Raising Revenues, Making Expenditures, and Borrowing Money: Legal Issues in Municipal Finance

Eric Shytle
General Counsel
Municipal Association of South Carolina

Municipal Association of South Carolina

Overview

1. Raising Revenues
2. Making Expenditures
3. Borrowing Money
4. Questions and Applications

Section 1

Raising Revenues

Revenues: Hypothetical

- A large percentage of City's land mass is occupied by tax-exempt institutions. To support fire service, Council proposes an "augmented fire services fee" that will be imposed on buildings that "by reason of their size, type of construction, use, and other relevant factors require the City to employ additional firefighters, deploy additional equipment and purchase equipment different in kind from that required to provide fire protection for the majority of structures." The fee will apply to tax-exempt institutions.
- The fee is calculated by applying three objective factors, which include the "needed fire flow," the "life risk factor," and a "suppression credit."
- From *Emerson College v. City of Boston*, 462 N.E.2d 1098 (Mass. 1984)

Primary Issue: Tax or Fee

- *Taxes* are compulsory payments that do not necessarily bear any direct relationship to the benefits of government goods and services received.
- *Fees* are imposed on specific persons, activities, or properties that receive a service or benefit (user fees).

Taxes or Fees: Why Does it Matter?

- *Taxpayer Protection*. State laws may require uniformity, supermajority vote or referendum, assessment or property value limitations, millage cap limitations, and specific statutory authority.
- *Application of Fees*. Generally fees (a) may not exceed the cost of value of the service being provided, and (b) may not be used for other purposes.
- *Constitutional Issues*. Generally, taxes are (or at least may be) more restricted by constitutional provisions.
- *Borrowing.* The nature of borrowing will be very different depending on whether it is secured by taxes or fees.

Sample Limits on Property Taxes

- *Caps on Annual Increase*. For example, in Massachusetts, total property tax revenues cannot increase more than 2.5% in a year. In South Carolina, millage rates cannot increase more than inflation and population growth; assessments cannot increase more than 15% in 5 years.
- *Caps on Total Taxes*. For example, in California, total property taxes cannot exceed 1% of assessed value.
- *Extraordinary Approvals*. For example, in Colorado all new taxes and tax rate increases must be approved by the voters.

Distinguishing Between Taxes and Fees

A general example, under Brown v. Horry County, 308 S.C. 180; 417 S.E.2d 565 (1992):

- a tax is an enforced contribution to provide for the support of government, whereas a fee is a charge for a particular service;
- a service charge is imposed on the theory that the portion of the community which is required to pay it receives some special benefit as a result of the improvement made with the proceeds of the charge;
- the revenues generated by a fee are used only to provide a benefit, and not paid into the general fund to defray customary governmental expenditures; and
- fees must be uniform.

Revenues: Hypothetical

- A significant percentage of the residential real property within the City is vacant because of foreclosures, heir property, or simple disuse.
- Council propose to impose a “vacancy fee” that will apply to residential properties that remain vacant for more than one year. The fee is objectively calculated by reference to the number of years that the property remains vacant and is designed to yield annual revenues that do not exceed the costs incurred by the City in codes enforcement, law enforcement, and fire protection services related solely to vacant homes. Revenues will be restricted to those purposes.

Primary Issue: Benefits v. Burdens

Many states do not allow fees to be imposed for *burdens* imposed by an entity or activity, but instead only on *benefits* conferred.

- For example: "Therefore, as to both [ordinances], we find Greenville County failed to satisfy the ... requirement that the 'government service or program ... benefits the payer in some manner different from the members of the general public.'" *Burns v. Greenville Cty. Council*, 433 S.C. 583, 589, 861 S.E.2d 31, 34 (2021)
- Other states reach a different conclusion. *See, e.g., Sinclair Paint Co. v. State Bd. of Equalization*,937 P.2d 1350 (Cal. 1997), concluding that an act imposing fees on manufacturers of lead-based products was valid insofar as it "imposed *bona fide* regulatory fees." The fees were intended "to mitigate the actual or anticipated adverse effects of the fee payers' operations" and "must bear a reasonable relationship to those adverse effects."

Other Special Types of Fees

- *Special Assessments*: Based on the value of benefits conferred on specific property, for example front-foot assessments for sewer lines or improvement district assessments for street lighting and sidewalks.
- *Development Impact Fees*: Exacted in return for permits or other government privileges, for example a per-unit fee for each new permitted structure (police, fire, roads, schools, and so on).
- *Utility Charges*: Generally permitted by statute to allow connection / tap fees and volumetric charges (based on consumption). May also allow for impact fees for new customers to recover capital costs of the system.
- *Franchises*: Imposed on physical occupation (utility companies) or use (ambulances, buses) of the public right-of-way. Some states require that the franchise charge be reasonably proportional to the costs / burdens of the occupation or use.
- In *most* cases, these charges are specifically authorized by state law.

General/Enterprise Funds

- *General Fund*. Taxes and generally applicable fees; primarily used for public safety. Historically also funded recreation, sanitation, codes enforcement, etc.
- *Enterprise Fund*. Money-making ventures like water, sewer, electricity, natural gas.
- *Transfers*. Municipalities can "transfer" money out of enterprise funds by (a) direct related expenditures, (b) indirect cost recovery, and (c) discretionary transfers.

Section 2

Making Expenditures

Technical and Procedural Issues

Every municipality will have some formal budgeting process. Be aware of:

- Advertising and public hearing requirements.
- Balanced budget requirements.
- How changes are made. Can the executive reallocate within lines? Within categories?
- The person of office in your form of government who has the authority to prepare and present the budget. It won't matter until it does.

You should also be aware of statutory provisions on procurement, investment, and financial conflicts of interest.

Expenditures: Hypothetical

- City is a major tourist destination and is particularly noted as a culinary center. Near the heart of the main restaurant district is a vacant warehouse building. A national culinary school has expressed interest in moving its main campus to the City.
- Council proposes that general funds be used to acquire, improve, and retrofit the vacant warehouse building and to offer it to the culinary school, free of charge, as an incentive to locate in the City.
- Adapted from *Saine v. State*, 709 S.E.2d 379 (N.C. 2011).

Primary Issue: Public Purpose

- At least 46 states have some form of "anti-gift" constitutional protections. The most common is public purpose. All expenditures (and all borrowing) must serve a *public purpose*. "A public purpose has for its objective the promotion of the public health, morals, general welfare, security, prosperity and contentment of all the inhabitants or residents within a given political division."
- Public purpose evolves over time. "A slide-rule definition to determine public purpose for all time cannot be formulated; the concept expands with the population, economy, scientific knowledge, and changing conditions" *Saine*, 709 S.E.2d at 385 (2011) (quoting prior North Carolina caselaw).
- Does it include industrial development? Commercial development? Support to residential redevelopers?

Example: The South Carolina Test

- The Court should *first* determine the ultimate goal or benefit to the public intended by the project.
- *Second*, the Court should analyze whether public or private parties will be the primary beneficiaries.
- *Third*, the speculative nature of the project must be considered.
- *Fourth*, the Court must analyze and balance the probability that the public interest will be ultimately served and to what degree.

Expenditures: Hypothetical

Public education is provided by separate school districts (i.e., not by municipalities). The local school district is experiencing severe financial strains and recently lost a referendum to increase its millage rate. The City has a healthy fund balance.

Council proposes two options:

- Make a one-time appropriation from fund balance to the school district.
- Increase its millage rate (within the statutorily permitted limit) and earmark the increase for recurring support of the school district.

Primary Issue: Corporate Purpose

- Corporate purpose is different from public purpose; corporate purposes are those purposes germane to the objects of the creation and existence of the municipality.
- The applicability of this rule varies widely from state to state, depending on Home Rule / Dillon's Rule, statutory implementation of municipal powers, and so on. It may be in the state constitution; some use the terms "municipal purpose" or "corporate purpose." Or it may be an organic principle.
- But it should be a useful guide to ask about any expenditure: Is this expenditure consistent with the purposes and functions of the municipality? Is the particular purpose or function in question delegated to some other governmental body, like a school district?
- The purpose of the two alternatives in the hypothetical is to illustrate that different rules may apply to raising revenues and to making expenditures.

Expenditures: Hypothetical

- City's retail businesses and restaurants are being severely harmed by economic or other conditions (e.g., public health emergency). Council wants to offer financial support to distressed businesses to help them survive and recover.
- Budgetary limitations, however, prevent the City from making direct financial contributions.
- Council proposes that the City establish a loan guarantee program, under which eligible businesses can borrow from approved financial institutions and the City will guarantee the debt.

Primary Issue: Lending of the Public Credit

- Another major anti-gift provision is referred to as the prohibition on lending of the public credit.
- In South Carolina: "The *credit* of neither the State nor of any of its political subdivisions shall be pledged or loaned for the benefit of any individual, company, association, corporation, or any religious or other private education institution."
- Can this be applied literally?
- Does it mean more than just public purpose?

Lending of the Public Credit Application

- *Public Purpose Only*. Some states have read this provision as essentially equivalent to the public purpose requirement; if the public is the "major" beneficiary, no violation.
- *Public Purpose Plus*. Other states conclude that when taxes are involved, the public benefit must be higher or more direct.
- *Deals with Investments*. The most logical approach (Maryland, Maine, others) is that the prohibition is on investments and lending. "Cash is not credit." The purpose is to avoid speculative ventures.

Section 3

Borrowing Money

Types of Bond Issues

- *General Obligation*. Involve a pledge of the "full faith and credit" of the municipality, which means the municipality could be forced to levy taxes to retire the debt. Debt limit, perhaps voter approval.
- *Revenue Bonds*. Secured by revenues of a "system." Not subject to a legal debt limit but contains coverage requirements in the issuing instrument.
- *Lease-Purchase*. A lease under which payments include a principal and interest component. At the end of the lease, the lessee owns the asset. Includes a non-appropriation clause and is therefore not "debt."
- *Other*. Special source revenue bonds, bond anticipation notes, tax anticipation notes, grant anticipation notes, conduit bonds….

Methods of Sale

- *Public*. Public sale raises disclosure issues, increases costs of issuance, and requires greater effort by the issuer. Public markets generally offer more competitive interest rates.
- *Private*. Sold directly to a bank to hold in its portfolio or to assign or re-sell. Less costly, less complex, generally higher interest rates. Also banks generally have size and term limitations (For example, $10mm and 10 years).

Local Counsel Opinion

- The local counsel opinion will vary according to the complexity of the deal, the firm serving as bond counsel, whether the issue is sold to the public or to a bank, and so on.
- Therefore, local counsel should ask early and often about the expected content of his or her opinion at closing.

Scope of Review and Reliance

- The opinion will list the sources upon which the opinion writer relies or has consulted.
- Generally, these sources will be the Federal and State Constitutions; applicable laws; local proceedings such as ordinances, resolutions, or even minutes; and documents specific to the deal.
- If you DIDN'T review something, or cannot speak to its reliability, then disclaim it.

Sample Conclusions

- The meetings at which the government approved the bonds were duly noticed and called.
- The issuer complied with applicable sunshine laws in approving the transaction.
- The person signing the bonds and bond documents was authorized to do so.
- The execution and delivery of the bonds does not conflict with any other agreements or local laws by which the issuer is bound.
- The issuer is not in default under any existing bond issues or contracts.
- No litigation is pending or threatened against the issuer that challenges the issuance of bonds or that could materially affect the issuer's ability to repay the bonds.

Basics of Tax Exemption

- *Purpose and Effect*. Interest payments on most municipal bonds are exempt from federal income tax. Purchasers of municipal bonds will therefore require a lower rate of interest, and tax exemption saves you money.
- *Private Use*. A bond-financed facility that has "private use" is not eligible for tax exemption. Sometimes, private use is easy. But what about a bank that sponsors your athletic field and gets naming rights? What about a private company that caters every event in your auditorium?
- *Arbitrage*. The issuer cannot earn a materially higher rate of return on the investment of bond proceeds than it is paying on the bonds.

Post-Closing Risks and Duties

- The bond lawyer handles these questions when the bonds are issued. But after the bonds are issued, local counsel may become the central player.
- Assume your municipality issues general obligation bonds to build a new public services complex. You are planning for future growth, so you build the complex larger than it needs to be. Initially, the only occupant of the complex is your municipality. But a few years down the road, growth is slower than expected, and your City Manager gets a request to lease the unused space in the complex to a local insurance firm. The unused space is 25% of the total square footage of the building.
- What do you think the IRS would say about this proposal?
- How do you keep the tax issues in mind?

Procedures for Tax Compliance

It's certainly wise to have a system that tracks or requires:

- The investment and expenditure of the bond proceeds;
- The nature, location, and use of all facilities or parts of facilities financed by the bonds;
- Periodic review of compliance with the legal requirements necessary to preserve the tax advantages of the bond;
- Hiring professionals or consultants as necessary to comply with the legal requirements applicable to the bonds, including the requirement to compute and pay rebate;
- Consultation with bond counsel prior to engaging in post-issuance credit enhancement transactions;
- Consultation with bond counsel before modifying the interest rate, maturity date, or other material terms of any outstanding bonds;
- Retention of records relating to the bonds for the period required by law.

Continuing Disclosure: Overview

For the initial disclosure issues, you'll have the assistance of bond counsel, underwriter, and underwriter's counsel. So I have only two notes here.

- First, you should read the disclosure. All of it. And you should, to the limits of your ability and influence, make yourself comfortable and confident that it is correct.
- Second, you should determine for which portions of the disclosure (if any) you will be required to opine. With respect to those sections, you need to be more than comfortable and confident.

Disclosure AFTER the Closing

- *SEC Rule 15c2-12*. Prohibits underwriters from offering bonds that don't have required continuing disclosure filings.
- *Annual Reports*. Each year while the bonds are outstanding, file an annual report with audited financial statements and certain additional data.
- *Material Events*. Also, the agreement will require timely filing when certain "material events" occur.

Annual Reports

- First, make sure that they are filed on time.
- If they cannot be filed on time (e.g., the audit is not finished), then file what you do have, tell the market what you don't have, and tell them when you expect to file. Then, file what you didn't have as soon as you do have it.
- Second, make sure that what you file is correct. After all, these are just as much market disclosures as the original Official Statement. In theory, people make secondary trades on the contents of the annual filings.

Sixteen Material Events: Examples

- Principal and interest payment delinquencies;
- Non-payment related defaults, if material;
- Unscheduled draws on debt service reserves or credit enhancements;
- Adverse tax opinions or determinations;
- Modifications to rights of security holders, if material;
- Defeasances;
- Rating changes;
- Bankruptcy or similar event;
- Merger, consolidation, or acquisition or sale of assets;
- Incurrence of certain financial obligations in addition to the obligation subject to disclosure, or other financial agreements, if material.

General Advice

- One of your responsibilities, then, is to create (or make sure that someone within your municipality creates) a system that reminds the municipality to file if any of these things occurs. It's easy to overlook the need to file unless (a) your bond counsel happens to ask, or (b) you have a reliable system in place to make it happen.
- Also, in a new Official Statement, you must describe your compliance with your prior continuing disclosure agreements.
- So, if your municipality was late in filing an annual report, or didn't file a material event notice, or otherwise breached the prior continuing disclosure agreements, you have to say that in the new Official Statement.
- As a bond lawyer, I used to be pretty casual about continuing disclosure. But the SEC and the MSRB are getting very, very concerned about this matter, and we can't afford to be casual anymore.

Section 4

Questions and Applications