching the numbers.” Tax-exempt bond financing may result in a lower interest rate than would be available through traditional lending, but the additional transaction costs may result in a cost of borrowing comparable to that of a traditional loan.

VII. Tax Credits

Tax credit programs offer credits against payment of certain state-imposed taxes, typically the Personal Income Tax (PIT), the Corporate Net Income Tax (CNI) and the Capital Stock and Franchise Tax (CSFT).

Tax credit programs come in many forms, and the eligibility criteria vary greatly. Some tax credits must be used by the business in the tax year in which the credit is awarded, while other tax credits may be carried forward for a period of time. As a general rule, unused tax credits are not subject to refund. Failure to comply with all of the requirements pertaining to the award of tax credits could lead to a rescindment of the credits.

A recent feature for some tax credit programs is “tradability,” allowing unused tax credits to be sold to other taxpayers. This tradability feature allows the business that was originally awarded tax credits but cannot use them to sell the credits to another business that can use the credits.

VIII. Tax Abatement

The principal tax abatement program for Pennsylvania is the Keystone Opportunity Zone (KOZ) program. Businesses that locate within a KOZ do not pay most Pennsylvania state taxes, nor do they pay local real estate or business taxes (collectively referred to as the “KOZ Benefits”). A KOZ exists only for a specified period of time and KOZ Benefits are available only while the zone is in existence. Most zones expire either at the end of 2010 or 2014. The KOZ Program and all remaining zones will expire by the end of 2018.

A business contemplating a move into a KOZ should consult with a tax advisor or counsel to determine its full eligibility for KOZ Benefits. A business seeking to locate a new facility within a KOZ is entitled to claim KOZ Benefits regardless of the size of the operations within the KOZ or the number of employees to be hired. However, a business currently located in Pennsylvania that wants to relocate its operations inside a KOZ may receive KOZ Benefits only if it meets one of the following criteria: (1) the business increases its workforce by 20% within the first year inside the KOZ; (2) the business makes a capital investment equal to 10% of its gross revenues for the prior calendar or fiscal year; or (3) the business enters into a lease

agreement for a term equal to the duration of the KOZ with an aggregate lease payment equal to a least 5% the business's gross revenues for the prior calendar or fiscal year.

If a business receives KOZ Benefits, but moves out of the KOZ within 5 years, or if a business relocates into a KOZ and fails to meet one of the three criteria described above, the business may be liable to pay the appropriate state or local taxing bodies' part of the value of the KOZ Benefits it received.

IX. Equity and Equity-Like Investments

The Ben Franklin Technology Development Authority, the Commonwealth Financing Authority and the Tobacco Settlement Board operate programs promoting venture capital investments. In some cases, direct equity-like investments are made in businesses and venture fund portfolios. The investment is typically in the form of a loan or subordinated debt instrument with returns based on financial performance. The investment must be "equity-like" and not true equity because the Pennsylvania Constitution prohibits the Commonwealth from being a joint owner or stockholder in any company.

The state also has loaned funds to several private venture capital funds located within the Commonwealth. These funds may target technology-oriented companies, biotech or health-oriented companies or targeted geographical areas, and the funds are required by the terms of the Commonwealth investment to invest a certain amount of moneys in Pennsylvania-based companies. Investment by these venture capital funds in Pennsylvania businesses are made as traditional equity

Whether the investment is equity or equity-like, the terms and conditions attached to that investment should be carefully reviewed by the business, its counsel and its tax advisor before acceptance.