

MEMORANDUM

TO: Eric Nakajima, MBI Executive Director
Elizabeth Copeland, MBI General Counsel

FROM: Greg Sandomirsky
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DATE: July 6, 2015

RE: Issuance by Cities and Towns of Tax Exempt Debt for Broadband Systems

Background

The Massachusetts Broadband Institute (“MBI”) was created by the Massachusetts Legislature in 2008 with the mission to extend affordable high-speed internet access to all homes, businesses, schools, libraries, medical facilities, government offices and other public places across the Commonwealth. To that end, after completion of the MassBroadband 123 network (the “Middle Mile”), MBI was given the authority in 2014 to invest up to \$50 million of additional state capital funds in broadband infrastructure for such broadband expansion. MBI expects to allocate these state funds to finance portions of the necessary broadband infrastructure across unserved and underserved cities and towns in Massachusetts.

A number of cities and towns in Western Massachusetts are exploring options to expand broadband capacity to their residents and businesses. MBI has been working with these cities and towns to assist them in determining their best options for broadband expansion and to provide grants from state funds for a portion of the hard and soft costs of broadband infrastructure development. Each city and town will also need to provide at least a portion of the funds necessary for broadband infrastructure development. Many of these cities and towns will want to issue debt obligations, preferably on a tax-exempt basis, to finance their portion of the costs.

Scope of Memo

This memorandum will focus on the legal ability of cities and towns to issue general obligation debt under current law for capital costs associated with broadband projects which will serve residents and premises within their jurisdiction. It will also address considerations with

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regard to issuing such debt on a tax-exempt basis, as municipalities typically do. This memorandum is intended to provide only general guidance. All cities and towns should consult their own bond counsel as early as possible in connection with any proposed debt financing of such broadband projects.

This memorandum does not address changes in state law which might add options for the municipalities and does not address the application of state procurement laws to any project undertaken or services contracted for by the municipalities, whether acting alone or as part of a group. While the role of a municipal lighting plant (an “MLP”) is mentioned as well as that of a cooperative made up of MLPs, this memorandum does not address how an MLP or any such cooperative of MLPS is formed or operated. Also, it does not address the questions of whether, apart from issuing general obligation debt, a Massachusetts municipality needs to form an MLP in order to go into the telecommunications business. Finally, this memorandum does not address the options available to municipalities in selling debt or the ability of any particular city or town to access the debt markets on attractive terms.

Validity of Debt

Section 8(8) of Chapter 44 of the Massachusetts General Laws provides that cities and towns may incur debt for a term of up to 20 years for “establishing, purchasing, extending or enlarging . . . a telecommunications system **operated by** a municipal lighting plant” (emphasis added).

The first issue which arises is that a municipality must form an MLP in order to fit under the wording in c.44:8(8). Traditionally, bond counsel will not read c.44:7(34), which allows 5 year debt for any other public project “not authorized in this section,” as available because c.44:8(8) expressly addresses telecommunications systems.

Drilling a bit deeper, the language requiring operation by a municipal lighting plant has raised questions for cities and towns which would like to outsource some portion of their broadband operations to separate entities. In all events, bond counsel to each city or town will need to review and be comfortable with the level of control being exercised by the city or town incurring the debt in order to issue their opinion as to the validity of the debt. Bond counsel should be involved early in the planning and development process in order to structure the broadband operations in a way that will allow for valid issuance of debt. This memorandum provides some general guidance, however, regarding how much city or town control is needed to still be considered “operated by” such city or town in compliance with state law.

In order for a broadband system to be considered “operated by” an MLP in accordance with the statute allowing issuance of debt, the MLP must demonstrate that it has at least a substantial role in the operation of such broadband system. Factors that could be considered to demonstrate a substantial role include (i) ownership for tax purposes, (ii) construction oversight, (iii) rate setting control, (iv) policy direction control, (v) burden for capital improvements, (vi) hiring and firing ability over operations staff, and (vii) oversight of maintenance and operations. The greater the level and extent of each of these measures of control, the more likely that the MLP will be able to demonstrate that it has a meaningful operational role in the broadband

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system enabling it to validly issue debt for development of the broadband system under c.44:8(8).

Tax Exemption of Debt

If a city or town is able to demonstrate sufficient control to be able to validly issue debt for its broadband system, it will also need to show that it meets certain requirements for such debt to be issued on a tax exempt (rather than a taxable) basis. As with the validity determination, the city or town's bond counsel will need to be comfortable that the assets to be financed with tax exempt bond proceeds are used in a way that meets the tax exempt financing requirements in order to render their opinion as to the tax exempt nature of the interest on the obligations.

Federal tax law requires that not more than 10% of the proceeds of tax exempt bonds may be used directly or indirectly for any trade or business carried on by any person other than a state or local governmental unit ("private business use") where such use results in more than 10% of the debt service on the bonds being secured by or derived either directly or indirectly from such private use ("private security or payment"). Private business use of the broadband system would result from ownership of bond financed assets by a private entity or lease of the bond financed assets to a private entity. Private business use could also result from a private entity managing, providing services for or operating the broadband system, unless certain safe harbors are met. Whether or not an arrangement with a private entity related to the broadband system will result in too much private business use and private security or payment to issue debt on a tax exempt basis is based on the particular facts and circumstances. Revenue Procedure 97-13 provides some safe harbors for issuers who want to have private entities manage their bond financed assets through management contracts. Additional interim guidance with regard to the safe harbors are found in Internal Revenue Service Notice 2014-67. Management contracts that are not based on net profits and that meet certain term and payment provisions as set forth in Revenue Procedure 97-13 do not give rise to private business use. Bond counsel should be consulted prior to execution of any management or service contract related to bond-financed assets to confirm that such contract will not cause the obligations to have too much private business use.

We are aware of one town that has recently issued tax exempt debt to finance a portion of its broadband system to be operated by its MLP. In that case, the town owns or will own the bond-financed broadband assets and entered into a short-term management contract with a private entity who will manage the system. The town set the service rates for its residents and the management contract with the private entity includes a schedule of rates for each level of service to the customer. The contract provides that the fees may not be changed by the service provider without town consent. Under the contract, the service provider is responsible for all of the billing to customers and handles customer calls, in return for receipt of the customer service fees. While there are certain variable costs passed along to the customers, those are payable to the town or the MLP and not the service provider. This contract was determined by bond counsel to meet the safe harbors of Revenue Procedure 97-13 and does not give rise to private use of the bond-financed assets. The town also has a service contract with a separate municipal

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entity that does not give rise to private use both because the separate municipal entity is not a private entity and because the compensation is not based on net revenues or profits.

Cooperative of MLPs

One of the proposals being developed involves numerous town MLPs forming a cooperative under MGL Chapter 164, Section 47C using the name “WiredWest.” Under the current plan, each town would issue bonds under c. 44:8(8) to fund a portion of the cost of the participation by its MLP in a regional fiber network to be operated by the WiredWest cooperative. Each MLP would have a proportional ownership and voting interest in WiredWest reflecting its financial contribution for capital and operating purposes. As long as WiredWest in turn maintains the operating control of the network as described above from the town’s point of view for a one town project, the bonds should validly be issued under c44:8(8). WiredWest would need to comply with the same private use limitations described above and so long as it complies with the safe harbor management contracting rules in connection with a contract with any private entity, the bonds could be issued on a tax-exempt basis. Again, as mentioned above, bond counsel should be consulted to review the details of the plans for development and operation before plans are finalized. To facilitate this process, towns in the regional network project may want to rely on the same bond counsel.

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