Legal Issues in Municipal Finance

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A Practice Note introducing legal issues in local government finance, including those that confront counsel when raising revenues, making expenditures, and borrowing money. This Note describes the different characteristics of taxes, fees, and bonds, and includes important practice information such as constitutional and statutory limitations.

Municipalities are governed by state law. For the most part, state governments permit municipalities a degree of autonomy, whether in a home rule or Dillon's rule jurisdiction, to address local finance and borrowing issues. Significant constitutional and statutory restrictions, however, curtail this autonomy. These restrictions vary from state to state. Every municipality faces at least some unique, local issues.

This Practice Note provides an introduction to the legal issues that local government attorneys must address when a municipality or county raises revenues, makes expenditures, and borrows money. This Note does not attempt to survey the detailed substantive context from state to state. Rather, this Note identifies finance and borrowing issues that municipal lawyers must address under their own state and local legal systems.

RAISING REVENUES

All payments exacted by local governments should be conceptually classified in one of the following categories:

- **Taxes.** Taxes are compulsory payments that do not necessarily bear any direct relationship to the benefits of government goods and services received. The primary purpose of a tax is to raise revenue for the government body imposing the payment (see Distinguishing Between Taxes and Fees). The three main types of taxes levied by municipalities are:
  - property taxes (see Property Taxes);
  - sales taxes (see Sales Taxes); and
  - income taxes (see Income Taxes).

  Most states require that the local power to tax, and the types of taxes that may be levied, be granted plainly and unmistakably by the state constitution or legislation.
- **Fees.** Fees are payments imposed on specific persons, activities, or properties that receive a service or benefit, or that act in ways that burden the rest of the population (see Distinguishing Between Taxes and Fees and Fees).
- **License Fees or Regulatory Costs.** License fees and regulatory costs are not designed to raise revenues but are instead designed to regulate behavior under the police power.

The degree to which these revenue sources are available to a municipality, the relative mix of these sources, and the uses to which a particular source may be applied varies from state to state. In some states, municipalities receive revenue from a combination of two taxes, most commonly property and sales taxes (see Property Taxes and Sales Taxes). Some states assign a portion of state-tax revenues to those municipalities with a substantial share of the state population (see Intergovernmental Revenue).

DISTINGUISHING BETWEEN TAXES AND FEES

Municipalities must classify individual sources of revenue because of the restrictions that are triggered when a charge is considered either a tax or a fee. These types of considerations include:

- **Uniformity.** Most states require that taxes be uniform, and local governments rarely forgive, reduce, or compromise taxes owed by a taxpayer or class of taxpayers.
- **Procedures for enactment.** Some laws may require supermajority vote or referendum, assessment or property value limitations, millage cap limitations, and statutory authority to impose taxes.
- **Constitutional limitations.** Taxes may be restricted by constitutional provisions.
- **Public purpose.** Almost every state requires the levying of a tax to serve a public purpose. In some states, courts apply a more stringent public purpose test to the levying of taxes than to the expenditure of non-tax funds.

- **Particular purpose for payment.** Whether a specific person, activity, or property receives a service or benefit, or acts in ways that burden the rest of the population. Fees are more appropriate if these apply. Fees generally may not:
  - exceed the cost of value of the service being provided;
  - be used for other purposes; or
  - be deposited into the general fund without segregation.
- **The different nature of incurring new debt secured by taxes versus fees.**
- **The purpose of a given charge.** The purpose can determine whether it is a tax or a fee, and the labels or titles used by a municipality to refer to given charges are not determinative (*Brown v. Horry County*, 308 S.C. 180; 417 S.E.2d 565 (S.C. 1992); *Bd. of Trs. of Minturn v. Foster Lumber Co.*, 548 P.2d 1276, 1277 (Colo. 1976)).

Another indicator that a charge is a tax is that it is based on an underlying value, for example, assessed value of property, or the cost of purchased goods, that does not correlate with the value of the service being provided. In a typical statement of the difference between a tax and a fee, the Washington Court of Appeals asked whether:

- The primary purpose of the charge was to raise revenue or to regulate conduct.
- The proceeds of the charge were deposited to the general fund or segregated in a special account.
- There was a nexus between the amount of the charge and the benefit received in exchange for payment.

(*Samis Land Co. v. City of Soap Lake*, 980 P.2d 805 (Wash. App. 1999).)

Regardless of the specifics imposed by each jurisdiction in tests or rules that distinguish between taxes and fees, the importance of the distinction lies in segregated budgeting and how the revenues can be spent. Revenue raised by impact fees, for example, must be spent on the specific impact the fee seeks to rectify, in some cases with precise geographic restrictions (see Impact Fees).

PROPERTY TAXES

Taxes on real and personal property are an important, if not the central, source of revenue for many municipalities and local governments. Property taxes are a type of ad valorem tax that are based on the value of the taxed property, and are set by a combination of:

- The property's assessed value (see Property Assessments).
- The tax rate for the taxing jurisdiction where the property is located (see Millage Rates).

The levying of a property tax, like budgeting and appropriating funds, is an important exercise of the governmental authority and almost always is subject to mandatory notice and due process requirements. Several state courts have invalidated taxes for failure to comply with the technical notice and due process requirements. For example, the Alaska Supreme Court invalidated a tax levy because the government failed to post a statutorily-required ten day notice (see *Stephens v. Rogers Constr. Co.*, 411 P.2d 205, 207 (Alaska 1966)).

Property Assessments

Municipalities determine the value assigned to property for the purpose of determining property taxes by assessing the property. This value is commonly referred to as the property's assessed value. County- or municipal-assessors often require certification by the state or a state-approved licensing authority. State law determines the factors that municipalities can consider when assessing a property's value. Assessed values tend to be less than fair market values, however, some states allow municipalities to use the sale price as the assessed value for years in which a sale occurs.

Municipalities commonly consider comparable property sale, and valuation methods specific to the type and location of the property, to determine assessed value. For real property, values are often based on a percentage of a property's market value, which may be based on the parcel's tax class or the type of parcel being taxed. There are many ways to determine assessed values as a percentage of market values. For example, the percentage of a residential parcel's market value is usually different than that of a commercial, mining, or agriculture parcel. Municipalities can also, when applicable, use a property's income earning potential to calculate its market value.

Certain classes, or types, of parcels of property are often exempt by state law. Property owned by charitable or public welfare organizations is often exempted from tax. Property owned by religious organizations is tax-exempt by state law, and implicitly under the US Constitution.

The value of property is not static. Changes to property values that affect taxes can include:

- Increased value associated with capital improvements made to parcels.
- Depreciated property value as a result of:
  - the passage of time; or
  - specific events that decrease the value of property.

For a fifty-state survey of applicable property taxes, including the kind of property that is taxable as real property, exemptions to real property taxes, the rate and nature of the taxes, and payment and collection procedures, see Real Estate Ownership: State Q&A Tool: Question 4 (3-517-4022).

Millage Rates

Municipalities, historically, could set their own millage rates, subject only to political and constitutional considerations. States have recently imposed limitations, such as millage caps and rollbacks (see Restrictions on Property Taxes).

The uniformity requirement is an important consideration for setting millage rates. Uniform millage rate requirements are codified in many state constitutions and statutes. Uniformity provisions require that all property of the same class within the same jurisdiction is taxed at the same rate. Regardless of how different classes of property are defined, property within that class must be taxed at the same rate.

Uniformity provisions also prohibit variances in property assessment procedures. The method used to calculate assessed value must be the same for all property within the same class. This includes placing the same emphasis on the factors that state law sets as the component considerations when calculating assessed values for all properties within the same class. Counsel should be aware that state-imposed uniformity requirements are also grounded in the Equal Protection Clause of the Fourteenth Amendment to the US Constitution, and violations may require defending claims in federal court (see Constitutional Limitations on Expenditures).

Restrictions on Property Taxes

Municipalities' property taxes are also restricted by state law or constitutional provisions that focus on the mechanics of the assessment and imposition. These restrictions include:

- **Absolute limitations.** Many state constitutions, state codes, and local charters limit the amount of taxes that a local government may impose. Those limitations may be expressed, for example, in terms of mills-per-dollar value of property. The most restrictive limitations appear in California and Missouri.
- **Reassessment caps.** Reassessment caps limit the increase in the assessed value of a taxed property within a specified period of time, but are commonly subject to a point of sale exemption.
- **Increase limitations.** Even in states and localities that do not have an absolute limit on millage rates, some have millage cap provisions that limit the amount that an existing millage rate may increase over a given period of time.
- **Rollbacks.** In some jurisdictions, the millage rate must be reduced in reassessment years, such that the same amount of taxes is generated as the prior millage.

SALES TAXES

Many local governments raise revenues through a sales tax. The rate, and even the ability to impose, local sales taxes vary widely across the country. The rates of sales taxes range between 0% (in many cities) and 6%. Sales taxes, similar to property taxes, must be applied uniformly. This limits local governments' ability to structure local sales tax rates as a regulatory tool. In addition to the basic sales tax, many local governments rely on special purpose, local option sales taxes (see Local Option Taxes).

LOCAL OPTION TAXES

Municipalities may be able to employ local option taxes. Municipalities or counties may be able to impose local option taxes by ordinance, referendum, or both, but they often require voter approval. Local option taxes do not depend on the value of property. Categories of local options taxes may include:

- **Local option sales tax.** A sales tax that is used primarily to reduce property taxes on owner-occupied residential property, and can be used in a general fund.
- **Capital project sales tax.** A sales tax that is used to fund a voter approved list of specifically identified capital projects, such as roads, government buildings, and recreation facilities.
- **Hospitality or accommodation taxes.** Hospitality and accommodation taxes are additional sales taxes on hotel stays or prepared meals. State law often requires that the proceeds of these taxes must be spent to encourage tourism.
- **Admissions and amusement taxes.** Admissions and amusement taxes are taxes on admission to an event, such as a movie, sporting event, or concert. These taxes may be imposed only if permitted under state law, which may limit the application of proceeds.

INCOME TAXES

In the absence of a clear grant of authority, local governments cannot tax earnings or income. Several states have granted local governments this authority, however, and the income tax is an important source of revenue for local governments in those states.

FEES

This section discusses different types of fees, which are payments in amounts that directly relate to the negative impact or received service, and that must be segregated, when budgeting and making expenditures, to the purpose of the fee.

Utility Revenue

A major source of municipal revenue is utility revenue from water, wastewater, natural gas, or electrical systems. These revenues are ordinarily booked in a separate enterprise fund for accounting purposes to separate those revenues from general government revenues. Many municipalities transfer enterprise fund revenues to the general fund, through a franchise fee, a direct transfer, or through indirect cost recoveries. State governments, rating agencies, and general fiscal prudence require restraint in the magnitude of those transfers. In some states, applicable law may restrict the purposes for, or magnitude of, transfers from the enterprise fund.

A major issue in raising utility revenue is the amount and nature of the charges. When raising utility revenue, the local government should consider whether:

- An engineered rate study is necessary to justify the rate schedule. If not, it should consider what records it needs to retain to justify the rate schedule.
- The local government can charge different rates for customers inside and outside of its territorial jurisdiction. If so, it should consider whether there are any limitations on the rates that can be charged outside of its territorial jurisdiction.
- The rate schedule explicitly or implicitly discriminates against certain types of:
  - customers, for example, residential, commercial, or industrial; or
  - individuals.

Discrimination could occur by creating zones of rates that are based on an apparently rational criteria, such as cost to treat, but that in fact reflect demographic differences in the zones (see Constitutional Limits on Expenditures). For information on equal protection claims brought under Section 1983, see Practice Note: Section 1983: Equal Protection Claims (w-002-6708).

- The rate schedule allows adequate funding for any depreciation or contingency funds that may be required by the local government's bond ordinance or by state law.

Franchise Fees and Business, Occupation, Privilege, and License Taxes

Most municipalities may impose a tax or fee on business activity within the municipality. These taxes or fees are generally determined by reference to the net or gross revenues of the business, with an offsetting credit for similar fees or taxes paid elsewhere. In some states, these taxes or fees are imposed and collected at the state level and then distributed proportionally to local governments.

If the tax or fee is based on gross revenues, the local government often uses rates of taxation based on Standard Industrial Classification (SIC) or North American Industrial Classification System (NAICS) codes to reflect the relative profitability of the business. In at least one state, courts have held that business license rates that are based on relative profitability statistics must be updated regularly. There generally are no unique restrictions on the application of business license revenues.

Many local governments also collect franchise fees for the use of public rights of way by private utility companies. Franchise fees may be applicable to telephone, television, electricity, natural gas, and other utilities that have physical infrastructure located within the local government's rights of way. The franchise fee is usually a flat percentage of revenues collected by the utility within the local government's territorial jurisdiction. There generally are no unique restrictions on the application of franchise fee revenues.

In considering the application of these taxes or fees, the local government lawyer should consider whether:

- The tax or fee is permitted under state law.
- The rate of taxation or fee correlates to an external circumstance, such as profitability. If so, counsel should consider whether the accuracy of that correlation has been recently updated.
- The tax or fee discriminates or unduly burdens interstate commerce, for example, by applying different rates on out-of-locality or out-of-state businesses, thereby violating the Commerce Clause.
- The tax or fee invidiously discriminates against one or more classes of activities, businesses, or taxpayers.

Permitting Fees and Service Charges

Local governments have increasingly come to favor fee-for-service methodologies that attempt to shift the responsibility to pay for a service to the entity that benefits from the service. Obvious examples include annexation requests, building inspections, zoning approvals, and other property specific requests that impose a cost on the responding government.

Although there is little question that a local government has the ability to charge for an identifiable service, state law does vary in the restrictions that apply to these charges. At a minimum, sound practice, and in many cases applicable law, requires that the charge be less-than or equal-to the cost to the government. Applicable law may also require separate accounting for a service fee and may restrict the expenditure of proceeds of the fee to the purpose for which the fee was imposed.

Some local governments have attempted to go beyond the traditional model for fees and charges and, for example, have imposed charges for:

- Protective fire gear damaged or destroyed in responding to a fire.
- 911 calls for motor vehicle accidents that involve out-of-jurisdiction vehicles.
- Externalities that burden the community or the surrounding neighborhood, such as chronically vacant properties.
- Vehicles that create more than ordinary wear on public roads.

Whether these fees are legal is almost entirely a local question (see Impact Fees).

Impact Fees

Local governments may attempt to offset the cost of new development by imposing impact fees. Impact fees can be fairly simple. For example, many water and sewer utilities have an impact fee that applies to new connections and is designed to offset the capital cost of the treatment infrastructure that the new connection will use. In other cases, an impact fee may seek to offset additional costs incurred for roads, schools, public safety, parks, sanitation, and many other government services. In high-growth communities, particularly along the developed coasts, local governments routinely turn to impact fees to defray the monetary pressures of explosive growth.

The use of impact fees, however, is almost invariably subject to serious limitations, including that:

- Many states impose elaborate notice and due process requirements, and, in some cases, require consent by the proposed payers, before an impact fee may be imposed.
- Many states require impact fees be supported by evidence that the fee is properly calculated to offset the specific costs imposed by the new development. Many states also require a formal engineering study, supported by long-term capital improvement plans, to justify the impact fees.
- Impact fees must be segregated into funds or accounts corresponding to the purpose for which they were paid. Those fees must further be kept separate from the general fund.
- In the most restrictive states, the local government must keep a long-term accounting of the impact fees paid and the corresponding expenditures. If receipts exceed actual expenditures, the government must refund the excess to the payers.

The State of Florida is a good example of the development of rules applicable to impact fees. In Florida, a valid impact fee must:

- Identify the local function burdened by the development, such as roads, police and fire, water and sewer systems, parks, or others.
- Clearly designate the geographic area on which the impact fees will be assessed and expended.
- Limit the period of time, not to exceed five years, that the government will expend the fees to install improvements.
- Assess particular parcels and developments under a legislated formula and calculations, sometimes called the technical report.

(Fla. Stat. Ann. § 163.31801).)

OTHER SOURCES OF MUNICIPAL REVENUE

Municipalities have also pursued different types of municipal revenue streams that cannot be placed in traditional categories.

Intergovernmental Revenue

There are many ways that local governments receive intergovernmental revenues, including by:

- **Federal and state grants.** When receiving a grant, the local government should:
  - study and understand the grant conditions and create systems that allow continuous monitoring for compliance;
  - keep detailed accounting records, with supporting records, regarding the investment and expenditure of the grant funds;
  - comply with any retention periods specified in the grant; and
  - preserve sovereign immunity in dealings with private parties. For a sample clause that can be used to preserve sovereign immunity in contracts with private parties, see Standard Clause, Non-Waiver of Sovereign Immunity Clause (w-001-4087). For information on local governments maintaining sovereign immunity, see Practice Note, Sovereign Immunity of State and Local Governments: Overview (w-001-1301).
- **Contract.** Local governments may share public safety or other functions. The contracts under which they share often result in transfers of intergovernmental revenues. As with grants, the local government should be sure to understand the contract terms, keep detailed accounting records, and observe rational retention periods.
- **Transactions that are essentially commercial in nature, but that involve another government.** For example, a regional water provider may sell water at wholesale to smaller governments for retail resale. For the most part, if possible, those transactions should be treated the same as any sale to a private party.

Special Assessments and Limited-Purpose Taxing Authorities

Municipalities should consider any taxes imposed by coextensive limited-purpose governments when considering its taxes on the same residents. In contrast to general-purpose governments, which administer the typical variety of government-services, limited- or single-purpose governments have purview only over a particularized subject matter.

State law may allow the creation of special tax districts or assessment districts for projects or services that benefit the specially taxed or assessed area.

Many states also allow the creation of redevelopment or tax increment financing districts to improve or redevelop certain areas in the municipality. These districts generally do not change the amount of taxes paid from the perspective of the property owner. Instead, they divert incremental property taxes from other taxing districts to the municipality.

Proprietary Actions

Local governments often act in proprietary capacities. Utility-based proprietary action can include selling commodities secondary to utility activities, for example:

- A water utility selling ice.
- A wastewater utility selling:
  - biosolids for fertilizer application; or
  - waste or reclaimed products.
- Any utility branch selling surplus government vehicles and equipment.

In some states, the sale of goods or services is be subject to competitive bidding or auction requirements, while in other states the procurement rules apply only to the purchase of goods and services. Regardless, the local government should know the applicable rules before engaging in proprietary transactions. Revenues received from proprietary transactions can usually be commingled in the general fund and applied for any lawful purpose.

Ordinance Enforcement and Fines

Fines and court fees are frequently a significant source of municipal revenue. Many states assess these fines and fees for support of the state-wide court system, but the remaining proceeds may be retained by the local government and expended in many different ways. Applicable law often requires, and it is good practice to, apply fines and court fees to support the local government's court and law enforcement systems.

Interest Collected on Unused Funds

In all states, applicable law restricts the manner in which local governments can invest funds on hand. Local governments must usually invest in US Treasury Bonds, other obligations supported by the full faith and credit of the United State, or obligations collateralized by those obligations. Some states allow investment in AAA-rated credits. Outside of limited contexts, such as pension funds and public hospital endowments, most state and local governments cannot invest in equities.

Interest collected on unused funds can generally be applied for any lawful purpose, without reference to any restrictions applicable to the corpus on which the interest was earned.

MAKING EXPENDITURES

Municipal expenditures are generally limited by:

- The source of the funds being used in a given expenditure.
- The purpose of the expenditure.

In short, the means by which a local government raises revenue often dictates how that money can be spent and requires segregating revenue streams to ensure compliance.

Other specific restrictions on expenditures often include:

- Satisfying the public purpose requirement (see Specific Limits on Expenditures).
- Satisfying the corporate purpose requirement.
- Abiding by a variety of state constitutional and statutory restrictions, including those that apply to the annual budget process (see Budgeting).
- Complying with the US Constitution (see Constitutional Limits on Expenditures).
- Adhere to ethical requirements, including funds-on-hand restrictions as well as those on lending public credit.

BUDGETING

Every municipality has a formal budgeting process. While this process varies significantly, local counsel should be aware of:

- Advertising and public hearing requirements.

- Balanced budget requirements.
- Restrictions to making subsequent changes.

The function of the executive is another important consideration for the municipal budget-making process, encompassing more than when the executive can unilaterally make changes to a budget. It is, therefore, important to work with the executive with this type of authority when crafting the budget.

A local government's budget should separately state its various revenue streams, as covering specific expenses in accordance with the difference between taxes and fees and the purpose of anticipated expenditures. The separation can be broadly categorized as stating the funds available in a general fund, which is composed of general revenue sources such as property taxes, as opposed to enterprise funds, which is composed of payments for specific-sources that must be used for specific purposes. In some states, the specificity required for the purpose of expenditures can apply to matters such as geography, where monies collected for a specific purpose can only be used within a certain radius from where collected (see Impact Fees).

Local governments generally cannot budget revenues in excess of expenditures to fund expenses or capital investments beyond the current budget cycle. A local government can budget for a reasonable surplus to be deposited into a reserve, depreciation, or contingency fund.

Common Budget Structures

Common structures for municipal budgets include:

- **Line item budgets.** A line item budget is a common form of budget. It is organized by department and then further organized by function. For example, each department may have an office supplies line item. Most budgets assign a code to that line item in which the first identifier refers to the department (for example, assume purchasing is 047) and the second identifier refers to the function (for example, assume office supplies is 131). In that case, the line item for office supplies in purchasing would be 047-131. The advantage of line item budgeting is its specificity. The disadvantage is that it makes it hard to see larger patterns and make generalized comparisons, because of that specificity.
- **Program budgets.** Program budgets come in many forms, but the most common is that a particular program has an overall budget with considerably less line item detail. In theory, this allows the program managers discretion to manage the budgetary resources to generate the best results.
- **Performance budgets.** Building on program budgets, performance budgets create an incentive by rewarding or punishing programs for their prior year performance. For example, exemplary performance by a program may lead the budget officers to increase the budget for that program in the next year. The advantage of performance budgeting is that it creates an incentive system for programs. The disadvantage is that the appropriate response to performance is often not clear. For example, a program may have underperformed because of poor management (suggesting a budget decrease is in order) or because of inadequate resources to carry out the desired mission (suggesting a budget increase is in order). Regardless, performance budgeting faces the same challenges as any performance management tool because measurement is often difficult, ambiguous, and time-consuming.
- **Zero-based budgets.** Zero-based budgets start without any presumption of decreasing, continuing, or increasing the prior year budget for a particular item. The budget instead starts from zero, and it is up to the department head to convince his or her budget officers that the requested budgetary amount is appropriate to the need.

SPECIFIC LIMITS ON EXPENDITURES

At least 46 states have some form of anti-gift constitutional protections. The most common anti-gift protection is a public purpose requirement. Under the public purpose requirement, all government expenditures must service a public purpose. The definition of public purpose varies from state to state and continues to evolve. In 1874, the US Supreme Court noted that, in determining whether an expenditure supports a public purpose, the court:

[M]ust be governed mainly by the course and usage of the government, the objects for which taxes have been customarily and by long course of legislation levied, what objects or purposes have been considered necessary to the support and for the proper use of the government, whether State or municipal. Whatever lawfully pertains to this and is sanctioned by time and the acquiescence of the people may well be held to belong to the public use, and proper for the maintenance of good government, though this may not be the only criterion of rightful taxation.

(*Loan Ass'n v. Topeka*, 87 U.S. 655, 665 (1874).)

Courts generally defer to legislative determinations made by the state government that the purpose in question is a public one.

All government expenditures must also serve a corporate purpose of the government. For municipalities, which are almost invariably general purpose governments, this restriction is often not meaningful because of the scope municipalities are afforded. In some cases, however, the limitation remains meaningful in states that have a combination of general- and special-purpose governments with coextensive geographic jurisdiction. For example, in a state with separate school districts, the construction of a new high school is unlikely to be a corporate purpose for a municipality.

State law also imposes expenditure-specific limitations, including:

- **Procurement.** The purchase of goods and services is almost always subject to public bidding requirements. Knowing and complying with these requirements is essential when crafting a budget across municipal departments.
- **Funds on hands.** State law often restricts the ability of the municipality to invest funds on hand. Loans are often considered investments that must be analyzed under this heading.
- **Statutory restrictions.** Some state-law restrictions apply to specific types of expenditures, such as expenditures on tourism.

CONSTITUTIONAL LIMITS ON EXPENDITURES

The principal constitutional limitation on expenditures is equal protection. Government expenditures may invidiously favor one class of activity, business, or person over others. If the basis of the classification implicates a suspect class, such as race, national origin, religion or alienage, the classification will almost certainly fail absent extraordinary justification. If the classification does no implicate a suspect class, it may be upheld on proof of a rational basis for the classification. For information on equal protection claims brought by plaintiffs under Section 1983, see Practice Note, Section 1983: Equal Protection Claims (w-002-6708).

MUNICIPAL BORROWING

The ability of a municipality to borrow is a product of state constitutional and statutory law, as well as judicial decision. A municipality cannot simply go to a bank and borrow money by signing a promissory note. A municipality that wishes to borrow must issue bonds.

MAJOR TYPES OF MUNICIPAL BONDS

The major types of bonds issued by municipalities are:

- **General obligation bonds.** Secured by taxes, general obligation bonds are commonly described as involving a pledge of the full faith and credit of the municipality, which means that the municipality could be forced to levy taxes to retire the debt. The issuance of general obligation debt can be subject to a debt limit, voter approval, or both. General obligation bonds are usually the most restricted, in terms of their purpose, amount, term to maturity, public approval process, and method of sale, because they implicate the taxing power.
- **Utility revenue bonds.** Secured by revenues of a utility system or systems, utility revenue bonds are not subject to a legal debt limit but do contain coverage requirements in the issuing instrument. Common requirements include:
  - an earnings test, where net revenues must be at least 110% of expenses and debt service; and
  - an additional bonds test, where the issuer cannot issue additional bonds unless net revenues are at least 120-150% of expenses plus debt service including the proposed new issue.
- **Lease-purchase agreements.** These agreements take the form of a lease under which lease payments include a principal and interest component. At the end of the lease, the lessee owns the asset or can purchase it for a nominal amount. This is effectively a financing lease, and the most common purpose to use this structure is either to streamline the acquisition of movable equipment or to evade the debt limit. The lease should contain a nonappropriation clause, which allows the lessee to fail to budget the lease payments, thereby forfeiting the collateral. This feature is ordinarily interpreted to mean that the lease is not debt for constitutional purposes. Some states modify this interpretation by statute.
- **Other revenue bonds.** State law may allow the securitization of revenue streams other than utility revenues, for example hospitality or accommodations fees, special assessments, tax increment payments, and certain types of sales tax payments. The common aspect of these bonds is that the underlying revenue stream is not a generally applicable tax that would implicate the full faith and credit of the issuer.
- **Special sources of revenue bonds.** These bonds are secured by payments or fees instead of taxes, for industrial projects that meet the state requirements for granting fee-in-lieu-of-tax (FILOT) treatment to a project.
- **Bond anticipation notes.** These notes are secured by the promise to issue a takeout bond in the future. These bonds are generally short-term obligations that serve as bridge financing until the permanent financing is put in place.
- **Tax anticipation notes.** These notes are secured by the receipt of future taxes. Municipalities with cash flow challenges can use these notes to fund operations pending the receipt of taxes. For example, if tax receipts arrive in February for an entity using a June 30 fiscal year, a tax anticipation note can cover budgeted expenses during the period before February.
- **Grant anticipation notes.** These notes are secured by the proceeds of a future grant, and, as with bond anticipation notes, can serve as bridge financing before a permanent financing solution is implemented.
- **Conduit bonds.** Less commonly used by municipalities, these bonds are generally secured by a loan agreement with a third party that ultimately receives and makes use of the bond proceeds. For example, an economic development authority would issue bonds to the market, loan the proceeds to an industry, and pledge the revenues under that loan agreement to the payment of the bonds. These bonds allow the government to serve as a conduit to raise financing for another entity.

PUBLIC VERSUS PRIVATE FINANCING

Bonds may be sold to the public capital markets or to a private entity (for example, a bank). Selling an issue to the public capital markets raises disclosure issues, increases the relative cost of issuance, and requires greater effort to the issuer. The public capital markets, generally, offer more competitive interest rates. Some issues also cannot be placed with a bank because of their size, term to maturity, or complexity.

A commonly misused phrase is to use the term "bank qualified" to mean a bond that is placed with a bank. The term "bank qualified" is a tax concept that allows favorable interest treatment to the bank for certain types of issues or issuers. A bond may not be bank qualified and may still be sold to a bank.

MARKET PARTICIPANTS

The issuance of bonds, particularly to the public capital markets, may involve a large number of parties. The most common participants are:

- **The issuer.** The issuer is the public entity issuing the bond or incurring a debt.
- **Underwriters.** In issues sold to the public capital markets, the entity that purchases the bonds from the issuer and then resells them to the public is the underwriter.
- **A financial advisor.** A financial advisor is an independent firm that assists and advises the issuer in, for example, structuring the bonds, selecting an underwriter, securing ratings, and acquiring credit enhancement.
- **A credit enhancer.** A credit enhancer is an entity that enhances the rating of the bonds, either by insuring their payment or by supporting them with a letter of credit.

- **A trustee.** A trustee is an entity serving in the interest of the bondholders to, for example, receive payments from the issuer, make payments to the bondholders, and enforce rights under the bond documents.
- **Bond counsel.** Bond counsel are, narrowly, the lawyers or law firm that opine that the bonds are legal, valid, binding, enforceable, payable from the pledged source of funds, and exempt from federal and state income taxation. In the traditional view, the bond counsel's client is the deal, not the issuer. This distinction may be important.
- **Issuer's counsel or local counsel.** Most likely, issuer's counsel are the municipality's in-house attorneys or the lawyers or law firm that represent the issuer. Local counsel normally opine on matters, including the existence and legal authority of the issuer, compliance with open meetings laws, procurement, and other requirements on local governments.
- **Underwriter's counsel.** Underwriter's counsel are separate legal counsel representing the underwriter. The primary duties of underwriter's counsel are to draft the Bond Purchase Agreement between the underwriter and the issuer and to coordinate the preparation of, and possibly opine on, the disclosure documents.

LOCAL COUNSEL OPINIONS

Local municipal counsel are usually expected to provide a formal opinion at the closing. The content of this opinion varies according to, among other things:

- The complexity of the deal.
- The firm serving as bond counsel.
- Whether the issue is sold to the public or to a bank.
- Whether the pledged revenues are subject to any peculiarities.

Local counsel should ask early and often about the expected content of their opinion at closing. It is not unusual to see local counsel surprised at the end of the deal when the form opinion is circulated.

CONTINUING DISCLOSURE OBLIGATIONS

Bond counsel, the underwriter, and the underwriter's counsel, should provide local municipal-counsel a great degree of assistance in relation to primary disclosures and related issues. Regardless, counsel for a municipality issuing a bond should:

- Read the disclosure in its entirety, and, to the extent possible, become confident that it is correct.
- Determine for which portions of the disclosure, if any, an official opinion is required.

While bonds or notes remain outstanding, municipal issuers are obligated to make public disclosures. The two types of continuing disclosures are:

- Annual reports (see Annual Reports).
- Material event notices (see Material Event Notices).

Annual Reports

By a specified date of each year during which the bonds remain outstanding, the municipality must file an annual report that contains its audited financial statements and certain additional data. The required additional data must be clearly identified in the agreement and is ordinarily simple updates of information in the Official Statement. For example, for a utility system revenue bond, the annual report usually updates the rate schedule, largest customers, and peak and average flows.

Additional considerations for annual reports include:

- **Timely filing.** If they cannot be filed on time because, for example, the audit is not finished, then counsel should file what is possible, inform the market what is not yet available, and tell the public when a full filing can be expected. Then, counsel should file as soon as possible.
- **Accurately filing.** Counsel should ensure what they file is correct. Filings include just as much market disclosure as the original Official Statement. In theory, people make secondary trades on the contents of the annual filings. For example, if a mistake is made in an annual filing about a debt service coverage ratio of 300%, but it is really 120%, there might be a problem. Counsel should review the filing thoroughly or, at minimum, ensure that review procedures are in place.

Material Event Notices

Even more challenging than an annual report, an issuance agreement provides that municipalities must timely notify the market when certain material events occur. The current list of required material events are:

- Principal and interest payment delinquencies.
- Non-payment related defaults, if material.
- Unscheduled draws on debt service reserves reflecting financial difficulties.
- Unscheduled draws on credit enhancements reflecting financing difficulties.
- Substitution of credit or liquidity providers, or their failure to perform.
- Adverse tax opinions, the issuance by the Internal Revenue Service (IRS) of proposed or final determinations of taxability, Notices of Proposed Issue (IRS Form 5701-TEB) or other material notices or determinations regarding the tax status of the security, or other material events affecting the tax status of the security.
- Modifications to rights of security holders, if material.
- Bond calls, if material, and tender offers.
- Defeasances.
- Release, substitution, or sale of property securing repayment of the securities, if material.
- Changes in credit ratings.
- Bankruptcy, insolvency, receivership, or similar event of the obligated person.
- The consummation of a merger, consolidation, or acquisition involving an obligated person or the sale of all or substantially all of the assets of the obligated person, other than in the ordinary course of business, the entry into a definitive agreement to undertake a similar action, or the termination of a definitive agreement relating to any of those actions, other than under its terms, if material.
- Appointment of a successor or additional trustee or the change of name of a trustee, if material.

One of the municipality's responsibilities is creating a system that reminds the municipality to file if any of these events occurs. It is easy to overlook the need to file a material event notice unless, either bond counsel happens to ask, or there is a reliable system in place to ensure filing.

POST-ISSUANCE TAX COMPLIANCE

Interest payments on most municipal bonds are exempt from federal income tax. Municipal bond buyers, therefore, require a lower rate of interest on a municipal bond than they would for a taxable bond. Tax exemption provides a benefit to an issuing municipality in the form of a lower cost of borrowing. To qualify for and maintain the tax exemption, however, the issuer must comply with elaborate federal rules.

As with disclosure, bond counsel can provide detailed analysis and advice regarding potential tax risks in your deal. The two main issues are:

- **Private Use.** Regardless of certain private activity bonds, which are beyond the scope of this Note, a bond-financed facility that exceeds the safe harbor thresholds for private use is not eligible for tax exemption. Private use is sometimes easy to determine. For example, it would be private use to issue municipal bonds to build a new car dealership and then lease the dealership to a good friend.

  However, private use is not always easy to determine, and difficult examples include:
  - a bank that sponsors an athletic field and gets its name over the door;
  - a private company that caters every event in a municipal auditorium;
  - a private vehicle maintenance company that occupies a bond-financed city shop; and
  - parking spaces in a bond-financed public parking deck that are leased to a private hotel.
- **Arbitrage.** The issuer cannot earn a materially higher rate of return on the investment of bond proceeds than it is paying on the bonds. In this interest rate market that limitation is likely theoretical rather than practical, but a municipal issuer still needs to be aware of and follow the rules.

Bond counsel should handle these questions if they are raised when bonds are issued. Post-issuance, however, local government counsel may become the central player, and responsible for compliance. For example, consider the following hypothetical:

Assume a municipality issues general obligation bonds to build a new public services complex. The municipality is planning for future growth, and the complex is built larger than required when first constructed. Initially, the only occupant of the complex is the municipality. After a few years, growth progresses slower than expected, and the City Manager receives 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.

This hypothetical illustrates potential issues for the prohibitions both on private use and arbitrage, which the IRS could and likely would investigate. The point is that the municipality needs to have a system that ensures post-issuance compliance with the tax rules in place before potential issues become manifest. Post-issuance compliance procedures are voluntary, but the IRS recently began asking on Form 8038s whether the issuer had those policies and procedures in place.

Best practices for post-issuance tax compliance include 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, without limitation, the requirement to compute and pay rebate.
- Consultation with bond counsel before 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, which is currently the term of the bonds plus 3 years.

IRS Inquiries and Audits

Most municipal issuers are examined or audited by the IRS at some point and consulting with outside counsel may be necessary when this occurs. Installing post-issuance tax compliance procedures can reduce the burden of responding to IRS inquiries by:

- Decreasing the degree of the IRS's examination.
- Outright eliminating an IRS examination.

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