Chapter 6

TYPES OF FINANCING OBLIGATIONS

INTRODUCTION

This chapter provides a detailed description of 15 principal types of debt financing obligations. Each section describes a particular type of financing vehicle, the projects that it may be used to finance, its legal authority, process for approval and sale, important limitations, method of repayment and policy considerations. Also included for each type is a discussion of special federal tax issues which need to be considered, as well as appropriate cross-references to subsections within **Chapter 10, Continuing Disclosure and Investor Relations Programs**, **Chapter 4, State Constitutional Limitations**, and **Chapter 3, General Federal Tax Requirements**.

Variable rate debt and interest rate hedging products have become popular and important tools for many issuers in providing additional flexibility to better manage their debt programs. Following the review of the principal debt obligations in this chapter, the *California Debt Issuance Primer (Primer)* includes a basic overview of two popular approaches to variable rate debt and hedging: Auction Rate Securities are discussed in **Chapter 8, Fixed and Variable Interest Rate Structures** and Interest Rate Swaps are discussed in **Chapter 9, Synthetic Interest Rate Structures**.

Appendix E – Summary of Financing Obligations provides a quick reference to each of the debt financing obligations set out in a comparative format.

ASSESSMENT BONDS

DEFINITION AND PURPOSE

As defined by Proposition 218 and its implementing legislation, an assessment is any levy or charge imposed upon real property by a local agency for a special benefit conferred upon the real property from a public improvement. The term "special benefit" is likewise defined to mean "a particular and distinct benefit over and above general benefits conferred on real property located in the assessment district or to the public at large." Assessment bonds are issued upon the security of the assessments and are payable as to principal, interest, and redemption premiums, if any, from either:

- Scheduled installments respecting unpaid assessments, collected either by a direct billing to the property owner or by posting to the secured property tax roll of the county in which the real property is located, or
- Proceeds of prepayments of assessments made by property owners to discharge the lien of the unpaid assessment on a specific parcel

By far the most common assessment bonds in California local agency debt financing are those issued under the Improvement Bond Act of 1915 (Streets and Highways Code Sections 8500 et seq., the "1915 Act"). In addition to 1915 Act assessment bonds, most local agencies are authorized to issue assessment bonds pursuant to the Improvement Bond Act of 1911 (Streets and Highways Code Sections 5000 et seq., the "1911 Act"), and many charter cities have established their own assessment bond authorizing procedures under their municipal affairs powers. For a more detailed discussion of municipal affairs, see **Chapter 4, State Constitutional Limitations**. Both the 1915 Act and the 1911 Act are more fully discussed later in this chapter.

Issuance of assessment bonds is preceded by assessment proceedings in which the governing body of the local agency:

- Establishes the scope of the improvement project to be financed, in whole or in part, with assessment bond proceeds
- Identifies the parcels of land that are perceived to receive a special benefit from the subject improvements
- Establishes the estimated cost and expense of constructing the subject improvements and providing for the assessment proceedings and bond financing
- Determines a fair and equitable allocation of the estimated cost and expense to the benefited parcels in proportion to such benefit

- Following a public hearing, imposes and records the assessments as enforceable liens against the respective benefited parcels and provides an opportunity for property owners to prepay the assessment, without interest, prior to bond issuance

It is common practice to refer to the established area of benefit as an assessment district, but the assessment district is not a separate legal entity—it has no separate governing board and no authority to act independently of the local agency that establishes it, it cannot sue or be sued, and it is not a special district akin to a community services district, water district, or public utility district.

As discussed in more detail below, the proceeds of sale of assessment bonds may be used to finance a reasonably broad range of local public improvements, provided that the local agency can legitimately make a finding that such improvements impart special benefit to the parcels of land to be assessed. Examples of local public improvements that are commonly financed, in whole or in part, with assessment bond proceeds are local streets, streetlights, landscaping, sidewalks, sanitary sewers, water supply and distribution facilities, flood control and drainage improvements, and parking facilities.

LEGAL AUTHORITY; ISSUERS

California has many laws that permit assessment districts to be established to finance public improvements. Some of the laws combine the provisions governing issuance of bonds with the provisions for establishment of the assessment district in the same statute. Other laws only specify the procedures necessary to establish the assessment district and incorporate by reference another statute for the issuance of the assessment bonds.

Three general state statutory schemes are most commonly used in California assessment district financing and are discussed in detail in this section. They are:

- The 1911 Act, which contains both provisions for establishing assessment districts and for the issuance of bonds

- The Municipal Improvement Act of 1913 (Streets and Highways Code Sections 10000 et seq., the “1913 Act”), which contains only provisions for establishing assessment districts

- The 1915 Act, which contains only provisions for the issuance of bonds, and requires use of another statute to establish the assessment district, authorize the public improvements, and impose the assessments

In addition to these three general statutory schemes, which are available to local agencies generally, charter cities may enact their own procedures for assessment district formation and assessment bond issuance, and many charter cities have done so.

With the adoption of Proposition 218, Article XIIID was added to the California Constitution (see the discussion of Proposition 218 in **Chapter 4, State Constitutional Limitations – The Jarvis Family of Initiatives**). Section 4 of Article XIIID specifies both procedural requirements and various limitations applicable to all assessments, irrespective of whether they are imposed pursuant to a general statutory scheme or a charter city procedure, and Section 3 of Article XIIID provides that no assessment may be imposed by a local agency (including a charter city) except in conformity with Article XIIID in general and Section 4 in particular.

Article XIIID was added to the constitution without any provision being made in Proposition 218 for the amendment or repeal of pre-existing statutory provisions which were in conflict with the provisions of Section 4. Effective July 1, 1997, Sections 53750 et seq. were added to the California Government Code to begin the process of addressing such conflicts. The statutory provisions are discussed in more detail below. In summary, Government Code Section 53753, which closely follows the language of Section 4 itself, first specifies requirements for notice, protest, and hearing in assessment proceedings and, second, provides that any local agency complying with the Section 53753 provisions shall not be required to comply with any other statutory notice, protest, and hearing requirements that would otherwise apply, whether or not such other statutory requirements are in conflict with the corresponding provisions of Section 53753. See **Appendix D – Legal References – Amalgamated Edition of Proposition 218 and SB 919** for more detail on these provisions.

In 2003, the California Legislature enacted SB 392, which was signed into law by the Governor as Chapter 194, Statutes of 2003. Chapter 194 provided for the amendment or repeal of various pre-existing statutory provisions of the 1911 Act and the 1913 Act, primarily related to notice, protest, and hearing procedures, which were in conflict with the provisions of Government Code Section 53753. As a result, the notice, protest, and hearing provisions of the 1911 Act and 1913 Act are now consistent with the provisions of Section 4. Further legislation may be introduced as additional experience is gained in conducting assessment proceedings in light of the requirements and limitations of Section 4. In the meantime, local agencies considering the use of assessment bond financing will need to consider the practical and legal effects of these new provisions early in the planning process for any such proposed financing program.

In addition, all assessment district proceedings leading to assessment bond issuance (unless they are specifically exempted) must comply with the provisions of two other statutory schemes—the Special Assessment Investigation, Limitation and Majority Protest Act of 1931 (Streets and Highways Code Sections 2800 et seq., the "1931 Act") and Streets and Highways Code Sections 3100 et seq. (the "Notice and Foreclosure Provisions"). See further discussion in the section entitled **Process for Establishing Assessment Districts and Levying Assessments.**

The California courts have consistently distinguished assessments from taxes for purposes of both Articles XIIIA and XIIIB of the California Constitution. See the discussion of Articles XIIIA and XIIIB in **Chapter 4, State Constitutional Limitations – The Jarvis Family of Initiatives**. Accordingly, assessments are not subject to the limitation respecting ad valorem

taxes imposed by Section 1 of Article XIIIA, are not subject to the voter approval requirements respecting special taxes imposed by Section 4 of Article XIIIA, and are not subject to the appropriations limit of Article XIIIB, which applies only to proceeds of taxes.

See **Appendix D – Legal References – Table D-1-1** for a list of various statutes that authorize assessment districts to be established, including whether those statutes also authorize bonds to be issued and, if so, the type of bonds authorized.

See **Appendix D – Legal References – Table D-1-2** for a list of some of the local agencies that are authorized to establish assessment districts and issue assessment bonds. Where applicable, reference to the statute that authorizes that particular local agency to establish an assessment district is also provided in **Table D-1-2**.

IMPROVEMENTS THAT MAY BE FINANCED

The public improvements that are authorized to be financed by assessments levied under the 1911 Act and the 1913 Act are listed below. The reader should note, however, that even though these categories of improvements are expressly authorized by statute, the local agency will be required, in the course of the particular assessment proceeding with its own particular facts and circumstances, to make findings of special benefit to the parcels to be assessed and distinguish between the special benefit to those parcels and general benefit to the public at large. To the extent that the subject improvements are perceived to impart some degree of general benefit to the public at large, a corresponding portion of the cost and expense of the improvements must be financed from other sources legally available for such purposes. Section 4 of Article XIIID provides added emphasis to this issue by specifically providing that a local agency must separate the general benefits from the special benefits conferred by the improvements and only special benefits are assessable.

Many of the local agencies shown in **Appendix D – Legal References – Table D-1-2** that are authorized to levy assessments are authorized by their enabling statute to finance public improvements in addition to those public improvements authorized by the 1911 Act and the 1913 Act. Therefore, this list is not exhaustive. Furthermore, in appropriate circumstances, certain expenses deemed incidental to the improvement project, legal proceedings, and bond financing may be included in the assessments levied and therefore in the bond financing. See Section 5024 in the 1911 Act for illustrations of such incidental expenses.

Improvements Authorized by the 1911 Act. Section 5101 in the 1911 Act authorizes the following types of work and improvements:

- Grading and paving of streets and roads
- Construction of sidewalks, parks, bridges, tunnels, subways, or viaducts
- Sanitary sewers and related facilities

- Storm drains and related facilities
- Street lighting facilities and electrical and telephone service facilities, including the underground placement of existing overhead facilities
- Pipes and hydrants for fire protection
- Breakwaters, levies, and other flood or erosion protection
- Wells, pumps, dams, reservoirs, pipes, and other domestic water supply facilities
- Tanks, mains, pipes, and other domestic or industrial gas supply facilities
- Bomb or fallout shelters
- Wharves, piers, docks, and other navigation facilities
- Retaining walls, ornamental vegetation, land stabilization, and all other work auxiliary to any of the above

Improvements Authorized by the 1913 Act. Section 10102 in the 1913 Act authorizes assessments for any of the work and improvements enumerated in the 1911 Act, and Section 10100 supplements the 1911 Act list as follows:

- Water supply
- Electric power supply facilities
- Gas supply facilities
- Lighting facilities
- Transportation facilities designed to serve an area not to exceed three square miles and designed to operate on rails or similar devices
- Any "other works and improvements of a local nature"

With limited exceptions, the public work and improvements financed by assessment bonds issued on the security of assessments imposed under either the 1911 Act or the 1913 Act must be performed and constructed on public property, defined to include easements and rights-of-way that have been dedicated to and accepted by the local agency. An example of an exception relates to work on private property undertaken for the purpose of grade adjustment or to remedy a geologic hazard (including retaining walls or seismic safety work and improvements).

Acquisition of Improvements. Both the 1911 Act and the 1913 Act authorize the acquisition of previously constructed improvements under certain circumstances. Care is required to assure compliance with the specific requirements for such acquisition.

PROCESS FOR ESTABLISHING ASSESSMENT DISTRICTS AND LEVYING ASSESSMENTS

Preliminary. As indicated above, Proposition 218 added Article XIIID to the California Constitution, and Section 4 of Article XIIID contains important new assessment procedures and other provisions which may conflict with pre-existing statutory provisions, (the assessment procedures of the 1911 Act and the 1913 Act were not harmonized with Section 4 until 2003). Pursuant to Section 3 of Article XIIID, whenever such conflicts exist, the provisions of Section 4 govern. Aside from this supremacy provision of Section 3, Proposition 218 did nothing to further alleviate the resulting conflicts.

As a first step in resolving this situation, the California Legislature enacted SB 919 in June 1997, and it was signed into law by the Governor on July 1, 1997, as Chapter 38, Statutes of 1997, and took immediate effect as urgency legislation. Following is a brief discussion of those provisions of Chapter 38 that apply to assessment procedures and assessment bond issuance.

Section 53753. Section 5 of Chapter 38 added Sections 53750 et seq. to the California Government Code under the title of the Proposition 218 Omnibus Implementation Act (the "Implementation Act"). Section 53750 provides definitions of numerous terms utilized in Proposition 218. Section 53753.5 confirms that once a local agency has conducted assessment proceedings in compliance with the notice, protest, and hearing provisions of the Implementation Act, then those provisions shall not apply to any subsequent annual assessment procedure which may be required by the specific statutory scheme being utilized, unless that subsequent annual procedure entails an increase in assessments, as defined by Section 53750.

The most significant provisions of the Implementation Act for this discussion of assessment procedures are set forth in Government Code Section 53753, summarized as follows:

- ❒ The hearing on the engineer's report must be preceded by at least 45 days mailed notice to the affected property owners, and the notice must include:
    - The total amount proposed to be assessed and the amount proposed to be assessed on the specific parcel
    - The duration of the payments
    - The reason for the assessment and the basis upon which the amount was calculated
    - The date, time, and place of the public hearing
    - A summary of the procedures for completion, return, and tabulation of the newly-required assessment ballots, the central feature of the new protest procedures mandated by Proposition 218
    - A statement that the assessment shall not be imposed if the assessment ballots submitted in opposition to the assessment exceed those submitted in favor, with each

ballot weighted according to the amount of the proposed assessment on the parcel to which the ballot pertains

- ❐ The mailed notice must be accompanied by the assessment ballot, which must include:
  - The address to which the completed ballot may be returned, whether by mail or in person
  - Identification of the parcel to which the ballot pertains or a place where the property owner can identify the parcel
  - Identification of the property owner or a place where the owner can indicate his or her name, together with a signature line where the ballot can be signed prior to being returned
  - A place where the property owner can mark the ballot to indicate either support for or opposition to the proposed assessment
- ❐ The use of punchcard or bar-coded ballots is expressly permitted
- ❐ The marked and signed ballots must then be returned to the local agency in some manner that assures receipt prior to the close of the hearing. Each assessment ballot must be in a form that conceals its contents once it is sealed by the person submitting the ballot. Inclusion of a return envelope with the mailed notice and ballot is optional. If return envelopes are utilized, the local agency should provide a clear statement of the deadline for receipt of the marked and signed ballots.
- ❐ At any time prior to the conclusion of the public testimony at the hearing, any ballot previously filed may be changed or withdrawn by the person who submitted the ballot
- ❐ At the conclusion of the hearing, the ballots must be tabulated, using the weighted tabulation by amount of assessment. In the event co-owners of a parcel submit conflicting ballots, those ballots are allocated weight in accordance with the proportionality of ownership interests.
- ❐ A majority protest exists if ballots in opposition to the assessment exceed ballots in support, and in the event of a majority protest, the proposed assessment cannot be imposed. Unlike the pre-2003 provisions of both the 1911 Act and the 1913 Act, there is no authority to override a majority protest under any circumstances.

Because neither Proposition 218 nor the Implementation Act provides many of the essential components of a workable statutory scheme for imposing assessments and issuing assessment bonds, local agencies will still be required to select both a procedural act and a bond issuance act. A discussed above, both the 1911 Act and the 1913 Act are now consistent with Proposition 218 and Government Code Section 53753. However, to the extent that local agencies other than

charter cities seek to utilize assessment bond financing under a statutory scheme which is not yet consistent with Proposition 218 and Government Code Section 53753, they will be required to conduct the specified assessment proceedings in a manner which complies with the "overlay" of Proposition 218 and Section 53753.

The most widely used assessment procedure in California is the 1913 Act, and a summary of its provisions follows. The 1913 Act's provisions pertaining to notice, protest, and hearing are now expressly superseded by the corresponding provisions of Government Code Section 53753, as summarized above. Of particular significance is the introduction of the assessment ballot for measuring protest, the change from land area to amount of assessments in measuring protests, and the elimination of any ability to override a majority protest.

1913 Act. With the exception of developer-oriented assessment proceedings, public improvements constructed under the 1913 Act are constructed by public works contracts of the local agency, awarded after competitive bidding. Unless the local agency chooses otherwise and makes provision for construction financing to come from another source (such as bond anticipation notes, which are expressly authorized by the 1915 Act), the assessment bonds are sold prior to construction, and the monthly progress payments are made to the contractor from bond proceeds. The procedures for establishing an assessment district and imposing the assessments under the 1913 Act are summarized as follows:

- The legal proceedings start with approval of the boundary map, acceptance of petitions (if utilized), and adoption of the Resolution of Intention, which among other things directs the preparation and filing of the engineer's report. The boundary map is then recorded.

- The engineer's report containing the matters prescribed by the 1913 Act (as supplemented by Proposition 218) is filed and preliminarily approved, the hearing is scheduled, and the improvement project is put out to bid. The hearing schedule must allow for preparation of notices and assessment ballots and the completion of mailing them at least 45 days prior to the hearing.

- As assessment ballots are returned prior to the hearing, the responsible person (typically, the county clerk) compiles a record of ballots received and places them in safekeeping as public documents

- Prior to the hearing, project bids are opened, results analyzed, and the apparent best bidder identified. If the apparent best bid is below the cost estimate, consideration should be given to preparing an amended engineer's report to reflect reduced costs and reduced assessments, if appropriate. On the other hand, if the apparent best bid results in increased estimated costs and thus the need to increase assessments, a new cycle of notice, ballots, and hearing will be required.

- The hearing is conducted (and continued if appropriate) and at its conclusion ballots are tabulated and results announced. As indicated above, a majority protest, as

defined by Government Code Section 53753, precludes imposing the assessments. Otherwise, the local agency may approve the engineer's report (as initially filed or as modified), impose the assessments, and order the work and improvements to proceed.

- The assessments are recorded and become liens, and cash payment notices are mailed to the property owners. At the conclusion of the 30-day cash payment period, the local agency determines the amount of unpaid assessments.

- The local agency authorizes issuance of the assessment bonds and concurrently or later approves the Official Statement, if any, sells the bonds by either competitive or negotiated sale, and awards the construction contract

- Upon receipt of bond sale proceeds, a notice to proceed is given to the contractor and project construction commences. Upon completion of construction, leftover construction funds, if any, are distributed in accordance with the 1913 Act.

- Annually, over the life of the assessment bonds, installments on account of unpaid assessments, with interest, are collected from property owners (either by direct billing or by posting to the county property tax roll, depending on which kind of assessment bonds have been issued) and the monies collected are used to pay the bonds' principal and interest

1911 Act. Before 2003, a distinguishing feature of 1911 Act proceedings was that the hearing process was bifurcated. The subjects of the first hearing were limited to establishment of the boundary and the scope of the improvement project. The critical subjects of total costs and individual assessments were deferred to the second hearing, which was conducted following completion of the authorized work and improvements. Of particular significance was the fact that while the 1911 Act provided a majority protest procedure, it was tied to the first hearing, prior to a determination of total costs and individual assessments.

Clearly, this last feature of the 1911 Act was problematic under Proposition 218 and Government Code Section 53753. First, compliance with Section 53753 required that the proposed individual assessments be determined and that mailed notice of them be given to the affected property owners before the protest procedures were conducted. Second, assuming that a local agency chose, pursuant to Section 53753, to conduct protest procedures in connection with the second 1911 Act hearing (which was held after the improvement work is completed) this course of action ran the risk that the local agency would be precluded from imposing the assessments, by virtue of a majority protest, but with the improvement work already completed.

The 2003 amendments to the 1911 Act resolved these issues by amending or repealing those notice, protest, and hearing provisions that were inconsistent with the provisions of Proposition 218 and Government Code Section 53753. Now, the provisions of the 1911 Act concerning notice, protest, and hearing procedures expressly mandate that these procedures be conducted in accordance with the provisions of Government Code Section 52753.

All Assessment Proceedings. In addition to Proposition 218 and Government Code Section 53753, all assessment proceedings are subject to the provisions of the 1931 Act and the Notice and Foreclosure Provisions. The requirements of these two sets of provisions are detailed, and a full description of them is beyond the scope of this discussion. However, a brief summary follows.

The 1931 Act establishes a procedure for giving notice and holding a public hearing that essentially parallels the procedures contained in the 1911 Act and the 1913 Act, contains a limitation on the assessment that can be levied against any parcel, as measured by the value of the parcel, and establishes a procedure for a majority protest against the assessment. The 1931 Act also provides for a number of methods for dispensing with its requirements. The property owner petition is the most common of these.

The Notice and Foreclosure Provisions require that a boundary map and an assessment diagram be created according to the detailed specifications in the statute and filed with the county recorder. A notice of assessment in the form prescribed by the statute also must be recorded. The assessment lien becomes effective only upon the recordation of the notice of assessment in the office of the county recorder. Whenever assessment proceedings are abandoned, the resolution abandoning the proceedings must be filed with the county recorder.

Assessments (or the installments thereon) that are not paid when due become delinquent and subject the property on which the assessment lien is placed to foreclosure proceedings to recover the delinquent amounts, including late charges, penalties, and costs and expenses of foreclosure. Notice of any pending foreclosure proceedings must be given as provided by the Notice and Foreclosure Provisions. This notice is in addition to any other notice that may be required by the statutes that authorize the assessment districts.

PROCESS OF ISSUING ASSESSMENT BONDS

1911 Act Bonds. Under the bond issuance provisions of the 1911 Act (Sections 6400 et seq.), an assessment bond may be issued for the amount of each unpaid assessment of $150 or more on a particular parcel. The security for each assessment bond issued under the 1911 Act is the unpaid assessment lien on a particular parcel, and the principal amount of each bond is equal to the unpaid assessment on that parcel. Thus, one assessment bond may be issued in the amount of $1,500 and another may be issued in the amount of $265. Assessments under $150 may be collected upon the tax roll if the legislative body so determines.

1911 Act assessment bonds provide for payment of a principal installment to the bondholder annually, on January 2. The governing body may provide for the annual principal installments to be payable in other than equal annual amounts and may provide for the classification of assessments into different maturities so that some assessments (and, correspondingly, some of the assessment bonds) mature over a shorter period of time than others. Interest is payable semiannually on January 2 and July 2.

Local agencies considering the issuance of 1911 Act bonds should be aware of the following:

- At the present time, services of paying agent, registrar, and transfer agent are not generally available from outside service providers
- Billing and collection of installments of principal and interest on account of unpaid assessments to pay 1911 Act bonds cannot be made on the county property tax rolls, as with 1915 Act bonds

Accordingly, the treasurer of the local agency must handle these duties, and the staffing for and costs of performing these duties needs to be a part of the preliminary planning for the issuance of 1911 Act bonds. Furthermore, 1911 Act bond provisions (unlike those of the 1915 Act) contain no authorization to include administrative costs in the installments billed to property owners, so those costs must be estimated and provided for either as up-front incidental costs, which are funded directly from bond proceeds, or as annual administrative costs authorized under the statutory scheme for imposing the assessments.

Another important feature that distinguishes 1911 Act bonds from 1915 Act bonds is that foreclosure proceedings for enforcement of delinquent installments of principal or interest must be brought by and in the name of the bondholder, rather than that of the issuer as is the case with 1915 Act bonds. This feature is generally regarded as material in the determination of suitability of 1911 Act bonds for some investors who may not have the time or resources to pursue foreclosure on their own behalf.

For these and other reasons, issuance of 1911 Act bonds is relatively uncommon and generally regarded as suitable for only a limited segment of the investor community.

1915 Act Bonds. As stated earlier in this section, by far the more common assessment bond in California is the 1915 Act bond. The structure of a 1915 Act assessment bond issue is very different from the 1911 Act bond and much more closely resembles the structure of the other common debt instruments described in the succeeding sections of this chapter. Rather than issuing each individual bond upon the security of a specific unpaid assessment, 1915 Act bonds are issued in a pooling arrangement, with the security for all bonds of the issue being the aggregate of the liens on all the parcels within the assessment district. The entire principal amount of a specific 1915 Act bond matures on a specific September 2, and principal denominations are typically $5,000 or integral multiples thereof, with authority to depart from the $5,000 norm when appropriate. Interest is payable semiannually on March 2 and September 2. The maturity schedule for a 1915 Act bond issue is customarily structured to provide for equal annual debt service, although alternatives are authorized.

1915 Act bonds are customarily sold on a negotiated basis. The Resolution of Intention generally specifies a maximum interest rate and a maximum maturity. The final interest rate or rates, together with the maturity schedule, is customarily established when the bonds are sold.

Under the 1915 Act, certain determinations regarding terms of 1915 Act assessment bonds must be resolved and a determination stated in the Resolution of Intention. These are:

- Whether the local agency will obligate itself to advance available funds of the local agency to cure any deficiency that may occur in the bond redemption fund
- Whether a 2 percent delinquent penalty may be charged per month on the amount of a delinquent assessment, rather than the customary one-time late charges and the lower monthly penalties applicable to property tax delinquencies
- Whether the local agency will preclude itself from refunding the bonds for some stated period of time following issuance (not to exceed 10 years after the date of issuance)

LIMITATIONS ON TERMS OF BONDS

1911 Act assessment bonds are subject to the following limitations and requirements, imposed by statute:

- The maximum stated interest rate is 12 percent per year
- No authorization for capitalized interest
- Interest is required to be payable on January 2 and July 2
- Principal is required to be payable on January 2
- Bonds must provide a redemption premium of 5 percent over the life of the bond
- Property owners may prepay the entire outstanding assessment at any time upon payment of a premium to the bondholder
- The maximum maturity is 25 years
- The bonds must be serial bonds
- No authorization is provided for establishment of a reserve fund

1915 Act assessment bonds are subject to the following limitations and requirements by statute:

- The maximum stated interest rate is 12 percent per year
- Two years of capitalized interest is authorized
- Variable interest rate bonds are permitted
- Interest is required to be payable March 2 and September 2

- Principal is required to be payable on September 2
- Redemption premiums must be at least 3 percent for the first five years, but after that the local agency, at the time of bond issuance, may provide for redemption without premium
- The maximum maturity is 40 years
- The bonds may be serial bonds, term bonds, or any combination thereof
- Certain amounts may be collected each year to reimburse the local agency for the expenses of collection and administration
- Express authorization is provided for establishment of a reserve fund

METHOD OF REPAYMENT AND SECURITY FEATURES

Each 1911 Act bond is payable solely from the installments paid on account of a particular parcel, and payment of such installments is secured solely by the lien on that particular parcel, whereas 1915 Act bonds of a single issue are secured on parity by the pooled assessments on all of the parcels assessed for the improvements financed by the issue. 1915 Act bonds also may have a reserve fund for the benefit of bondholders and though rarely done, issuers of 1915 Act bonds are authorized to obligate themselves to advance available funds of the issuer to compensate for delinquent installments from property owners.

Assessments that are not paid when due become delinquent and the parcels upon which the delinquent assessments are levied are subject to judicial foreclosure or, where 1911 Act bonds have been issued, to an administrative foreclosure procedure known as the "treasurer's foreclosure." Delinquent assessments accrue penalties under the 1911 Act at the rate of 2 percent per month for assessment bonds and under the 1915 Act at either the same rate or the rate established for general taxes (currently, an immediate 10 percent late charge and, commencing July 1 after the delinquency, 1.5 percent per month). The first month's penalty under the 1911 Act may be kept by the treasurer as a cost of servicing the delinquency.

When 1911 Act bonds have been issued, the foreclosure accelerates the remaining unpaid principal, with the foreclosure sale price established on that basis. The 1911 Act bond in question is actually surrendered and canceled following completion of the foreclosure sale, and the former bondholder receives either cash, if a third party submitted the winning bid at the sale, or title to the property. When 1915 Act bonds have been issued, there is no acceleration of unpaid principal, and the foreclosure sale price is based upon only the delinquent installments of principal and interest, together with penalties, late charges, and attorneys' fees and costs of foreclosure. Assuming a bid in excess of the minimum, the winning bidder takes title to the parcel subject to the continuing lien of future installments as they come due and payable. In the event no adequate bid is received, further proceedings are required, a discussion of which is beyond the scope of this *Primer*.

Property upon which there are assessment liens may be divided. Both the 1911 Act and the 1915 Act contain provisions by which the remaining unpaid assessment can be apportioned among the new parcels in accordance with the benefits received. Costs associated with the procedure to reapportion the assessment may be paid by the property owner or included in the amended assessment. Under the 1911 Act, except under limited circumstances, the bondholder must generally approve any division of land that secures a bond and new assessment bonds corresponding to the new liens and parcels must be issued to the bondholder.

Generally, assuming the ratio of the value of the land to the amount of the assessment is sufficiently high, no additional security such as a letter of credit or bond insurance is necessary or, if available, cost effective for assessment bonds. In certain circumstances, primarily property development situations where the project land is undeveloped and the assessments are comparatively high, issuers or bond underwriters may require the developer to provide a letter of credit to assure timely payment of assessment installments until such time as the credit risk is reduced through development and sale of at least substantial portions to third parties or the general public. To date, bond insurance has been found to be cost effective only with respect to refunding of assessment bonds after significant portions of the assessed property have been developed and sold.

SPECIAL FEDERAL TAX CONSIDERATIONS

In addition to the special federal tax considerations discussed in this section and relating to whether assessment bonds are private activity bonds, the other limitations and requirements described in **Chapter 3, General Federal Tax Requirements** (such as limitations relating to arbitrage bonds and hedge bonds) continue to apply.

General. Assessment bonds may, under certain circumstances, be private activity bonds, the interest on which is taxable. Each assessment district proceeding that includes property owners who do not constitute the general public (e.g. commercial enterprises, businesses, or developer districts) or that will allow the public improvements financed by the bonds to be used in a special manner by a business entity must be analyzed to determine whether the Private Business Tests or the Private Loan Test are satisfied. These issues must be analyzed with particular care when there is only one property owner, such as a developer.

The Private Loan Test and the "Tax Assessment Loans" Exception. As described in **Chapter 3, General Federal Tax Requirements,** an issue of bonds is an issue of private activity bonds if such issue satisfies the Private Loan Test. For federal tax purposes, assessments paid over time are generally deemed to be loans. Accordingly, assessment bonds would satisfy the Private Loan Test and would be private activity bonds. However, the tax code contains an exception for certain tax assessment loans, which are the deemed loans that arise when a governmental unit permits or requires its residents to pay a tax or assessment over a period of years.

U.S. Treasury regulations explain that tax assessment loans are not treated as loans for purposes of the Private Loan Test if:

- The loans arise from the imposition of a mandatory tax or other assessment of general application
- The assessments are imposed for one or more specific, essential governmental functions, and
- Owners of both business and nonbusiness property benefiting from the financed improvements are eligible or required to make deferred payments on an equal basis

The equal basis rule does not prohibit the use of due on sale clauses in connection with assessment or special tax financings, so long as the due on sale clause does not single out certain sales for special treatment. The equal basis rule does prohibit the guarantee of payment of assessments by a deemed borrower if it is reasonably expected that payments will be required under the guarantee.

Additionally, U.S. Treasury regulations provide some significant guidance on the types of activities or facilities that qualify as "essential governmental functions." In general, utility or system improvements owned by a governmental entity and used by the general public (e.g. streets, telephone, electric and cable television systems, and sewage or water facilities) serve essential governmental functions. Otherwise, the service provided by the financed facilities must be customarily performed by governmental entities and the facilities must be owned by a governmental entity.

Private Business Tests. Even if an assessment bond is not a private loan bond, it still may be a private activity bond if it meets the Private Business Tests.

In general, the special rules for assessment bonds cause the Private Payment or Security Test to be satisfied whenever the Private Business Use Test is satisfied. This follows from a rule that provides "special assessments paid by property owners benefiting from financed improvements are not generally applicable taxes." Payments made in respect of privately used property, even if made by the general public, are "private payments" that count against the Private Payment or Security Test unless the payments are generally applicable taxes. Presumably a broadly spread assessment, such as a city-wide or school district-wide assessment, will be a tax of general application. Otherwise, the Private Payment or Security Test is meaningless for assessment bonds.

Notwithstanding the loss of flexibility as a result of the obsolescence of the Private Payment or Security Test, the Private Business Use Test provides flexibility. Subject to the essential governmental function requirement, governmentally owned facilities will not have private business use to the extent the financed facilities are intended to be available and in fact are reasonably available to individuals as well as businesses. Even a special economic benefit to a

limited number of private businesses and limited actual use by the public will not pose a problem. For example, a governmentally owned dead-end road into a private business park or a remote business location, or a cul-de-sac for an industrial park, is not treated as used in a private trade or business, so long as use of the road is not restricted in any fashion.

Three criteria can be used to determine whether assessment bond proceeds will be treated as governmentally used and not as used in the "trade or business" of a commercial entity or business:

- The facilities are designed to serve and are available for use by members of the general public in the governmental unit on an equal basis
- The ultimate ownership and operation of the facilities is with the governmental unit, and
- Development of the land within the district and transfer of the public improvements to the governmental entity is expected to occur with reasonable speed and in fact occurs promptly upon completion of the public improvements

Although it may not be necessary to satisfy each of these three criteria in every instance, the possibility that any one of them may not be satisfied should trigger a particularly detailed federal tax analysis of the financing transaction. Recently released U.S. Treasury regulations provide significant new guidance for analyzing these issues.

POLICY CONSIDERATIONS

The decision to issue assessment bonds may involve a number of competing policy considerations. Many of the types of improvements that may be financed with assessment bonds also may be financed with Mello-Roos bonds, general obligation bonds, or revenue bonds. Financing improvements with assessment bonds results in distributing the project cost to the parcels deemed specially benefited by the project work and improvements. As an overall strategy for financing certain types of improvements, this may be fair. On the other hand, if similar improvements for other parts of the issuer's jurisdiction were financed with bonds that spread the cost of those improvements more widely, it may be appropriate to finance new improvements of the same type in the same way as before.

Second, once the decision to use assessment bonds has been made, the determination of the method for spreading the assessments is a often a sensitive and contentious matter, especially if the owners of some of the parcels to be assessed object to one or more aspects of the assessment proceeding. Managing the objections of unhappy property owners, especially in light of Proposition 218, may entail a determination by the local agency to pay some portion of the project cost and expense from other sources.

Finally, assessment proceedings often are considered in connection with new land development within the jurisdiction of the local agency, and the question arises as to whether the local agency

should support or encourage the development or the developer in such a manner. Many local agencies have adopted formal policies and guidelines to assist in making these sensitive policy determinations.

COMMERCIAL PAPER

See information in **Chapter 8, Fixed and Variable Interest Rate Structures**.

Financing Leases and Certificates of Participation

Definition and Purpose

A financing lease provides a public agency with an alternative to issuing bonds to finance capital assets over a multi-year period.

A tax-exempt lease financing typically falls into one of two general categories:

- A public agency may finance a capital asset by leasing it directly from the vendor or leasing company, with the lessor receiving a portion of each rental payment as tax-exempt interest, or
- In the event the public agency wishes to utilize a tax-exempt lease in connection with the sale of municipal securities, certificates of participation, representing undivided interests in the rental payments under the tax-exempt lease, may be sold to the public

A typical certificate of participation (COP) financing for a construction project might be structured as follows. A public agency that wishes to undertake a construction project enters into a tax-exempt lease with a nonprofit corporation, JPA, leasing company, bank, or other lessor. The lessor acquires the applicable site, either by purchasing it from a third party or by leasing it from the public agency. The lessor, with the assistance of the public agency, undertakes the construction of the project to be located on the site and leases the improved site to the public agency pursuant to a financing lease. The lessor's rights to receive payments under the lease are assigned to a trustee, which executes and delivers to an underwriter, COPs in the lease payments. A portion of each lease payment is designated as tax-exempt interest. The proceeds of the sale of the COPs are used to pay the costs of acquiring and constructing the improvements.

Projects That May Be Financed

A tax-exempt lease may be used to finance any property that the public agency has the statutory authorization to lease. As a general matter, only land and depreciable property may be leased. Generally, the leased property is a capital asset to be used by the public agency in its own operations.

However, some public agencies, such as redevelopment agencies and charter cities may use tax-exempt lease financing to provide a facility for the use of a nongovernmental borrower. The public agency acquires the property by lease or installment purchase and then leases or sells it to the nongovernmental borrower. The public agency's obligation to pay rent or installments is structured as a special fund obligation, limited to the payments it receives from the nongovernmental borrower. Often, the stream of payments from the public agency is sold to investors through the issuance of COPs.

Asset Transfer Financing. So-called asset transfer financings follow the basic pattern of a tax-exempt lease financing. However, in this type of financing, the property that is the subject of the lease (typically an unencumbered public improvement such as a city hall, police station, or other government building) is already owned by the public agency lessee. The lessee leases or sells the property to a lessor (purchaser) and immediately leases (or repurchases) the property back. Often, the funds derived from an asset transfer financing are deposited into a capital improvement fund or other building or construction fund to pay the cost of construction or acquisition of various public improvements. In addition, the lessor (purchaser) will often raise funds to purchase the property by assigning the right to receive payments to a trustee, without recourse, who will execute and deliver COPs.

The asset transfer structure allows a public agency to meet current capital requirements by realizing cash from the value of existing, unencumbered assets. In the event the leaseback is structured as a long-term lease, the public entity can begin making lease payments immediately since it has immediate use and occupancy of the existing improvements, and thus there is no need to capitalize interest during the construction period for the project to be financed and no risk associated with noncompletion of the construction project.

POLICY CONSIDERATIONS

Historically, financing leases and COPs have been used when bond financing was determined to be unavailable or undesirable for a variety of reasons, including:

- The election requirements of the California Constitution, the relevant statutes, or a city charter could not be met
- The facility to be financed generated no revenues on its own (e.g. a city administrative office building) and local general obligation bonds were not permitted (1978 through 1986)
- A statutory interest rate limitation applicable to bonds was below the market rate
- A statute authorizing bonds required a competitive sale in a market in which negotiated sale was more appropriate
- Other restrictive conditions on the use of bond proceeds or the procedures of issuance were contained in the bond statute

The asset transfer financings are essentially methods of leveraging public assets and borrowing all or a portion of the value of the public agency's equity in those assets in order to finance other desired assets. A public agency must determine as a policy matter whether such a use of existing assets is appropriate in meeting present and future capital requirements. For a complete discussion of the policy considerations for lease revenue bonds, see *Guidelines for Leases and Certification of Participation* (CDIAC 1993).

SECURITY AND SOURCES OF REPAYMENT

Long-term Leases. Payments made by a public agency pursuant to a long-term lease may be made from any lawfully available funds of the public agency. Security for a long-term lease may be impaired, however, due to:

- The possibility that failure to complete a project may result in the legal inability to pay rent
- The abatement of rent during the lease term if beneficial use and occupancy of the leased property is unavailable because of calamity or otherwise, and
- The absence of any right to accelerate rental payments and the corresponding requirement of bringing a lawsuit for annual rental payments as they come due in each year

See **Chapter 4, State Constitutional Limitations – The 1879 Constitution – The Debt Limit**.

To reduce these risks, a long-term lease often includes the following protections:

- In the event the leased project is to be constructed, interest is capitalized during the construction period. In addition, the construction contractor is often required to provide payment and performance bonds, and "all-risk" insurance in an amount equal to 100 percent of the replacement cost of the project. In certain circumstances, earthquake and flood insurance may be required. Liquidated damages for late completion of the project also may be required in a daily amount equal to daily rental on the tax-exempt lease.
- After the completion of construction of the project, the lessee is often required to maintain the insurance described above, plus rental interruption insurance
- A bond reserve fund may be required in an amount equal to the maximum annual rental payment under the lease and held by an independent trustee for the COPs
- A title insurance policy in an amount equal to the aggregate principal amount of the tax-exempt lease may be required in a lease of real property

Non-appropriation Obligations. Rating agencies have treated non-appropriation obligations with caution, requiring that any property financed on this basis be "essential to a governmental purpose" and that if the right not to appropriate payments is exercised (and the property is therefore returned to the control of the lessor), the public agency covenants not to replace the property for some period of time. This sort of a nonreplacement covenant may not be valid under California law. Additionally, the rating agency often requires that non-appropriation obligations also incorporate a covenant to include the installment payments in annual budgets submitted to the obligor's governing board. This is simply a promise by the obligor to have its legislative body consider appropriating funds to pay the installments under the obligation

annually—it is not a covenant to adopt the budget so submitted. Publicly marketed California leases are ordinarily not non-appropriation obligations and usually include a covenant to budget and appropriate lease payments as long as the leased property can be used.

While a tax-exempt lease may simply involve a lease of personal or real property from a private entity to a public agency as lessee, a tax-exempt lease financing may be structured in such a manner that the governmental entity not only acquires property, but also disposes of property. If the financing structure involves a disposition of property by the public agency, two major concerns regarding statutory authority are raised—statutory procedures for disposing of property and the public purpose requirement.

Statutory Procedures for Disposition of Property. Special limitations and authorizations relating to dispositions of property are sometimes contained in the organic acts of the governmental entity. In certain instances, public agencies may be required to publicly bid the lease or other disposition of publicly owned property pursuant to so-called surplus property statutes. (See, for example, Government Code Sections 25363 and 25526 for counties.) This may be of special significance in certain sale-leaseback financings. Other procedures in particular circumstances may be required, such as the publication of the notice of intention to convey property.

Exemptions from public bidding requirements are available to, among others, parking authorities leasing a parking facility to a city in which the authority is located (Streets & Highways Code Sections 32952 and 32957), certain redevelopment agency contracts (Health & Safety Code Sections 33430 et seq.), and joint powers authorities (Government Code Sections 6500 et seq.). In addition, counties may, pursuant to a four-fifths vote of the board of supervisors, sell or lease county-owned property without complying with any competitive bidding requirements if the county repurchases or leases back the property as part of the same transaction.

Public Purpose Requirement. Any lease by a public agency (whether to acquire or dispose of property) must be in furtherance of a proper public purpose. California courts have invalidated leases of municipal property to private persons as unconstitutional uses of public property, where a predominate public purpose for the lease could not be identified.

PROCESS FOR APPROVAL

The particular statutory leasing authorization must be reviewed to determine the approval requirements in connection with entering into a tax-exempt lease. In some instances, it may be necessary to competitively bid the lease or other disposition of property pursuant to laws affecting the acquisition or disposition of publicly owned properties.

PROCESS FOR SALE

Certificates of participation can be sold at either competitive or negotiated sale.

LIMITATIONS ON TERMS

Interest Rate. Statutory interest rate limitations applicable to bonds are not applicable to the principal and interest components of a tax-exempt lease when the statute authorizing the lease has no interest rate limitation. Therefore, many tax-exempt leases have no statutory interest rate limit.

Lease Term. The statute authorizing the lease may limit the maximum lease term. Additionally, in the event a long-term lease is utilized, the term of the lease will generally be limited to the useful life of the property.

Variable Rate Leases. Certain types of tax-exempt leases may contain an interest component that varies during the lease term. However, if a long-term lease is used, rental payments may not satisfy the fair rental value requirement if they fluctuate with market interest rates.

LEGAL AUTHORITY

In analyzing a tax-exempt lease financing, it is important to remember that the public agency is using its authority to acquire or dispose of property, rather than its authority to incur debt. While the terms "tax-exempt lease" or "financing lease" will be used herein, the tax-exempt obligation may be structured as an installment purchase agreement, installment sale agreement, or lease-purchase agreement, as explained below.

Constitutional Considerations. Generally, the California Constitution requires voter approval for issuance of long-term debt paid from the general fund of a city, county, school district, or the state. In a tax-exempt lease, the public agency's obligations under the lease are designed to avoid classification as "debt" for purposes of the constitution. This can be done in several ways using judicially created exceptions to the constitutional debt limit.

Long-term Lease. A long-term lease containing an obligation to pay fair-market rental in each year in which beneficial use and occupancy is tendered to the public agency—a long-term lease—is outside the constitutional debt limit. The most significant aspects of a long-term lease are as follows:

- Rentals may only be paid in those periods in which beneficial use and occupancy of the leased property is available to the lessee
- Acceleration of rental payments is not permitted
- The obligation to pay rental payments may be from any lawfully available funds of the lessee, which may covenant to place in its annual budget the rentals that are due and payable during the fiscal year

- The terms and conditions in the lease must be similar to lease terms found in a commercial context for similar types of facilities

- The lease term should not extend beyond the anticipated useful life of the leased property and fair market rental should be paid

Non-appropriation Obligation. In certain circumstances a public agency may determine to obligate itself only for payments due in the then current fiscal year without treating the obligation as "debt" for constitutional purposes. Such obligations, which may be leases, installment sales agreements, or lease-purchase agreements, are referred to herein as non-appropriation obligations. The name given the obligation is immaterial. What is important is that the contract be terminable by the public agency in its sole discretion at least once during each fiscal year.

Special Fund Obligation. Certain contracts may be called leases but, like a non-appropriation obligation, do not rely upon the long-term lease exception to the constitutional debt limitation. In such cases, the rental or installment payments due under such obligations are payable exclusively and solely from a designated special fund of the public agency identified in the contract. This special fund must be derived from activities related to the purposes for which the special fund obligation is issued. It may not be additionally secured by recourse to the general fund or taxing powers of the public agency. As is the case with a non-appropriation obligation, the obligation need not be called a "lease"—the key element is the limited source of funds from which periodic payments can be made by the public agency. Such obligations may provide for acceleration of payments upon default.

Statutory Considerations. Any public agency with the authority to acquire or dispose of either real or personal property can enter into a tax-exempt lease. California statutes contain a multitude of provisions authorizing various public entities to acquire a variety of specific kinds of property. A listing of the most commonly used of these statutory provisions is provided in **Appendix D – Legal References – Table D-5-1**.

FEDERAL TAX ISSUES

Apart from the issues discussed immediately below, financing leases and certificates of participation do not present many unique federal tax issues. The various limitations and requirements described in **Chapter 3, General Federal Tax Requirements**, such as limitations relating to private activity bonds, arbitrage bonds, and hedge bonds, continue to apply. The federal tax issues relating to lease financings are identical for financing leases and COPs.

If the interest paid pursuant to a lease is to be exempt from federal income taxes, the interest must be separately stated and designated as "interest." Additionally, and in direct contrast with the constitutional debt limitation analysis discussed above, the lease must be recharacterized, for federal tax purposes, as a borrowing transaction (e.g. as a financing lease, conditional sales agreement, or installment purchase contract) rather than as a true lease. In other words, in order

to have tax-exempt interest, one must first have interest, and in order to have interest, one must have a debt. The federal and state tax legal authorities that characterize an obligation as a debt when that obligation is called a lease are well-established and represent an analysis that is completely separate from the characterization of the obligation as a lease for purposes of avoiding the constitutional debt limitation.

Among the circumstances articulated by the Internal Revenue Service that would warrant characterization of a transaction as a debt (also called a conditional sales agreement or a finance lease) are the following:

- Portions of the periodic payments are made specifically as applicable to equity to be acquired by the lessee
- The lessee will acquire title upon the payment of a stated amount of "rentals" under the contract
- The total amount that the lessee is required to pay for a relatively short period of use constitutes an inordinately large proportion of the total sum required to be paid to secure the transfer of the title
- The agreed "rental" payments materially exceed the current fair rental value. This may be indicative that the payments include an element other than compensation for the use of property
- The property may be acquired under a purchase option at a price which is nominal in relation to the value of the property at the time when the option may be exercised, as determined at the time of entering into the original agreement, or which is a relatively small amount when compared with the total payments required to be made
- Some portion of the periodic payments is specifically designated as interest or is otherwise readily recognizable as the equivalent of interest

SPECIAL STATE TAX ISSUES

State Income Tax Exemption for the Interest Component of Financing Leases. The general provision in the California Constitution stating that "bonds issued by the State or a local government in the State" are exempt from personal income tax applies to installment sale contracts and leases. Several Franchise Tax Board General Counsel opinions have been issued concerning the exemption of the interest component of installment sale contracts and leases under the constitutional provision.

Property, Sales, and Transfer Taxes. Whether or not property tax and sales tax may be payable in a particular transaction depends largely upon the facts surrounding the transaction. Generally, ad valorem property tax need not be paid by a public agency, however, it may be that a private entity leasing property to a public agency retains some taxable interest in the leased property. Typically, it is necessary for a public agency leasing property to covenant, to the

extent permitted by law, to indemnify the lessor for the cost of ad valorem property taxes, sales, or transfer taxes, if any, that may be levied in connection with the leased property.

Insofar as sales taxes are concerned, public agencies must pay sales tax on personal property that they purchase, and if real property is the only property sold, no sales tax is payable. In some instances, a resale license might be utilized to document the fact that no additional sales tax is payable upon both segments of a sale/saleback transaction.

LOCAL AGENCY GENERAL OBLIGATION BONDS

DEFINITION AND GENERAL FEATURES

General obligation (GO) bonds are the simplest bond security type. In California, they require a supermajority voter approval and as a result are utilized infrequently by many local governments. General obligation bonds are secured either by a pledge of the full faith and credit of the issuer or by a promise to levy property taxes in an unlimited amount as necessary to pay debt service, or both. The State of California's general obligation bonds are full faith and credit bonds, to which the state's General Fund, rather than any particular tax revenue, is pledged. The various general obligation bond programs of the State of California are described in **Appendix A – Working with State Agencies**.

With very few exceptions, local government agencies are not authorized to issue full faith and credit bonds. The general obligation bonds of such agencies are typically payable only from ad valorem property taxes, which are required to be levied in an amount sufficient to pay interest and principal on the bonds coming due in each year. These property tax revenues are distinct from general property tax collections and are dedicated to debt service payment and cannot be levied or used for any other purpose. Some local agencies may also pledge revenues of the facilities financed by the bonds as additional or even primary security for the bonds. Interestingly, relatively few statutes (other than those relating to the state's bonds) use the designation, "general obligation bonds" and it may be more accurate to think of these obligations as "unlimited tax bonds."

Under Article XVI, Section 18 of the State Constitution, no county, city, town, or school district may incur indebtedness without a two-thirds popular vote. This article was modified in 2000 through the enactment of Proposition 39, which authorizes bonds for repair, construction, or replacement of school facilities, classrooms (if approved by 55 percent local vote for projects evaluated by schools), community college districts, and county education offices for safety, class size, and information technology needs.

Some other local government agencies may be authorized by statute to issue bonds without voter approval, or with a simple majority vote. However, under Section 1(b) of Article XIIIA of the constitution, any new indebtedness to be repaid from an ad valorem tax levied against real property must be approved by a two-thirds vote of the qualified electors, and the bonds may only be used to finance "the acquisition or improvement of real property." Therefore, whenever a local agency considers using general obligation bonds to finance projects, it is important to understand what constitutes real property, and what is an acquisition or improvement thereof. In other words, what types of projects and property may and may not be financed with general obligation bonds?

PROJECTS THAT MAY BE FINANCED

There is no direct legal authority defining what is and what is not "real property" for purposes of

Article XIIIA, and therefore the language of Article XIIIA, “for the acquisition or improvement of real property” is subject to interpretation in each instance. There is general agreement among practitioners and issuers that the limitation to “real property” means that vehicles, equipment, furnishings, supplies, and labor may not be financed with general obligation bonds. Generally, anything that is truly portable or can be removed from land or a building without causing damage to the land or building, may not be financed.

“Improvement” does not include ordinary repairs, maintenance costs, or supplies, and these may not be financed with proceeds of general obligation bonds. Fixtures, equipment, and materials that become part of or are affixed to land or to a building in the course of making legitimate improvements to real property are probably appropriately considered real property improvements, although direct legal authority for financing each of these particular items is lacking. Similarly, labor costs, professional fees (such as for general contractors, architects, real estate appraisers, and brokers), real estate closing costs, and other costs directly connected to real property acquisition and improvement are probably also appropriately financed from general obligation bonds.

While ongoing maintenance may not be financed with general obligation bonds, even though it contributes to the physical condition of real property and its improvements, deferred maintenance probably may be financed, especially as that term is used by school administrators. So long as deferred maintenance refers to projects that involve replacement of major systems or building components, such that the project is properly classified as an improvement to real property, it can be financed with general obligations bonds. For example, if a roof is so badly deteriorated that it must be replaced rather than patched, this is properly deemed an improvement to real property.

Not every interest in land is “real property” for purposes of Article XIIIA. For example, while local agencies may acquire permanent ownership in a fee and lesser interests such as easements, it is doubtful that acquisition of a leasehold interest is a permitted use of general obligation bond proceeds. Therefore, payment of rent—the price of a leasehold interest—without acquiring some more permanent interest probably would not be permitted.

Interest earnings on bond proceeds generally also must be applied to approved real property purposes, unless an issuer has specific authority permitting another use. If authorized by statute, costs incidental to issuing the bonds, including costs of conducting the bond election, may be paid from the proceeds of the bonds.

While the State Constitution permits general obligation bonds to be issued to finance any real property acquisition and improvements, additional limitations may be specified by the authorizing statutes for the various entities permitted to issue general obligation bonds. Local agency general obligation bonds are customarily used to finance publicly owned facilities, including public office buildings, school buildings, utility system improvements, and infrastructure. Local agencies also may use general obligation bonds to finance privately owned

facilities that sufficiently advance a public purpose. The legislature has authorized cities and counties, for example, to make loans to private landowners for seismic safety improvements to real property. Unless it is for a public purpose, the giving or lending of a local agency's credit or public funds is prohibited by Article XVI, Section 6 of the State Constitution. Even if appropriately authorized under state law, when private parties directly and specially benefit from public financing, the interest on the general obligation bonds may be taxable. See **Chapter 3, General Federal Tax Requirements**.

Each Local Agency Has Its Own Authority To Finance Various Projects. Many of the statutes authorizing local agencies to issue general obligation bonds have not been updated to conform with the restrictions of Article XIIIA, discussed above. Thus some issuers would appear to have the authority to issue bonds for equipment or operating costs, and to do so when authorized by a simple majority vote or without any popular vote at all (see text boxes below for each issuer type).

City Projects

General law cities may use general obligation bonds to finance the acquisition, construction, or completion of the real property portion of any "municipal improvement," which includes:

- ✓ Hospitals
- ✓ Convention halls
- ✓ Veterans' homes
- ✓ Parks and boulevards
- ✓ Toll bridges
- ✓ Seismic strengthening of unreinforced masonry buildings
- ✓ Redevelopment projects
- ✓ Sewage treatment plants
- ✓ Airports
- ✓ Flood control
- ✓ Acquisition of land for conveyance to the federal government
- ✓ The real property portion of any "municipal improvement"
- ✓ "Works, property or structures necessary or convenient to carry out the objects, purposes and powers of the city"

A charter city may also issue general obligation bonds to finance the real property portion of any project that is determined to be a "municipal affair", subject to any financing limitations specified in such charter or elsewhere in the State Constitution. See **Chapter 4 –State Constitutional Limitations – The 1879 Constitution – Charter Cities**.

County Projects

Counties may finance the real property portion (including improvements) of any purpose for which the board of supervisors is authorized to expend the funds of the county. Explicit authority also exists for funding:

- ✓ Highways
- ✓ Toll bridges
- ✓ Airports
- ✓ Seismic safety improvements (including making loans for that purpose)
- ✓ Redevelopment projects
- ✓ Acquisition of land for conveyance to the federal government for military bases and for other federal purposes
- ✓ Improvement of nonnavigable streams

School District Projects

School districts may use general obligation bonds for:

- ✓ The purchase of school lots
- ✓ Building or purchasing school buildings
- ✓ Making alterations or additions to school buildings other than as necessary for current maintenance
- ✓ Repairing, restoring, or rebuilding school buildings damaged by fire or other public calamities
- ✓ Permanent improvement of school grounds
- ✓ Carrying out of sewer projects
- ✓ Demolition of any school building to replace it with another school building, whether or not in the same location
- ✓ Refunding outstanding indebtedness

Special District Projects

General obligation bonds may be issued by a large number and variety of special districts in California, for an equally varied number of purposes. Because of the differences in statutory authority among these districts, a detailed list of the specific features of special district bonds, what they may be used for, how they are approved and issued, or the limitations characterizing each type is beyond the scope of this section. For information about the particular entities and where the legal authority for their general obligation bonds may be found, see **Appendix D – Legal References – Table D-2-1**.

Interpretation of Voter Authorization. General obligation bonds may be used only for the purposes approved by the voters. Taken together, the statutes (or charter provisions) authorizing the election and the issuance of the bonds, the resolution calling the election, and the specific language contained in the ballot measure itself, create a manner of contract which is binding upon the local agency once the voters have given their assent.

The ballot measure proposed to the voters must recite the purposes for which the proceeds will be used, but the local agency's governing body may choose how precisely or how generally to state those purposes. Courts have held that a general statement of the question reserves to the issuer the flexibility to spend bond proceeds as it wishes, within the terms of the authorization. This is true despite any specific promises or assertions made by public officials or bond supporters at the time of the election, including those made in official plans, ballot arguments, or campaign propaganda. On the other hand, if the ballot measure is too specific with regard to the projects to be financed (e.g. "a two-lane steel and concrete bridge 300 feet in length traversing the railroad tracks at 14th Avenue"), the local agency may be bound to build what the voters have approved, and may not be able to change its plans in the future despite changes in circumstances or spending priorities.

A ballot measure that is specific as to the purposes for which the proceeds will be used also may trigger the California Environmental Quality Act. For more information on the application of environmental laws to public finance transactions in general, see **Chapter 5, Environmental Issues**.

POLICY CONSIDERATIONS

Advantages. *G*eneral obligation bonds have historically provided issuers with the lowest borrowing costs because the broad security pledge yields the highest possible bond rating and widest investor acceptance. Also, bond insurance can be less costly or even unnecessary. A reserve fund is usually not required (or even permitted), leaving more bond proceeds for project purposes (or keeping bond par to the minimum necessary.) Many financing terms are dictated by statute, often allowing the legal documentation to be less complex than for other types of bond issues. Lastly, local GO bond issuers are guaranteed that their operating funds will not be diverted to pay debt service on the bonds.

Disadvantages. On the other hand, local agencies may find certain of the legal and procedural requirements of general obligation bonds to be disadvantageous if not insurmountable:

- **Supermajority Needed.** Voter approval (two-thirds for most entities) is difficult to obtain, costly, and time-consuming

- **Timing Requirement.** A minimum of 88 days is required to call an election for most agencies and at least 123 days is required for a school district. Additional time is needed to certify the election results before the local agency may even begin proceedings to authorize the debt issue.

- **General Fund Cost.** The county registrar of voters should be able to provide the estimated cost per voter. If the election fails, the local agency's general fund will normally have to bear this cost. In any event, no taxpayer funds may be used to support the bond measure campaign.

- **Limited Financing Options.** Statutory restrictions on the financing terms for some local agencies, such as requirements for level amortization of debt, competitive sale, and maximum number of years to repay, may be undesirable compared to alternative financing methods

- **Incomplete Financing.** Projects that require significant investment in furnishings and equipment for their ordinary use, such as school desks and chairs, computers, office equipment, police cars, fire engines, and other personal property, cannot be completed without additional alternative financing for those components

Table 6-1
Statutory Debt Limits
(as percentage of assessed value of all taxable property)

Issuer Type	Bonding Capacity
General Law Cities	3.75 percent
Counties	1.25 percent, generally
	3.75 percent, for water conservation and flood control projects and the construction of select county roads
Unified School Districts	2.5 percent
Other School Districts	1.25 percent

Other Public Policy Issues. Property taxes securing GO bonds are levied on all nonexempt property in a municipality, which may not be appropriate or ideal if a project only or more directly benefits a specific area. Alternate taxing structures can be crafted (within reason) to provide exemptions for certain taxpayers, or to tax other types of property differently, or to redistribute the tax burden. These taxes can be pledged to the repayment of a different type of tax-exempt bonds and may be a preferred financing mechanism (see the section on **Mello-Roos Bonds** in this chapter).

It should be noted that each local agency authorized to issue GO bonds receives its own bonding capacity or debt limit, usually expressed as a fixed percentage of the assessed value of taxable

property in the jurisdiction of the issuer (see the section on **Process for Approval**). This limitation is distinct from and additional to the constitutional debt limit (see **Chapter 4, State Constitutional Limitations – The 1879 Constitution – The Debt Limit**). Even with voted bond authorization, an issuer may not issue bonds if its outstanding debt is at or exceeds its statutory debt limit. Since there are now many special districts overlapping the traditional boundaries of counties, cities, and school districts, the potential has increased for the general obligation debt of these various overlapping entities to each be within their legal limit, and yet in combination impose an unacceptable tax burden on the owners of taxable property.

SECURITY AND SOURCES OF PAYMENT

General obligation bonds are secured by the legal obligation to levy an ad valorem property tax upon taxable property in the jurisdiction of the issuer in an amount sufficient to pay the debt service. In the case of certain revenue-producing facilities, the bonds may be additionally, or even primarily, secured by or paid from revenues generated by those facilities financed from the bonds. Certain special districts have old statutory authority to issue bonds secured by what are called ad valorem "assessments," but under Article XIIIA, it is not clear if these statutes authorize the levy of ad valorem taxes to pay the bonds. Issuers should consult with bond counsel to determine if such bonds may still be issued and if taxes or assessments may be levied to pay them.

PROCESS FOR APPROVAL

For local agencies not covered under Proposition 39, the approval process for general obligation bonds must include an election at which at least two-thirds of the qualified electors approve the issuance of bonds, and in doing so approve the levy of an ad valorem tax to pay the bonds. Proposition 39 related entities require a 55 percent majority (see **Chapter 4, State Constitutional Limitations – The 1879 Constitution – The Debt Limit** and **The Jarvis Family of Initiatives – Proposition 13**). Each local agency may have its own additional requirements, as described below:

Cities. The process for approval of a general obligation bond issue by a city includes the following steps:

- The city council must pass a resolution by a two-thirds vote of all of its members (*not* just two-thirds of a quorum) determining that the public interest or necessity demands the acquisition, construction, or completion of any municipal improvement

- At any subsequent meeting, the city council must adopt an ordinance on its second reading by a two-thirds vote of all of its members (again, *not* of a quorum) which places a bond proposition specifying the amount and purposes of the bonds before the city's electors

- Publication or posting of the ordinance is required

- The election is usually conducted on behalf of the city by the county registrar of voters

- Following passage, the city council adopts a resolution specifying the terms under which all or a portion of the authorized bonds will be issued

Counties. The process for approval of a general obligation bond issue by a county includes the following steps:

- The board of supervisors adopts a resolution calling a bond election and specifying, among other things, the purposes for which the indebtedness is to be incurred and the maximum amount of bonds proposed to be issued

- The election is conducted by the county registrar of voters

- Following passage, the board of supervisors adopts a resolution specifying the terms under which all or a portion of the authorized bonds will be issued

School districts. The usual process for approval of a general obligation bond issue by a school district includes the following steps:

- The school board adopts a resolution ordering the county superintendent of schools to call a bond election in the school district. The order must specify the purposes for which the indebtedness is to be incurred, the maximum amount of bonds proposed to be issued, and the maximum interest rate permitted to be paid

- Notice of the election must be posted in the district

- The election is conducted by the county registrar of voters

- Following passage, the school board adopts a resolution requesting the board of supervisors of the county and the county superintendent that has jurisdiction over the school district, to issue the bonds on behalf of the school district

- The board of supervisors of the county adopts a resolution ordering the sale and specifying the terms of the school district's bonds

An alternative sale and issuance procedure is permitted if the school board elects to issue bonds under the Government Code rather than under the Education Code. In that event, following a successful election, the school board authorizes and issues the bonds directly, and the board of supervisors of the county is not required to take action. It is important, however, for the school district to coordinate its efforts with county officials, especially in order to ensure that the board of supervisors approves the levy and collection of the ad valorem tax by county tax officials.

PROCESS FOR SALE

Cities. Competitive sale is required. After the receipt of bids, the bonds are awarded to the maker of the best bid (see text box on **Calculating the Winning Bid** for more on the best bid). The award is usually made by an officer authorized to act on the city council's behalf. If no bids are received (or no bids conform to the bid requirements) or if the city council determines that no bid is satisfactory or that no bidder is responsible, the bonds may be sold at negotiated sale. The bonds must be sold for not less than par.

Calculating the Winning Bid

At competitive sale, the winning or best bid (confusingly also called the "highest bid" and the "lowest bid," referring to either the price paid for the bonds or the interest rates) is the bid that provides the issuer with the lowest interest cost, typically calculated by the Net Interest Cost (NIC) or True Interest Cost (TIC) method. The TIC method is generally preferred to the NIC method, because it also adjusts for the time value of money. However, because the TIC cannot be easily calculated without a computer, NIC was commonly used when personal, and particularly portable, computers were less available. See **Appendix C – Debt Financing Terms and Concepts** for an explanation of the NIC and TIC methods.

Counties. Either competitive or negotiated sale of the bonds is permitted. The statute provides that county general obligation bonds be "sold at the times, in the amounts, and in the manner prescribed by the board (of supervisors), but for not less than par."

School districts. Either competitive or negotiated sale of the bonds is permitted (unless the alternative Government Code provisions are used, in which case only competitive sale is permitted). The bonds may be sold at a discount of no greater than 5 percent.

OTHER LIMITATIONS ON TERMS OF BONDS

The terms of bonds of each local agency may be further limited by the statutes governing the issuance, as shown in Table 6-2. It also is important to remember that the statutes for each local agency's general obligation bonds may be superseded by the provisions contained in the Government Code, which are intended to apply to the bonds of all local agencies. Thus, for example, many issuers would appear to be limited to annual interest rates of 8 percent and below, however, there is an overriding provision in Government Code Sections 53530 et seq. which allows rates of up to 12 percent per annum for all local agency bonds. Similar exceptions may affect the permitted term of the bonds, sale procedures, publication requirements, permitted uses of proceeds, etc. In addition, most—but not all—statutes prescribing an issuer's debt limit as a percentage of assessed valuation have not been updated to take into account the provisions of Article XIIIA, Section 1(a), which requires property to be assessed at its full cash value, rather than one-fourth of that value. Rather than taking the stated debt limit literally when a statute has not been updated, the better view is to read such a limit in light of Article XIIIA. Thus, for example, a city's limit of 15 percent (Government Code Section 43605) should now be read as 3.75 percent.

Table 6-2
Local Agency Bond Term Limits

Issuer	Maximum Maturity	Amortization Limitations
City	40 years	Approximately level debt service Capital appreciation bonds permitted (effective yield may not exceed 12 percent)
County	40 years	Approximately level debt service Capital appreciation bonds permitted (effective yield may not exceed 12 percent)
School District (under Education Code)	25 years	Principal amortized as board of supervisors provides Capital appreciation bonds permitted (effective yield may not exceed 12 percent)
School District (under Government Code)	40 years	Approximately level debt service Capital appreciation bonds permitted (effective yield may not exceed 12 percent)

LEGAL AUTHORITY

Legal Authority in General. The California Constitution contains several provisions governing the issuance of general obligation bonds:

All Issuers

- Article XVI, Section 18—two-thirds favorable vote required for bonds of cities, counties, and school districts

- Article XIIIA, Section 1(b)—exception from 1 percent real property tax limit for taxes to pay voter-approved general obligation bonds to finance the acquisition or improvement of real property

- Article XIIIB, Sections 8(g) and 9(a)—exception from appropriations limit for debt service on general obligation bonds

- Article XIII, Section 20—power of legislature to provide maximum property tax rates and bonding limits for local governments

- Article XIII, Section 26(b)—exemption from state income taxes for interest on local government bonds

Cities

- The general authorization and procedures for issuance are found at Government Code Sections 43600 et seq. Alternative procedures for issuance are found at Government Code Sections 53506 et seq.

- The charter of any charter city may contain special authorization, limitations, and procedures pursuant to "home rule" powers granted under Article XI, Section 5 of the California Constitution

Counties

- The general authorization and procedures for issuance are found at Government Code Sections 29900 et seq. Alternative procedures for issuance are found at Government Code Sections 53506 et seq.

School districts

- The general authorization and procedures for issuance are found at Education Code Sections 15100 et seq. Alternative procedures for issuance are found at Government Code Sections 53506 et seq.

Special districts

- The general authorization and procedures for issuance vary for each issuer. See **Appendix D – Legal References – Table D-2-1.**

SPECIAL FEDERAL TAX ISSUES

General obligation bonds do not present many unique federal tax issues. The various limitations and requirements described in **Chapter 3, General Federal Tax Requirements**, such as limitations relating to private activity bonds, arbitrage bonds, and hedge bonds, continue to apply.

REFUNDING BONDS

Local agencies have statutory authority to refund and redeem their outstanding general obligation bonds prior to the stated maturity date, provided that the bonds were issued following the enactment of such authority. Bond owners are then assumed to have purchased their bonds with the knowledge that they could be redeemed. Usually the bonds also must contain a statement to this effect, giving notice to bondholders. The issues that arise in refunding of general obligation bonds are much the same as those for refunding of other bonds, with the following important differences:

- The benefits to the local agency of issuing refunding bonds are indirect since the debt service savings achieved must be passed on to taxpayers rather than retained by the

issuing entity. That is, a municipality may not levy property taxes to repay GO bonds in excess of the principal and interest due to bondholders. As a result, when the debt cost is reduced through a refunding, the property tax levy must also be lowered.

- General obligation refunding bonds may be issued without voter approval, and the principal amount of the bonds will not count against the voted authorization, because the bonds being refunded have already been approved and the refunding is deemed to be merely a change in form of the indebtedness. This assumes, however, that the issuance of refunding bonds does not create any additional debt burden on the taxpayers, which has not been approved by the voters. Therefore, the general obligation bond refunding statutes require the refunding to produce debt service savings—the total principal plus net interest cost to maturity on the refunding bonds must be lower than that of the bonds to be refunded. Any costs of issuance paid from sources other than refunding bond proceeds (and interest earned thereon) must be added to the costs of the refunding bonds. If refunding was not one of the originally authorized purposes for the bonds, then a new election must be held to approve the refunding bonds.

MARKS-ROOS BONDS

DEFINITION AND GENERAL PURPOSES

The Marks-Roos Local Bond Pooling Act of 1985 (Article 4 of the Joint Exercise of Powers Authority law, Government Code Sections 6584 et seq., the "Marks-Roos Act") provides joint powers authorities (JPAs) with broad powers to issue bonds for a wide variety of purposes. As the name of the act implies, the law was originally enacted to facilitate local bond pooling efforts, which allowed local agencies to achieve lower costs of issuance through spreading fixed costs across a number of small issues. Its usage has been substantially more broad, however, as its flexibility allows it to be used for single project financings as well.

Prior to the adoption of the Marks-Roos Act, JPAs had been commonly used to accomplish public financings under Article 2 of the Joint Exercise of Powers law, typically for public utility financings. Article 2 is still used by a number of these issuers for public power, water, wastewater, and other utility-type financings. However, due to the extra procedural requirements of Article 2 (such as the requirement that the local agency approve each financing by ordinance subject to referendum), Article 4 has become a much more popular tool for JPA financings.

The most common uses of the Marks-Roos Act with respect to bond issuance are:

- To finance "public capital improvements" (defined in Government Code Section 6546) directly
- To create "pooled" bond issues
- To finance working capital or insurance programs

Marks-Roos bonds may only be issued by JPAs, which are special governmental entities created under the Joint Exercise of Powers Authority law (Government Code Sections 6500 et seq.) by agreement between two or more "public agencies" (as defined in Government Code Section 6500). The parties to the joint exercise of powers agreement are called members of the JPA. Some JPAs are "captive" entities of a jurisdiction—for example, a JPA made up of a city and its own redevelopment agency. Other JPAs are multi-jurisdictional and issue bonds for all or some of their members. For example, the California Statewide Communities Development Authority has over 200 member agencies and issues bonds for a wide array of projects. Once a JPA is formed, it has all of the powers specified in the Marks-Roos Act. That is, a JPA issuing bonds under the Marks-Roos Act (and in some circumstances the local agency contracting with the JPA) need not follow other bond act requirements in the issuance of the bonds.

Marks-Roos bonds are bonds of the JPA that issues them, as opposed to bonds of the member agencies. The member agencies are not liable or otherwise obligated on the bonds unless they expressly agree to assume such liability.

Marks-Roos bonds are issued for the purpose of assisting local agencies with their financing needs. "Local agencies" are defined to include the sponsoring member of the JPA (or any agency or subdivision of that member) or any city, county, city and county, authority, district, or public corporation of the state.

In order to use the Marks-Roos Act, the local agency for which the bonds are being issued must determine that there are significant public benefits for taking that action. "Significant public benefits" are defined to mean:

- Demonstrable savings in effective interest rate, bond preparation, bond underwriting, or bond issuance costs
- Significant reductions in effective user charges levied by a local agency
- Employment benefits from undertaking the project in a timely fashion
- More efficient delivery of local agency services to residential and commercial development

These determinations are typically made by resolution of the legislative body of the local agency at the time that the local agency approves the financing.

In addition, California Government Code Section 6586.5(a)(2) states that an authority may not issue bonds unless a member of the authority within whose boundaries the public capital improvement is to be located has approved the financing, among other things. This requirement provides a "nexus" between the members of the JPA and the project.

PROJECTS THAT MAY BE FINANCED

Public Capital Improvement Bonds

Marks-Roos bonds may be issued to directly pay the cost of public capital improvements. Direct financing of these improvements under Marks-Roos Act generally takes the form of bonds issued by the JPA and secured by payments to be made under a loan agreement, installment purchase agreement, or lease between the JPA and the local agency which is paying for the project. Under this type of arrangement, the JPA is acting as a conduit issuer for the local agency and has no obligation on the bonds other than to make payment from the payments received under the underlying agreement with the local agency. The source of revenues for the underlying agreement with the local agency can vary greatly and will determine which type of agreement will likely be used.

Public capital improvements include the following:

- An exhibition building or other place for holding fairs
- A coliseum, stadium, sports arena, or sports pavilion

- Any other public buildings
- A regional or local public park, recreational area, or recreational center
- A facility for the generation or transmission of electrical energy (but not a retail distribution system)
- A facility for the disposal, treatment, or conversion to energy and reusable materials of solid or hazardous waste or toxic substances
- Facilities for the production, storage, transmission, or treatment of water or wastewater
- Local streets, roads, and bridges
- Bridges and major thoroughfares construction
- Mass transit facilities or vehicles
- Publicly owned or operated commercial or general aviation airports and airport-related facilities
- Police or fire stations
- Public works facilities, including corporation yards
- Public health facilities owned or operated by a city, county, city and county, special district, or authority
- Criminal justice facilities, including court buildings, jails, juvenile halls, and juvenile detention facilities
- Public libraries
- Publicly owned or operated parking garages
- Low-income housing projects owned or operated by a city, county, city and county, or housing authority
- Public improvements authorized in a project area created pursuant to the Community Redevelopment Law (see the section on **Tax Allocation and Other Redevelopment Bonds** in this chapter)
- Public improvements authorized pursuant to certain assessment acts and the Mello-Roos Act (see the sections on **Assessment Bonds** and **Mello-Roos Bonds** in this chapter)
- Telecommunication systems or service

- Programs, facilities, rights, properties, and improvements for the management, conservation, reuse, or recycling of electric capacity or energy, natural gas, water, wastewater, or recycled water, including demand side or load management and other programs and facilities designed to reduce the demand for, or permit or promote the efficient use of, those resources

- Certain equipment related to the above facilities

If the local agency is a city, county, or school district and the payments are to be made from the local agency's general fund, the agreement will likely be a lease. For more detail on lease financing, see the section on **Public Lease Revenue Bonds** in this chapter**.** If the source of payment is a local enterprise fund (such as a water system enterprise fund), the agreement will probably be an installment purchase agreement or loan agreement.

What are Local Obligations?

Local obligations eligible for acquisition by the JPA include:

- ✓ Bonds (including, but not limited to, assessment bonds, redevelopment agency bonds, government issued mortgage bonds, and industrial development bonds)
- ✓ Notes (including bond, revenue, tax, or grant anticipation notes)
- ✓ Commercial paper, floating rate, and variable maturity securities
- ✓ Any other evidences of indebtedness
- ✓ Certificates of participation
- ✓ Lease-purchase agreements

Pooled Financings

The most basic purpose of the Marks-Roos Act is to enable the issuance of so-called pooled" bonds. Pooled bonds are issued for the purpose of acquiring bonds or other obligations of a local agency (usually called "local obligations"). The act provides that the JPA may purchase, with the proceeds of its bonds or its revenue, local obligations issued by any local agency at public or negotiated sale. Local obligations purchased pursuant to the Marks-Roos Act may be held by the JPA or sold to public or private purchasers at public or negotiated sale, in whole or in part, separately or together with other bonds issued by the authority. The projects that may be financed with the proceeds of the local obligations acquired by the JPA in the pooled financing must be projects eligible for financing under the law governing the issuance of the local obligations. See the appropriate section in this chapter for more information regarding the permitted uses of proceeds of specific local obligations.

Large Scale TRAN Pools – 2004

California Statewide Communities Development Authority (CSCDA)	$803,750,000
California School Cash Reserve Program Authority	$754,330,000
San Diego County School District (SDCSD)	$404,315,000
California Community College Finance Authority (CCCFA)	$188,690,000
Los Angeles County Schools (LACS)	$60,890,000
South Coast Local Education (SCLE)	$59,500,000
Santa Barbara Schools Financing Authority (SBSFA)	$21,200,000

Large-Scale Pools

The pooled bond provisions of the Marks-Roos Act have spawned a number of large-scale pooled financings, including large TRAN pools for school districts, cities and other local agencies (see text box on **Large Scale TRAN Pools – 2004**). For more

information on TRAN financings, see the section in this chapter on **Tax and Revenue Anticipation Notes (TRANs).** While less common, the Marks-Roos Act also has been used to establish pooled financing programs for long-term borrowing. In these types of financings, the local agencies participating in the pool will issue their underlying local obligations simultaneously for sale to the JPA, which will then sell its Marks-Roos bonds for the purpose of acquiring the local obligations.

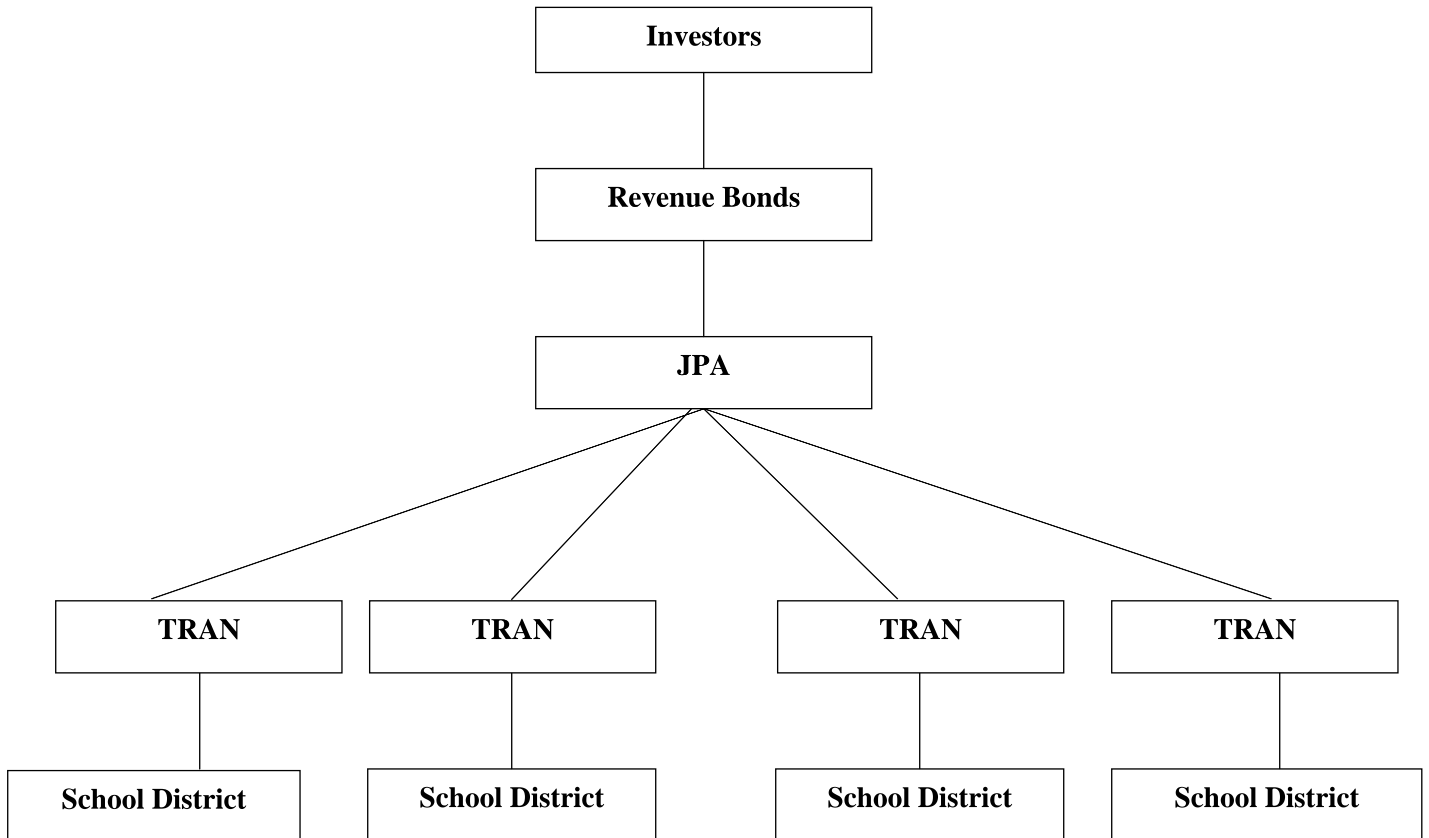
Captive Pools

In addition, the Marks-Roos Act has been used to accomplish pooled financings for JPAs, in which the projects being financed relate to one or a small number of related local agencies, such as a city and its own redevelopment agency. In this type of financing, the Marks-Roos bond proceeds are used to acquire one or more local obligations from the one or more of the interrelated local agencies that are members of the JPA. These local obligations are typically acquired at the same time as the issuance of the Marks-Roos bonds. This type of financing might be used when an entity has two or more small financings to do at the same time—for example, a city lease financing of building rehabilitation and a redevelopment agency financing of infrastructure for the project area. If each financing is so small that it would not be particularly efficient on its own, combining them into a pooled financing issued by a JPA may make sense. Care should be taken, however, to assure that the credit quality of one of the pooled financings is not so weak as to drag down the credit of the overall issue, thus increasing the interest rate for the relatively stronger financing.

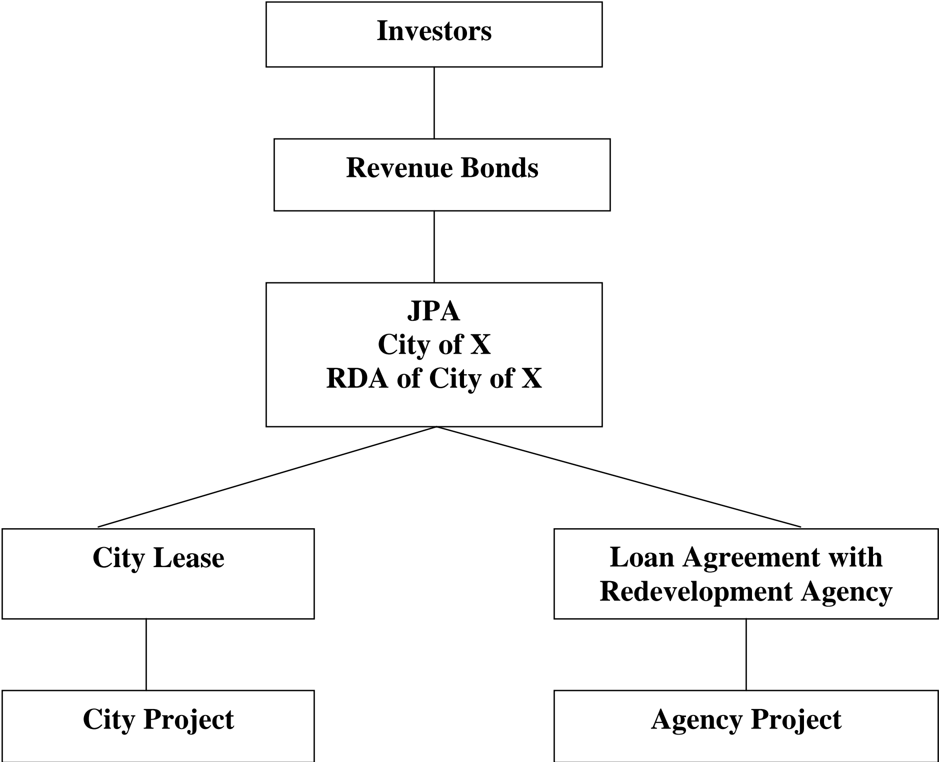
Blind Pools

A blind pool financing is one in which the JPA does not have firm commitments from local agencies for the underlying projects (and the local obligations financing them). The pooled bonds are issued, and the funds are used at a later time (not to exceed 90 days after issuance) to acquire local obligations for projects. If there is a lag (not to exceed 90 days) between the time of the issuance of the Marks-Roos bonds and the time local obligations are acquired, the proceeds of the Marks-Roos bonds are typically invested in a guaranteed investment contract which earns enough interest, in addition to any capitalized interest, to pay interest on the Marks-Roos bonds until the local obligation payments commence. In the event that the local obligations are not acquired, the proceeds of the Marks-Roos bonds are used to retire the Marks-Roos bonds. These financings create a number of difficulties, because the identity of the local obligations acquired and projects financed may change during the 90-day origination period to make loans. Disclosure can be difficult, and federal tax issues (such as the reasonableness of the expectation that the bond proceeds will be spent) abound. Issuers should be exceedingly cautious in approaching any blind pool financing and carefully weigh the risks against the benefits.

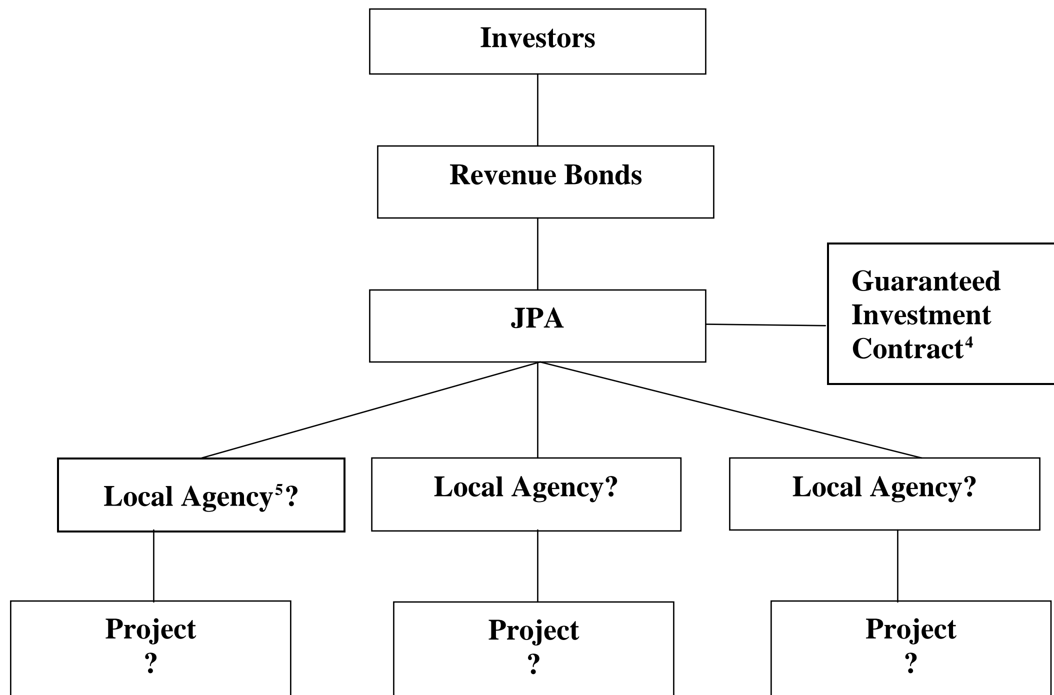
Flow Chart 6.1
Large-Scale Pool



Flow Chart 6.2
Captive Pool



Flow Chart 6.3
Blind Pool



[4] A Guaranteed Investment Contract holds bond proceeds until loans are made to local agencies. If all the money is not loaned, the contract is liquidated and the bonds are redeemed.

[5] Typically, several local agencies have indicated interest in borrowing from the pool, but have not made binding commitments. The identity of local agencies and projects may change.

Working Capital and Insurance Programs

The Marks-Roos Act also permits JPAs to issue bonds to finance a working capital or insurance program. Working capital programs financed with Marks-Roos bonds are generally structured in the form of pooled financing for TRAN issues. In addition, Marks-Roos bonds may be used to finance the capitalization of captive insurance entities providing liability and other forms of insurance to the members of the JPA. A detailed description of these insurance programs is beyond the scope of this *Primer*.

POLICY CONSIDERATIONS

Public Capital Improvement Bonds

The Marks-Roos Act is a very useful and flexible tool for financing public capital improvements. Essentially, the policy considerations governing Marks-Roos bonds are the same as those related to the underlying form of repayment arrangement (i.e. to lease financing if the underlying arrangement is a lease, or to enterprise revenue financing if the underlying arrangement is a loan or installment purchase agreement payable from enterprise revenues, and so on). In these situations, the act is merely a tool to allow bond issuance.

Often, the alternative to using Marks-Roos bonds for these types of projects is to use certificates of participation (COPs). Some financial advisors and underwriters believe that there may be a marketing advantage to issuing Marks-Roos bonds secured by an underlying lease or installment purchase agreement over COPs in those same agreements. While the economic security for each structure is practically identical, some financial advisors believe that the market perceives a bond to be a stronger instrument than a COP.

Pooled Bonds

Because of the wide range of pooled financings that may be accomplished under the Marks-Roos Act, it is difficult to arrive at general policy guidelines for these types of issues. The policy issues relevant to a large multi-jurisdictional pooled issue may be quite different than those relevant to a captive JPA pool financing.

Multi-jurisdictional Pooled Issues

From a local agency's perspective, deciding whether or not to participate in a pooled financing along with other agencies involves balancing a number of factors. The following advantages and disadvantages should be carefully considered:

Advantages:

- Typically lower costs of issuance due to economies of scale
- Interest rate may be lower due to "diversification" effect of the pool (this is more likely to be true if the local agency's credit strength is average or below average

compared to all pool participants or if the pool obtains bond insurance which could not be obtained on a stand-alone basis)

- Some structures allow reduced reserve fund size
- The financing team and structure of the financing (including the documentation) is typically in place, which means that the local agency does not have to start from scratch

Disadvantages:

- Timing of issue dictated by pool organizer, which may not coincide with local agency's preferred timing
- Little flexibility to alter arrangements to suit particular local agency concerns
- Interest rate may be higher than stand-alone financing (this is more likely to be true if the local agency's credit strength is higher than the average for the pool participant)
- Agencies with a large borrowing compared to the average pool participant may not be able to maximize the terms of the bonds for their own situations

Other Pooled Financings

As described above, Marks-Roos bonds may be issued to pool any local agency obligations. This flexibility has resulted in a wide variety of pooled structures including:

- Pools only issued to acquire local obligations of one local agency—for example, a lease obligation and a redevelopment obligation to finance separate projects pooled together and financed through a single issue of Marks-Roos bonds
- Pools that finance infrastructure for separate assessment districts through the acquisition of assessment bonds issued for each district
- Pools that finance projects for private developers (even outside the geographic boundaries of the JPA's members) or for local agencies, which are not even members of the JPA and have no connection to the entities that formed the JPA other than their participation in the pooled financing

While the Marks-Roos Act has been used to great advantage by local agencies to successfully finance a wide variety of projects, some Marks-Roos bonds have been structured in abusive ways and have been the source of several defaults and controversial financings. These troubled financings have typically involved:

- Projects that do not have any relationship to the JPA or its members

- Pooled issues that relied on overly optimistic predictions of the ability to fund local obligations, and

- Inadequate safeguards with respect to the credit quality of the local obligations being acquired

When considering participation in this type of structure, a local agency should ask itself the following questions:

- Is there a real advantage in transaction cost savings to doing the pooled financing?

- Does the pool appropriately take advantage of diversification of credit to the benefit of all projects?

- Is there a public purpose for this JPA (and its members) to finance a project for an unrelated local agency?

- If the local obligations are not being acquired simultaneously with the issuance of the Marks-Roos bonds, are there adequate assurances that the local obligations will in fact be acquired?

- Do the pooled bond documents provide adequate safeguards with respect to additional debt so that the credit quality of the Marks-Roos bonds will not be compromised in the future?

PROCESS FOR APPROVAL

Marks-Roos bonds must be authorized by a resolution adopted by the JPA at a regular or special meeting of the JPA board. In addition, the local agency or agencies participating in the financing must approve the documents they are entering into as required for the particular type of agreement or local obligation involved. (See the appropriate section in this chapter for more detail on these requirements for the particular type of underlying obligation.) Finally, the local agency that is participating in the financing must make the determination of "significant public benefits" discussed above. This is accomplished by a resolution of the local agency, which may be combined with the resolution approving the other local agency documents. Written notice of the proposed sale must be given to the California Debt and Investment Advisory Commission, no later than 30 days prior to the sale of any Marks-Roos bonds, as required by Government Code Section 8855.

PROCESS FOR SALE

Marks-Roos bonds may be sold at public or private sale, as determined by the governing body of the JPA, after giving due consideration to the recommendations of any local agency to be assisted from the proceeds of the bonds.

In addition, the JPA may enter into a bond purchase agreement with a local agency or agencies. The bond purchase agreement must specify the maximum rate of interest, the cost of issuance, the amount of required reserve, and the procedure to be used in case of default. Notwithstanding any other provision of law, local agencies may sell their bonds to the JPA on a negotiated basis without compliance with any public sale requirement included in the statutes under which the bonds are issued. This provision allows local agencies, which otherwise would be required to sell their bonds at public sale, to sell their bonds at negotiated sale to the JPA, which can then either resell those same bonds at negotiated sale to an underwriter or use the bonds as local obligations to secure Marks-Roos bonds sold at negotiated sale to an underwriter.

OTHER LEGAL REQUIREMENTS

The Marks-Roos Act has been amended several times in recent years and new requirements and restrictions have been imposed on Marks-Roos bonds as a result. The more important of these limitations are as follows:

Loan Restriction. Loans may not be made to local agencies for working capital or insurance, unless that purpose is first approved by unanimous vote of the governing body of the JPA.

Investment Criteria. In the case of bonds issued by a JPA to acquire local obligations, the offering documents for the bonds must clearly delineate the types of local obligations and minimum credit standards.

Suitability. A financial advisor, investment advisor, underwriter, broker, dealer, or municipal securities dealer may not recommend the purchase, sale, or exchange of a municipal security to a JPA unless they have reasonable grounds to believe and do believe that the recommendation is suitable for the JPA in light of the JPA's investment criteria and responsibility to safeguard public funds.

Self-Dealing. In the case of bonds issued by an authority to acquire local obligations, the underwriter of the bonds, and the financial advisor and investment advisor to the authority, may not sell to the authority any security or obligation issued by a state or local government from its dealer inventory or that it underwrote or otherwise placed on behalf of another client.

Conflict of Interest. A broker, dealer, municipal securities dealer, or other firm that underwrites a bond issue of a JPA cannot serve as financial advisor or investment advisor to the JPA on decisions relating to the investment of the proceeds of that bond issue.

Yield Restriction. Bonds issued by any local agency cannot be purchased by a JPA at a price to yield in excess of 1 percent of the yield of the issue of Marks-Roos bonds issued to purchase the bonds of the local agency.

Limit on Excess Cashflow. At least 95 percent of the receipts by the JPA from bonds of a local agency purchased by the JPA shall be used for one or more of the following purposes:

- To pay principal, interest, redemption prices, or fees for credit enhancement on the issue of Marks-Roos bonds used to acquire those bonds of the local agency
- To pay or reimburse administrative costs of the bonds of the JPA used to acquire those bonds of the local agency
- To pay or reimburse a local agency for principal, interest, or redemption price on bonds of that local agency
- To establish reasonable reserves for the payment of debt service on the Marks-Roos bonds
- To purchase other bonds of a local agency
- To pay or reimburse fees and expenses charged to the JPA by third parties, excluding any member of the JPA, for services relating to administration of the Marks-Roos bonds or of the program established by the JPA for purchase of local agency bonds

Required Filing. The JPA law (see Government Code Section 6503.5) requires that when a joint powers agency is created or its joint powers agreement is amended, an information filing must be made with the California Secretary of State before the agency may issue bonds.

Reporting. Government Code Sections 6586.5 and 6586.7 specify that, prior to issuing Marks-Roos bonds, any agency whose project does not meet certain defined exemption criteria must send a notice to CDIAC and the State Attorney General advising them of its intention to hold a public hearing concerning the proposed project. This notice must include the date, time, and location of the hearing, as well as the names and contact information for members of the financing team, geographic location of the project being financed, and a brief description of the project. In addition, the Government Code requires a JPA adopting a resolution of intent to issue bonds to send a copy of the resolution to CDIAC and the State Attorney General. Authorities exempted from the public hearing notification requirement are also exempted from this filing requirement. In addition, those issuing bonds under Article 1 of the Joint Powers Authority section of the Government Code are exempt as well.

In addition, each year, after the sale of any Marks-Roos bonds for the purpose of acquiring local obligations, the JPA is required to supply certain information to CDIAC.

Marks-Roos Advice. Local agencies may request advice from CDIAC regarding the formation of local bond pooling authorities and the planning, preparing, insuring, marketing, and selling of Marks-Roos bonds.

REFUNDING BONDS

The Marks-Roos Act permits a JPA to issue refunding bonds for the purpose of refunding any bonds, notes, or other securities of the authority then outstanding. Refunding bonds also may pay any redemption premiums, accrued interest, or costs of issuance.

SPECIAL FEDERAL TAX ISSUES

In general, Marks-Roos bonds do not present many unique federal tax issues. To the extent the debt service payments on the local obligations matches the debt service payments on the Marks-Roos bonds, the various federal tax limitations and requirements described in **Chapter 3, General Federal Tax Requirements**, such as limitations relating to private activity bonds, arbitrage bonds, and hedge bonds, continue to apply.

Pooled Financings

One type of Marks-Roos financing, however, can present a number of unique federal tax concerns. The use of Marks-Roos bond proceeds to acquire two or more local obligations can cause certain additional federal tax requirements to apply. Principally, these additional requirements limit the period of time that proceeds of the Marks-Roos bonds can be held and invested at the JPA level, prior to acquiring the local obligations. So long as the local obligations to be acquired are known on the date the Marks-Roos bonds are issued and will be acquired within the 90-day origination period authorized under the Marks-Roos Act, these additional federal tax limitations should be satisfied. If, however, the local obligations to be acquired are not known on the date of issuance of the Marks-Roos bonds, particular care must be taken to comply with the additional federal tax requirements.

Also, where local obligations will be acquired, it is not necessary to assure that the local obligations themselves are tax-exempt, because only the Marks-Roos bonds need be tax-exempt in order to allow investors to exclude interest thereon from income for federal tax purposes. As a practical matter, the issuance of the local obligations without complying with all of the requirements for tax exemption (the filing of Form 8038, for example) does not release the local agency from all tax law requirements, for they still must comply with requirements necessary to assure the tax-exempt status of the Marks-Roos bonds (for example, private business use restrictions, investment limitations, expenditure of proceeds requirements, etc.).

MELLO-ROOS BONDS

DEFINITION AND PURPOSE

The Mello-Roos Community Facilities Act of 1982 (the "Mello-Roos Act") provides a mechanism by which certain public entities, such as cities, counties, special districts, school districts, joint powers entities, and redevelopment agencies, can finance the construction and/or acquisition of facilities and the provision of certain services. The Mello-Roos Act authorizes such a public entity to form a Community Facilities District (a "CFD" or "district"), otherwise known as a Mello-Roos district. Once formed, the district can finance facilities and provide services. Upon approval by a two-thirds vote of the registered voters or landowners within the district, the district may issue bonds secured by the levy of special taxes.

The special taxes are not assessments, and there is no requirement that the special tax be apportioned on the basis of benefit to property. This affords greater flexibility in designing the special tax. A special tax levied by a district is not an ad valorem property tax under Article XIIIA of the California Constitution, however, the lien of the special taxes has the same priority as property taxes.

PROJECTS THAT MAY BE FINANCED

A district may finance the purchase, construction, expansion, improvement, or rehabilitation of real or other tangible property with an estimated useful life of five or more years, or planning and design work that is directly related thereto. The financed facilities do not need to be physically located within the district. In general, a district may finance the purchase of facilities that are completed before the resolution of formation to establish the district is adopted. A district also may finance the purchase of facilities that are completed after the adoption of the resolution of formation, so long as such facilities were constructed as if they had been constructed under the direction and supervision, or under the authority of, the local agency creating the district. This means, at a minimum, that the prevailing wage law applies if the resolution of formation is adopted before the public improvement is completed. In addition, a district may finance facilities to be owned or operated, or services to be provided, by an entity other than the entity that created the district, pursuant to a joint community facilities agreement or a joint exercise of powers agreement entered into pursuant to the Mello-Roos Act.

Facilities. Examples of the types of facilities that may be financed are as follows:

- Local park, recreation, parkway, and open-space facilities
- Elementary and secondary school sites and structures that meet the building area and cost standards of the state Allocation Board
- Libraries
- Childcare facilities

- Facilities to transmit and distribute water, natural gas pipeline facilities, telephone lines, facilities to transmit or distribute electrical energy and cable television lines for customers that do not have those services or to mitigate existing visual blight

- Facilities, whether publicly or privately owned, for flood and storm protection purposes, including storm drainage systems and sandstorm protection systems

- Any other governmental facilities the legislative body creating the district is authorized by law to contribute revenue toward, construct, own, or operate

- Work to bring buildings or real property, including privately owned buildings and real property, into compliance with seismic safety standards and regulations, if such work is certified as necessary by local building officials

- Work deemed necessary to repair damage to real property caused by the occurrence of an earthquake within any county or area designated by the President of the United States or the Governor as a disaster area (subject to certain limitations in the Mello-Roos Act)

- Work deemed necessary to repair and abate damage caused to privately owned buildings and structures by soil deterioration (subject to certain limitations in the Mello-Roos Act)

A district may not own any facilities for the transmission or distribution of natural gas, telephone service, or electrical energy and may only operate and maintain those facilities pursuant to an agreement with a public utility.

A district may be used to eliminate fixed special assessment liens on property within the district and to repay any indebtedness secured by any tax, fee, charge, or assessment levied within the area of the district, or may pay debt service on that indebtedness.

The legislative body may enter into an agreement for the construction of discrete portions or phases of facilities to be constructed and purchased. The agreement may include any provisions that the legislative body deems necessary or convenient. However, the agreement must identify or specify all of the following:

- The specific facilities or discrete portions or phases of facilities to be constructed and purchased

- Procedures to ensure that the facilities are constructed pursuant to plans, standards, specifications, and other requirements as determined by the legislative body

- A price or a method to determine a price for each facility or discrete portion or phase of a facility

- Procedures for final inspection and approval of facilities or discrete portions of facilities, for approval of payment, and for acceptance and conveyance or dedication of the facilities to the local agency

Services. Types of services that may be provided by a district are as follows:

- Police protection services

- Fire protection and suppression services and ambulance and paramedic services

- Recreation program services, library services, maintenance services for elementary and secondary school sites and structures, and the operation and maintenance of museums and cultural facilities

- Maintenance of parks, parkways, and open space

- Flood and storm protection services including, but not limited to, the operation and maintenance of storm drainage systems and sandstorm protection systems

- Removal or remedial action services for the cleanup of any hazardous substance released or threatened to be released into the environment

The Mello-Roos Act contains restrictions on services authorized by landowner election. Such services may only be paid for by a CFD to the extent that they are in addition to those provided in the territory of the CFD before it was created. The services to be paid for by the CFD may not supplant services already available within that territory when the CFD was created. In addition, a landowner election may not authorize the levy of a special tax for recreation program services, library services, school maintenance services, or museum and cultural facility maintenance services. Such restrictions do not apply, however, to services authorized by registered voter election.

POLICY CONSIDERATIONS

The nature of the facilities and services to be financed or paid for largely determines whether special taxes are levied instead of special assessments. Special taxes permit the financing of general benefit facilities such as libraries and schools, which are not authorized by the special assessment statutes. In addition, the financed facilities are not required to be located in the district, which allows a district to finance regional facilities. Finally, the flexibility allowed in structuring a Mello-Roos tax formula (also known as the rate and method of apportionment) may make a Mello-Roos financing a more attractive alternative than an assessment district financing. Because of the election requirement, the Mello-Roos Act has been used as a financing vehicle primarily where the voters are landowners rather than registered voters.

Compared to special assessment financings, most Mello-Roos district financings are complicated. Because of the flexibility provided by the Mello-Roos Act, special tax formulas are

often quite complex and specific, making it difficult for a property owner to understand the nature of the burden on his property. Great care must be taken in designing the special tax formula to reduce political concerns and to provide clear and complete disclosure to home-buyers of the burden imposed by the special tax.

SECURITY AND SOURCES OF REPAYMENT FEATURES

Mello-Roos bonds are payable from and secured by special taxes, which are levied upon the property in the district according to the rate and method of apportionment approved by the voters in the district. Like assessments, special taxes are levied upon real property and are not a personal debt of the property owners. The remedy for delinquencies is foreclosure. The general fund of the local agency that created the district is not obligated to pay debt service on the bonds. A bond reserve fund is permitted, and the special tax may be levied to replenish the bond reserve fund so long as the tax rate does not exceed the maximum special tax rate approved by the voters in the district.

The proceeds of a special tax may only be used to pay the cost of providing the facilities, services, and incidental expenses authorized by the election. Special taxes are generally collected in the same manner as ad valorem property taxes. They are also subject to the same penalties and the same procedure, sale, and lien priority in the case of delinquency as ad valorem property taxes. However, the legislative body may adopt another collection procedure, including direct billing of property owners, if circumstances so require.

The legislative body may provide additional security for the bonds by covenanting on behalf of the bondholders that it will commence foreclosure proceedings by a specified time if a special tax installment is delinquent. Because the foreclosure process can be lengthy, the legislative body also may provide for special tax alternate procedures, such as the waiver of delinquency and redemption penalties and the acceptance of bonds tendered in payment of special taxes or at a foreclosure sale.

The legislative body may require additional security for the bonds in the form of a letter of credit or a guaranty where the land in the district is largely undeveloped and is owned by a few persons. The additional security is typically only required until the district is fully developed and the property is sold to the general public. Bond insurance may be available for bonds issued by substantially developed districts, but is not commonly available for bonds issued by new, undeveloped districts.

The formula for levying special taxes may be based upon a variety of factors, including density of development, square footage of construction, acreage, or zoning. Unlike special assessment districts, there is no requirement that the special tax be based upon the benefit a parcel receives from the facilities or services to be financed, however, the tax must be levied on a reasonable basis, as determined by the legislative body of the district.

PROCESS FOR APPROVAL – ESTABLISHING COMMUNITY FACILITIES DISTRICT AND LEVYING SPECIAL TAX

Adoption of Local Goals and Policies. Local agencies that initiate proceedings to establish districts on or after January 1, 1994 must first adopt local goals and policies concerning the use of the Mello-Roos Act. The policies must at least include:

- A statement of the priority that various kinds of facilities will have for financing through the use of the Mello-Roos Act, including public facilities to be owned and operated by other public agencies (such as school districts)
- A statement concerning the credit quality to be required of bond issues, including criteria to be used in evaluating the credit quality
- A statement concerning the steps to be taken to ensure that prospective property purchasers are fully informed about their taxpaying obligations under the Mello-Roos Act
- A statement concerning the criteria for evaluating the equity of tax allocation formulas, and the desirable and maximum amounts of special tax to be levied against any parcel
- A statement of the definitions, standards, and assumptions to be used in appraisals required by the Mello-Roos Act

In addition, the local goals and policies adopted by school districts must include a priority access policy that gives priority attendance access to students residing in a school district whose residents have contributed to the financing of the construction of school district facilities.

Initiation of Proceedings. Proceedings to establish a district may be instituted in any of the following ways:

- By initiative of the legislative body
- By written request signed by two members of the legislative body containing the information required by the Mello-Roos Act
- By petition signed by not less than 10 percent of the registered voters residing within the proposed district
- By petition signed by the owners of not less than 10 percent of the area of land within the proposed district

If the facilities to be financed by the district will be owned or operated by an entity other than the local agency creating the district, the local agency and the entity must enter into a joint community facilities agreement or a joint exercise of powers agreement prior to the adoption of

the resolution of formation creating the district. No local agency that is a party to a joint community facilities agreement or a joint exercise of powers agreement may have primary responsibility for formation of the district unless that local agency is:

- A city, a county, or a city and county
- An agency created pursuant to a joint powers agreement that is separate from the parties to the agreement, is responsible for the administration of the agreement, and is subject to certain notification requirements under the Government Code
- An agency that is reasonably expected to have responsibility for providing facilities or services to be financed by a larger share of the proceeds of special taxes or bonds of the district created pursuant to the joint exercise of powers agreement or the joint community facilities agreement than any other local agency

Resolution of Intention. A resolution of intention to establish a district must be adopted within 90 days after a written request or a petition to create the district is filed with the legislative body of the local agency that will form the district. The resolution of intention must:

- State that the district is being formed pursuant to the Mello-Roos Act
- Describe the proposed boundaries of the district (which need not be contiguous)
- State the name of the proposed district
- Describe the facilities or services to be financed in a manner sufficient to allow a taxpayer within the district to understand what district funds may be used to finance
- Describe any financing plan, lease, lease-purchase, or installment-purchase arrangement that will be used to finance the facilities
- Identify any completed facilities to be purchased or incidental expenses to be incurred
- State that except where funds are otherwise available, a special tax will be levied annually to pay for the facilities and services and that it will be secured by recordation of a continuing lien against all nonexempt property in the district
- Specify the rate and method of apportionment and manner of collection of the special tax in sufficient detail so each landowner or resident is able to estimate the maximum annual amount to be paid, and if the special taxes will be levied against property used for private residential purposes, specify:
    - the dollar amount of the maximum special tax, and state that such amount will not be increased by more than 2 percent per year

  - the tax year after which no further special tax will be levied or collected (except that a special tax levied in or before the final tax year and that remains delinquent may be collected in subsequent years), and

  - that under no circumstances will the special tax levied against any parcel be increased as a consequence of delinquency or default by the owner of any other parcel within the district by more than 10 percent

- Specify the conditions under which the obligation to pay the special tax may be prepaid and permanently satisfied

- Fix a time and place for a public hearing not less than 30 days or more than 60 days after the resolution of intention is adopted

- Describe any adjustment in property taxation to pay prior indebtedness

- Describe the proposed voting procedure

Report. When the resolution of intention is adopted, the legislative body must direct each officer responsible for providing one or more of the proposed facilities or services to file a report at or before the time of the hearing that contains:

- A brief description of the type of facilities or services required to adequately meet the needs of the district

- An estimate of the cost of providing the facilities or services

- If the district proposes to purchase completed facilities or to pay incidental expenses, an estimate of the fair and reasonable cost of those facilities or expenses

- If the district proposes to finance removal or remedial action for the cleanup of any hazardous substance, either:

  - A remedial action plan, or

  - A determination that the remedial action plan is not required—however, the legislative body may condition financing of the removal or remedial action upon approval of a remedial action plan

Notice. The clerk of the legislative body is required to publish a notice of the public hearing once, in a newspaper of general circulation in the proposed district, at least seven days before the public hearing, containing the information required by the Mello-Roos Act. Notice of the public hearing also may be given by first-class mail to each registered voter and to each landowner within the proposed district, sent at least 15 days before the public hearing.

Protests. Oral or written protests may be made at the public hearing by any interested persons or taxpayers against the establishment of the district, the extent of the district, the type of

facilities or services to be provided, or the regularity or sufficiency of the proceedings. Protests about the regularity or the sufficiency of the proceedings must be in writing and filed with the clerk of the legislative body prior to the hearing, and must specify the irregularities or defects. Written protests may be withdrawn at any time before the conclusion of the hearing.

Majority Protest to Formation of District. If 50 percent of the registered voters or six of the registered voters (whichever is more) residing in, or the owners of one-half or more of the nonexempt land in, the territory proposed to be included in the district protest against the establishment of the district, the proceedings to create the district or to levy the special tax must be discontinued for a period of one year. If the majority protest is only against the furnishing of a specified type of facility or service, that facility or service must be eliminated. If the protest is against levying a specified special tax, that special tax must be eliminated.

At the public hearing, the resolution of intention may be modified by eliminating proposed facilities or services, reducing the special tax, or removing territory from the proposed district. Any modification of the resolution of intention that would increase the probable special tax must be preceded by a report analyzing the impact of the proposed modification on the special tax, which report must be considered prior to approval of the modification.

Resolution of Formation. If, at the conclusion of the public hearing, the determination is made to establish a district, a resolution of formation must be adopted. The resolution of formation must:

- Contain all of the information contained in the resolution of intention
- State that the proposed special tax to be levied in the district has not been precluded by majority protest
- Identify the facilities and services to be funded
- State the name, address, and telephone number of the entity responsible for preparing the annual roll of special tax levy obligations by assessor's parcel number and for estimating future special tax levies
- State that upon recordation of a notice of special tax lien, a continuing lien to secure each levy of the special tax will attach to all nonexempt real property in the district and will continue until the special tax obligation is permanently satisfied or the legislative body ceases collection of the special tax
- State the county of recordation and the recording information for the boundary map of the proposed district
- Determine by a specific finding whether the proceedings were valid and in conformity with the Mello-Roos Act

Election. The levy of a special tax must be approved by two-thirds of the votes cast by the qualified electors of the district in a general or special election held at least 90 days, but not more than 180 days, after the public hearing. These time limits may be waived with the unanimous consent of the qualified electors and the concurrence of election officials, and this action is typically taken in a developer (i.e. landowner vote) district.

Determining Who Votes. The vote on the special tax must generally be by registered voters residing in the district. However, if fewer than 12 persons have been registered to vote within the district for any of the 90 days preceding the close of the public hearing, the vote must be made by the landowners within the district. Similarly, if the special tax will not be apportioned on any then-residential property, the vote may be by the landowners within the district. Each of such landowners must be granted one vote for each acre or portion of an acre owned within the district.

Manner of Conducting Election. The election may be conducted by mail, or ballots may be delivered by personal service to the voters. A ballot proposition may combine the questions relating to the levy of a special tax, the incurring of bonded indebtedness, and the establishment or change of an appropriations limit. If the vote is to be by the landowners of the district, analysis and arguments may be waived with the unanimous consent of all of the landowners, and such waiver must be stated in the order for the election.

Recordation and Notice of Special Tax Lien. Upon a determination by the legislative body that the requisite two-thirds of votes cast in the election are in favor of levying the special tax, the clerk of the legislative body must record a notice of special tax lien in the office of the county recorder for each county in which the district is located, whereupon the lien of the special tax will attach as provided in Section 3114.5 of the Streets and Highways Code.

Levy of Special Tax. The provisions of Streets and Highways Code, Sections 3100 et seq. apply to any proceedings taken under the Mello-Roos Act. The special tax must be levied initially by an ordinance adopted by the legislative body, and thereafter (assuming the tax is levied at the same or a lower rate than in the ordinance) it may be adjusted annually by the adoption of a resolution. Reasonable administrative costs incurred in collecting the special tax may be deducted by the tax collector.

Annual Report. Any CFD formed after January 1, 1992 must prepare, if requested by a resident or landowner of the district, an annual report within 120 days after the last day of each fiscal year. The district may charge a fee for the report not in excess of the actual costs of preparing the report. The report must include the following information for the fiscal year:

- The amount of special taxes collected for the year
- The amount of other monies collected for the year and their source, including interest earned

- The amount of monies expended for the year

- A summary of the amount of monies expended for facilities, services, costs of bonded indebtedness, costs of collecting the special tax, and other administrative and overhead costs

Extension of Authorized Facilities and Services and Changes in Special Taxes. After adoption of the resolution of formation, the legislative body, 25 percent or more of the registered voters residing in the district or the owners of 25 percent or more of the land in the district may institute proceedings to change the types of public facilities or services financed by the district, change the rate and method of apportionment, or levy an new special tax, as specified in the Mello-Roos Act.

Disclosure Requirements. In addition to the continuing disclosure requirements under SEC Rule 15c2-12, the Mello-Roos Act requires the legislative body to supply certain information to CDIAC by October 30 of each year after the sale of any bonds, until the final maturity of such bonds. The information required to be supplied to CDIAC includes:

- The principal amount of the bonds outstanding

- The balance in the bond reserve fund

- The balance in the capitalized interest fund, if any

- The number of parcels which are delinquent with respect to their special tax payments, the amount that each parcel is delinquent, the length of time that each has been delinquent, and when foreclosure was commenced for each delinquent parcel

- The balance in any construction funds

- The assessed value of all parcels subject to special tax to repay the bonds as shown on the most recent equalized roll

In addition, the Mello-Roos Act requires the legislative body to notify CDIAC within 10 days upon the occurrence of either a failure of the local agency or the paying agent or fiscal agent to pay principal and interest due on the bonds on any scheduled payment date, or withdrawal of funds from a reserve fund to pay principal and interest on the bonds beyond the levels set by CDIAC.

Proposition 218. Proposition 218 added Article XIIIC and Article XIIID to the California Constitution. Article XIIID has no direct application to bonds issued under the Mello-Roos Act, because they are authorized by a two-thirds vote of the qualified electors of the district. Article XIIIC states, among other things, that ". . . the initiative power shall not be prohibited or otherwise limited in matters of reducing or repealing any local tax, assessment, fee or charge." As discussed above, the Mello-Roos Act provides for a procedure, which includes

notice, hearing, protest, and voting requirements, to alter the rate and method of apportionment of an existing special tax. However, the Mello-Roos Act also prohibits the legislative body from adopting any resolution to reduce the rate of any special tax or terminate the levy of any special tax pledged to repay any debt incurred pursuant to the Mello-Roos Act unless the legislative body determines that the reduction or termination of the special tax would not interfere with the timely retirement of that debt. Consequently, although the matter is not free from doubt, it is likely that Proposition 218 has not conferred on the voters the power to repeal or reduce special taxes if such reduction would interfere with the timely retirement of any bonds issued by a district. For more information regarding Proposition 218, see **Chapter 4, State Constitutional Limitations – The Jarvis Family of Initiatives.**

Process for Approval – Issuing Bonds

The legislative body may generally only sell Mello-Roos bonds if it determines, prior to the sale of the bonds, that the value of the property in the district that would be subject to the special tax will be at least three times the principal amount of bonds to be sold plus the principal amount of all other bonds outstanding and secured by a special tax or a special assessment on the property in the district. However, if the legislative body concludes that the proposed bonds do not present any unusual credit risk (due to credit enhancement or for other reasons), or that the bond issue should proceed for specified public policy reasons, then such determination need not be made.

The proceedings to issue bonds secured by the levy of a special tax are usually combined with proceedings to establish a district. In such cases, a resolution of intention to issue bonds is adopted at the same time as the resolution of intention to establish the district. The local agency is required to hold a public hearing regarding the proposed bond issuance and to publish notice of the hearing, which actions are typically combined with the public hearing and notice published in connection with the establishment of the district. At the public hearing, any interested person may appear and present any matters material to the question of issuing the bonds. After the public hearing, a district may authorize the issuance of bonds by adopting a resolution of necessity to issue bonds, and a resolution to incur bonded indebtedness.

Resolution of Necessity. The resolution of necessity must:

- Contain a declaration of the necessity for the indebtedness
- State the purpose for which the proposed debt is to be incurred
- State the amount of the proposed debt
- State the time and place for a hearing by the legislative body on the proposed debt issue

Resolution to Incur Bonded Indebtedness. The resolution to incur bonded indebtedness must:

- State that the legislative body deems it necessary to incur the bonded indebtedness
- State the purpose for which the bonded indebtedness will be incurred
- State that either the whole of the district or a portion of the district will pay for the bonded indebtedness, as previously determined by the legislative body
- State the amount of debt to be incurred
- Describe the maximum the bonds to be issued will run before maturity, which term may not exceed 40 years
- State the maximum annual rate of interest to be paid, payable annually or semiannually, or in part annually and in part semiannually
- State the date of the election (which may be consolidated with the election to levy the special tax), the polling hours if the election will not be conducted by mail, or the hour when the mailed ballots must be returned to the election officer if the election is conducted by mail

If more than two-thirds of the votes cast at the election are in favor of incurring the indebtedness, the legislative body may, by resolution, provide for:

- The form, execution, and issuance of the bonds
- The appointment of a paying agent or bond registrar
- The execution financing documents securing the bonds
- The pledge or assignment of any revenues of the district to the repayment of the bonds
- The investment of bond proceeds and other revenues, which investment provisions must comply with the restrictions in the Mello-Roos Act
- The date or dates to be borne by the bonds, maturity date(s) of the bonds, and the place(s) and time(s) that the bonds are payable
- The denominations, forms, and registration privileges of the bonds
- Any other terms and conditions determined to be necessary by the legislative body

PROCESS FOR SALE

Mello-Roos bonds may be sold at negotiated sale if the governing body determines that a negotiated sale would result in a lower overall cost. Otherwise, the bonds must be sold at competitive sale.

MAXIMUM AMOUNT; OTHER LIMITATIONS ON TERMS OF BONDS

The maximum amount of the bonds that may be issued is the amount approved by the qualified electors at the bond election. Bonds may bear fixed or variable interest at a rate not exceeding 12 percent per year. Interest on the bonds may be paid annually or semiannually.

The maximum maturity of any bond may not exceed 40 years.

SPECIAL FEDERAL TAX CONSIDERATIONS

The federal tax considerations that apply to a community facilities district are identical to the tax considerations that apply to assessment districts. See the section in this chapter on **Assessment Bonds**.

PENSION OBLIGATION BONDS

DEFINITION AND PURPOSE

Pension obligation bonds (POBs) are typically issued to pay some or all of a pension plan's unfunded accrued actuarial liability (UAAL).

In order to achieve the expected budgetary relief, the issuer hopes to invest the bond proceeds at a rate higher than the total cost of borrowing. The desired result is that the transaction reduces the annual pension contribution required to fund the plan by more than the total cost of borrowing.

The proceeds of the bonds are transferred to the issuer's pension system as a prepayment of all or part of the unfunded pension liabilities of the issuer, and the proceeds are invested as directed by the pension system. The payment of debt service on pension obligation bonds is typically an unconditional obligation of the issuer, payable from its general fund. The debt service payments replace the obligation of the issuer to make annual contributions for the unfunded liability financed with the pension bonds.

In California, issuers of pension obligation bonds have included both cities and counties. Pension obligation bonds payable from an issuer's general fund are based on the theory that the payment of the unfunded liability to the issuer's pension plan is an "obligation imposed by law" which is, therefore, not subject to the constitutional debt limit. Because of limited case law authority on this exception to the debt limit, a judicial validation action is required in order to establish the validity of the obligation.

MECHANICS AND ACTUARIAL ASSUMPTIONS OF DEFINED BENEFIT PLANS

The defined benefit pension fund's main objective is to determine the current and future benefit payments (liabilities) versus the level of current contributions and future investment income (assets) needed to satisfy the benefit payments. Pension fund management's goal is to determine the optimum level of contributions to fully fund the promised benefits. The text box **Pension Funding Formula** provides pension fund math reduced to its simplest form.

Pension Funding Formula

C + I = B + E

Where:

C = Contributions (Employer, Employee, or both)

I = Income from investments

B = Benefits paid

E = Expenses for plan administration

Based on complex actuarial calculations, a contribution amount (C) is determined, which will allow for the accumulation of the assets and investment income, "I," needed to pay for "B." Expenses (E) will be a variable, based on the plan's business policy.

If "B" is predicted accurately but "I" is less than expected, the only alternative for bringing the formula back into balance is to increase "C." If "I" is greater than expected, "C" will be reduced. In most cases, the variable "C" is the responsibility of the employer and employee. The employer takes the risk if "I" is less than expected, and thus must increase contributions, and conversely is rewarded with lower contributions if "I" is greater than expected.

Unfunded Actuarial Accrued Liability

The UAAL is calculated as the actuarial present value of all future benefits, less the actuarial present value of all future normal costs, less the current actuarial value of assets. The resulting UAAL may either be positive (under-funded) or negative (over-funded). The UAAL is not an accounting liability. The UAAL is the actuarial liability associated with prior years under the entry age cost method, assuming that the plan will continue into the future.

In terms of benefits, it reflects expected future pay increases for current members and expected future service for those members. UAAL also can be created by program improvements such as increases in the multiplier and retiree benefit increases. With the investment and contribution side of the equation, it reflects current and expected future returns on investments along with contributions by employees and their employer. Actuarial gains and losses also will impact the UAAL. Gains and losses represent the difference between the actual experience of the program and its assumed experience. Changes in actuarial assumptions and/or methods also impact the UAAL. A complete discussion of pension fund policy and mechanics is described in the California Debt and Investment Advisory Commission's *California Public Fund Investment Primer.*

PROJECTS THAT MAY BE FINANCED

Pension obligation bonds are issued to finance all or part of the unfunded pension liabilities of the issuer. The amount of unfunded liability is the difference between pension system assets and expected revenues and the expected pension benefits previously earned by and payable to employees. This amount is estimated by the pension system's actuary on the basis of assumptions regarding:

- Mortality
- Valuation of current assets
- Rate of return on investments
- Projected salary increases attributed to inflation
- Across-the-board raises and merit raises
- Increases in retirement benefits

- Age at retirement and any cost of living adjustments

These actuarial assumptions will change from time to time and may have a large impact on the amount of the unfunded liability. Thus the amount of unfunded liability could become greater or smaller than that financed with pension obligation bonds. The amount of unfunded liability is generally treated as debt in (footnotes to) the financial statements of the issuer.

POLICY CONSIDERATIONS

Economics of Pension Obligation Bonds and Potential Risks. Pension obligation bonds are typically issued during periods of historically low taxable interest rates (as explained below, interest on pension obligation bonds is generally subject to federal income taxation). At low interest rate levels there is an opportunity for interest rate savings when comparing the rate on the bonds with the assumed rate of return on investments (the "assumed rate") assigned by the pension system to unfunded liabilities. The actuary for the pension system determines the assumed rate based on a conservative estimate of the pension system's projected reinvestment rate (the frequency of this determination depends on the total membership of the pension system). The expected economic benefit to the issuer is the spread between the interest rate on the bonds and the assumed rate.

Issuing a POB involves risks that should be considered before issuance. First, the UAAL is just a "snapshot" at a specific point in time. As new benefits are added or factors affecting the underlying actuarial estimates change, the UAAL may become positive or negative. Issuing a POB does not eliminate this potential risk. Second, there is no guarantee that pension fund investments will earn or exceed actuarial assumptions. To achieve any real saving from issuing a POB, the issuer needs to earn an investment return that exceeds the total cost of borrowing during the period the POB is outstanding. Theoretically, investing bond proceeds from a POB in higher risk investment instruments should produce a rate of return sufficient to service the debt and add to the pension fund portfolio. However, short-term market downturns producing low or negative investment returns can cause the public agency's UAAL to rise to the pre-POB issuance level or higher. An employer hoping to reduce or eliminate its UAAL amortization payment by using a POB may find itself in the undesirable position of owing a pension contribution (including UAAL amortization payment) at the same time the POB debt payments are due. Moreover, issuing POBs to fund annual pension contributions can have a negative impact on the issuer's credit rating if the projected returns fail to materialize and the issuer needs to increase pension contributions along with servicing the POB debt.

Still another component of the economics of most pension obligation bond financings is that the term and the amortization schedule of the unfunded liability can be changed to more closely match the budgetary needs of an issuer. For the pension system, however, it may be disadvantageous from an investment point of view to receive substantial lump sum prepayments (compared with regular periodic payments), particularly at a time when reinvestment rates are relatively low. For more information regarding the policy considerations with respect to pension

obligation bonds, see GFOA Recommended Practice: *Evaluating the Use of Pension Obligation Bonds (1997 and 2005) (DEBT & CORBA)* at **www.gfoa.org**.

Federal Reimbursement Question. Most pension system costs are treated as overhead for purposes of seeking federal reimbursement for indirect costs. After the first county pension obligation financing at the end of 1993, a question was raised by the Office of Management and Budget (OMB) about whether interest on bonds issued to refund unfunded pension obligations for covered employees will be an "allowable cost" for reimbursement in the same manner as interest on the unfunded liability previously paid to the pension system at the assumed rate, under OMB Circular No. A-87 (relating to federal reimbursement of certain costs of state or local governments in administering federal programs). On January 31, 1994, OMB issued a letter that resolves this question favorably in most cases. However, attention should be paid to compliance with the conditions set forth in that letter or otherwise confirming with OMB that federal reimbursements will not be jeopardized.

SECURITY AND SOURCES OF PAYMENT

Pension obligation bonds are issued as unconditional, general fund obligations of the issuer. The taxing power of the issuer, however, is not pledged and bondholders do not receive liens on property of the issuer. The bondholders, therefore, are unsecured, general fund creditors of the issuer. While issuers typically provide pension obligation bondholders with very few financial covenants, issuers often covenant to deposit the annual debt service on the bonds with the bond trustee at the beginning of each fiscal year. There is no bond reserve fund for pension obligation bonds.

Ratings. Because POBs replace existing pension obligations, they are not generally viewed as adding to the debt burden of the state or local government issuer (much like a conventional refunding). In general, rating agencies consider the effects of pension obligation bonds within the general overall long-term credit ratings. They do not view POBs as a credit weakness if approached with a reasonable, conservative, and attainable long-tern strategy for managing the UAAL within their current financial plan.

PROCESS FOR APPROVAL

The issuance of pension obligation bonds is typically authorized by resolution of the governing body of the issuer, and the bonds are usually issued pursuant to Government Code Sections 53580 et seq. (the "Local Agency Refunding Law"). For the full text of the Local Agency Refunding Law, see **Appendix D – Legal References – State Statutes of General Application – Overriding Bond Authorizations.**

Validation Action. Article XVI, Section 18 of the State Constitution prohibits cities and counties from incurring indebtedness exceeding one year without an election. Pension obligations do not fit into any of the well-recognized exceptions to this constitutional debt limitation, such as the special fund exception for revenue bonds or the lease exception, but do

qualify for the lesser known exception for "obligations imposed by law." For more information, see **Chapter 4, State Constitutional Limitations – The 1879 Constitution – The Debt Limit.** Because there is relatively scarce authority for this exception in the law, the validity of the debenture/contract as an obligation imposed by law is validated pursuant to Sections 860 et seq. of the Code of Civil Procedure and so is the validity of the bonds issued to refund the debenture/contract.

The validation action also may include such other matters as the size of unfunded liability, using the bonds to extend the term of original amortization of the unfunded liability, including costs of issuance in the amount of bonds (including in the bond issue the current and/or next fiscal year's normal annual contribution related to current employment at a discount for prepayment) and derivative products. The validation action generally requires approximately 45 days from the date of filing, and can be run concurrently with other work on the financing so that little additional time is required. Validation also has been considered crucial by the rating agencies, which generally require the 30-day appeal period to run before closing the bond issue. A typical pension obligation financing, including the validation action, takes roughly four to five months.

PROCESS FOR SALE

Pension obligation bonds issued pursuant to the Local Agency Refunding Law may be sold at either public or private sale or on a negotiated sale basis. The purchase price of the bonds may be either above or below par, as the issuer determines. In the event the issuer determines to sell the bonds at public sale, the issuer is required to advertise the bonds for sale and invite sealed bids on the bonds by publication of a notice once at least ten days before the date of the public sale in a newspaper of general circulation circulated within the boundaries of the issuer. If one or more satisfactory bids are received, the bonds are required to be awarded to the highest responsible bidder. If no bids are received or if the issuer determines that the bids received are not satisfactory, the issuer may reject all bids received.

To date, most pension obligation bonds have been sold on a negotiated, rather than competitive bid, basis.

OTHER LIMITATIONS ON TERMS OF BONDS

Since pension obligation bonds rely on the "obligations imposed by law" exception to the constitutional debt limit, the aggregate principal amount of bonds should not exceed the obligation imposed by law plus incidental expenses. Thus, in order to qualify under the "obligations imposed by law" exception to the constitutional debt limit, the aggregate principal amount of pension obligation bonds should not exceed an amount equal to:

- The unfunded liability of the pension system (as calculated by an actuary), and
- Costs of issuance of the bonds

Pension obligation bonds are not sized to include a bond reserve fund (as a reserve fund is neither imposed by law nor an incidental expense). As the practice has developed, it has become common to fund the issuer's normal contribution in the current year (and according to some counsel, the next fiscal year), under the logic that these amounts are legally required payments and thus are "obligations required by law." Sizing of a pension obligation bond is usually one of the issues that is validated in the validation action discussed above.

The Local Agency Refunding Law imposes few additional restrictions on the terms of the bonds. The bonds can either be serial or term bonds, bear such date and mature on such dates as determined by the issuer, bear interest at either a fixed or variable rate, and contain redemption provisions as determined by the issuer.

LEGAL AUTHORITY

The taxable pension obligation bonds issued in California have been structured as refunding bonds issued pursuant to the Local Agency Refunding Law. The existing unfunded liability to the pension system is first evidenced by a written debenture (or, in the case of PERS, a written contract), which "evidence of indebtedness" is then eligible for refunding under the Local Agency Refunding Law. In addition to the Local Agency Refunding Law, charter cities also may issue POBs pursuant to an ordinance adopted by the city council.

Alternative financing structures exist, including issuance, by or at the direction of the pension system, of certificates of participation in the unfunded liabilities and other structures that might permit the system to undertake a financing without the public entity's participation or benefit. So far, such alternative structures have not been pursued in California.

The 1937 Act Counties. Twenty-one California counties, including the first three to issue pension bonds, have established retirement systems that are subject to the County Employees Retirement Law of 1937 (the "1937 Act"). The 1937 Act provides that the county has an obligation (the "obligation imposed by law") to make payments to the pension system that, together with the required employee contributions, will be sufficient to provide for the payment of all prospective benefits. This obligation has two components:

- Payments toward future pension benefits associated with current employment
- Payments toward the unfunded liability

The 1937 Act permits the unfunded liability to be amortized over a period of not to exceed 30 years, with an "assumed interest rate" based on the assumed future earnings rate of the pension system.

Charter Cities. A number of charter cities also have substantial unfunded pension liabilities to the retirement systems established by their respective charters. Although not subject to the 1937 Act, analogous "obligations imposed by law" can usually be found in the charter.

The structure of the pension obligation bond financings so far used for cities is essentially identical to that for counties.

PERS. Public entities that are members of the California Public Employees' Retirement System (PERS) are authorized by the Government Code to participate in and to make all or part of their employees members of PERS by contract. Thereafter they are obligated to make contributions to PERS as provided in the Government Code, including payments in respect of unfunded liability as determined by an actuary, amortized over periods particular to each public entity not exceeding 40 years, with interest at an assumed rate. Accordingly, these public entities also may engage in pension obligation financings.

SPECIAL FEDERAL TAX ISSUES

The Tax Reform Act of 1986 changed the federal tax law as it relates to pension obligation bonds making it virtually impossible to structure a new, tax-exempt, pension obligation bond financing. Except for refinancings of pension obligation bonds originally issued prior to the Tax Reform Act of 1986, all of the pension obligation bond financings that have closed in California in recent years have been issued on a federally taxable basis. The interest on these bonds, however, is exempt from State of California personal income tax.

PUBLIC ENTERPRISE REVENUE BONDS

DEFINITION AND PURPOSE

Public enterprise revenue bonds are bonds that finance facilities for a revenue-producing enterprise and are payable from the revenues of that enterprise. Examples of such enterprises include an airport, a water system, a power system, a sewer system, a single power plant, or a bridge. Revenues may include such items as service charges, tolls, connection fees, admission fees, and rents. This section discusses the issuance of public enterprise revenue bonds by cities, counties, and joint powers authorities.

As described in this section, voter approval is required for revenue bonds issued under the Revenue Bond Law of 1941 (Government Code Sections 54300 et seq., the "1941 Act"). This requirement and others in the 1941 Act have resulted in many issuers using alternative revenue bond financing structures when financing improvements to their revenue-generating enterprises. See the sections in this chapter on **Marks-Roos Bonds** and **Financing Leases and Certificates of Participation – Legal Authority – Special Fund Obligations.**

LEGAL AUTHORITY; ISSUERS

Constitutional Considerations for Cities and Counties. California courts have determined that revenue bonds of cities and counties are not required by the California Constitution to be approved by a two-thirds vote in a bond election because the revenue bonds are not payable from taxes or from the general fund of the issuer. Rather, they are paid solely from a special fund consisting of enterprise revenues. To qualify for the special fund exception, the revenues must relate to or be derived from the enterprise that is financed in whole or in part by the bonds.

Statutory Authorization. Cities and counties generally may issue public enterprise revenue bonds under the 1941 Act. Bonds may be issued for water conservation, treatment and supply, garbage collection, treatment and disposal, sewage collection, treatment and disposal, parking, ferries, airports, harbors, hospitals, golf courses, and electric energy generation and transmission (but not distribution).

Charter cities may, unless limited by their charters, adopt ordinances establishing their own procedures for the issuance of revenue bonds for enterprises authorized (or not prohibited) by their charters or which incorporate certain of the procedures set forth in the 1941 Act without being bound by the restrictions therein (e.g. the 1941 Act requirement for a majority vote election may be eliminated).

See **Appendix D – Legal References – Table D-3-1** for a list of other statutory authorizations for the issuance of public enterprise revenue bonds.

Public agencies also are authorized to join together to create a separate entity—a joint powers authority (JPA)—to issue revenue bonds for a project. The Joint Exercise of Powers Law (Government Code Sections 6500 et seq.) authorizes the establishment of these joint powers authorities and the issuance of revenue bonds by them for a wide variety of projects and programs.

The following projects and programs can be financed and undertaken with a JPA:

- Public buildings (generally)
- Working capital programs
- Insurance programs
- Fair and exhibition facilities
- Stadiums, sports arenas, parks, and recreational centers
- Electric generation and transmission facilities
- Solid waste disposal, treatment, or conversion facilities
- Water facilities and wastewater facilities
- Streets, roads, bridges, and mass transit or vehicles facilities
- Airports, police stations, and fire stations
- Public works facilities (including corporation yards)
- Public health facilities
- Criminal justice facilities (including court buildings and jails)
- Public libraries
- Public parking garages
- Low income housing projects
- Redevelopment improvements
- Telecommunications systems or services
- Computers
- Service vehicles

- Public improvements authorized by the various special assessment and Mello-Roos statutes

Projects That May Be Financed

Revenue bonds may be used to finance generally any type of revenue producing improvement subject to any limitations that may appear in the statute pursuant to which the issuer is proceeding. Charter cities with proper charter authority can establish through ordinances revenue bond procedures for almost any public facility that is of a revenue producing nature.

Process for Approval

Under the 1941 Act, the process for the approval of bonds includes the following steps:

- A resolution is adopted by the majority vote of the governing body of the local agency that:
    - States the purpose of the proposed issue
    - Estimates the cost of the project
    - States the principal amount of bonds, the maximum interest rate, and the date and manner of the election to vote on the issuance of the bonds, and
    - Specifies that the bonds shall be revenue bonds payable exclusively from the revenues of the enterprise and are not to be secured by the taxing powers of the local agency
- The resolution is published either:
    - Once a day for at least seven days if the newspaper is published at least six days a week
    - Once a week for two succeeding weeks if the newspaper is published less than six days a week, or
    - If there are no such newspapers, the resolution is posted in three public places in the local agency for two succeeding weeks
- A majority vote must be obtained at the election on the proposition of issuing bonds for the stated purpose
- Issuance and sale of the bonds is authorized by resolution of the governing body of the local agency

Certain requirements with respect to the process for approval of bonds under other revenue bond laws are specified in **Appendix D – Legal References – Table D-3-1**.

For JPAs, the first step is the creation of the JPA by the execution of a joint exercise of power agreement among the public entity members. The JPA is required to file a notice with the Secretary of State within 30 days of the effective date of the agreement, setting forth the name, date, and purpose of the JPA.

The agreement must specify the purpose for the agreement or the powers to be exercised by the JPA. In addition, the manner of exercising such powers must be specified as being subject to the restrictions upon the manner of exercising power of a designated member.

Revenue bond issuances by a JPA must, in certain cases, be approved by ordinances enacted by all of the parties to the JPA or those who will have projects financed by the bond issuance. The ordinance is required to be published and is subject to referendum for the 30-day period (60 days where a county is a public agency) following publication.

PROCESS FOR SALE

Under the 1941 Act, the issuer may sell the bonds at a price above or below par in a manner, at public or private sale, as it determines by resolution.

Certain sale process requirements for public enterprise revenue bonds issued under other statutes are covered in **Appendix D – Legal References – Table D-3-1**.

For JPAs, certain bonds may be required to be sold at par at competitive sale. Other JPA bonds, such as bonds for the generation and transmission of electric energy, the disposal or conversion of solid waste, an intermodal container transfer facility, or for a fair and exhibition facility, and projects financed under the Marks-Roos Local Bond Pooling Act of 1985 (Government Code Sections 6584 et seq.), may be sold at negotiated sale or at a price less than par, or both.

LIMITATIONS ON TERMS OF BONDS

Under the 1941 Act, the maximum stated interest rate is 12 percent per year and the bonds may have a term of up to 40 years. The issuer may specify any premium payable upon early retirement of the bonds.

Certain limitations on the terms of bonds issued under other statutes are listed in **Appendix D – Legal References – Table D-3-1**.

For JPAs, the interest rate may be either fixed or variable and interest may be payable at the times specified in the bond resolution.

METHOD OF REPAYMENT AND SECURITY FEATURES

As described above, public enterprise revenue bonds are secured by a lien upon, and from, the revenues of the revenue producing enterprise or facility. Commonly, an operating history of the enterprise or feasibility studies are used to determine that projected revenues will be sufficient to

pay operation and maintenance expenses of the enterprise or facility, revenues on the bonds and an additional amount known as coverage. In addition, the issuer will generally covenant in the bond resolution or indenture to establish rates and charges for the products or services provided by the enterprise or facility sufficient to provide revenues to pay such amounts and to provide coverage. Coverage is generally expressed as the ratio of net revenues (i.e. revenues less operation and maintenance expenses other than depreciation) to debt service (e.g. 1.2 times coverage).

SPECIAL FEDERAL TAX CONSIDERATIONS

As described in **Chapter 3, General Federal Tax Requirements**, the federal tax limitations and requirements for tax-exempt debt apply to public enterprise revenue bonds. For example, in order to be tax-exempt, public enterprise revenue bonds must not be arbitrage bonds or hedge bonds.

However, tax-exempt public enterprise revenue bonds may be issued to finance airport, port, mass commuting, water, sewer, solid waste disposal, and certain other facilities even if the bonds are private activity bonds, because each of these types of facilities are a category of qualified private activity bonds. As described in the private activity bond discussion in **Chapter 3, General Federal Tax Requirements,** the Private Business Tests may be satisfied on the basis of a private business owning, leasing, managing, or acquiring output from a particular facility. It is very common for airport revenue bonds or port revenue bonds to be private activity bonds.

Because public enterprise projects tend to be large and expensive, the most significant practical federal tax limitation for qualified private activity bond financing is the volume cap requirement. In California, volume cap is a scarce resource. The good news on this front is that qualified private activity bond financing for airport, port, and solid waste disposal facilities that are owned by a public agency are exempt from the volume cap requirement. In fact, ownership of the financed facilities by a public agency is a requirement for all airport and port qualified private activity bonds. Among other things, this ownership requirement typically limits any lease of such facilities to a private business to a maximum term of 80 percent of the useful life of the facility. For a more detailed discussion of the types of facilities that constitute airport, port, mass commuting, water, sewer, and solid waste disposal facilities and the other limitations relating to qualified private activity bonds, the reader should review the discussion on qualified private activity bonds in **Chapter 3, General Federal Tax Requirements**.

Additionally, an increasing number of public enterprises are considering various forms of "privatization." To the extent the business arrangements relating to privatization cause bonds already issued or to be issued to be private activity bonds, tax-exempt financing may not be available and remedial action may be required to preserve the tax-exempt status of outstanding bonds. As described in the discussion on management or service provider contracts in **Chapter 3, General Federal Tax Requirements,** however, it is often possible to allow for privatization

by way of a service or management contract without causing bonds to become private activity bonds.

REFUNDING BONDS

Public enterprise revenue refunding bonds are generally authorized to be issued without an election and by means of a negotiated sale (see, generally, the Local Agency Refunding Bond Law (Government Code Sections 53580 et seq.)). If the local agency determines to sell the bonds pursuant to the Local Agency Refunding Bond Law at negotiated sale, the local agency must, on the Report of Final Sale filed with the California Debt and Investment Advisory Commission, explain the reasons why the local agency determined to sell the bonds at negotiated sale instead of at competitive sale.

PUBLIC LEASE REVENUE BONDS

DEFINITION AND PURPOSES

Public lease revenue bonds are issued by a public entity (such as a JPA) or on behalf of a public entity (such as by a nonprofit corporation on behalf of a city) and provide a means to finance capital improvements to be leased to a public agency. The bonds are payable solely from lease payments paid by a public agency other than the issuer.

Unlike a certificate of participation (COP) financing (see the section in this chapter on **Financing Leases and Certificates of Participation**), the lease to the public entity need not be a financing lease because the bonds themselves, which are issued by or on behalf of a public entity, are the tax-exempt obligations and the lease simply provides the security for payment of the bonds.

PROJECTS THAT MAY BE FINANCED

Joint Powers Authorities. Perhaps the most frequent type of issuer of lease revenue bonds is a JPA. JPA lease revenue bonds may be used to finance the projects or programs listed in this chapter in the section on **Marks-Roos Bonds – Projects That May be Financed with Marks-Roos Bonds – Public Capital Improvement Bonds.**

Nonprofit Corporations. Nonprofit corporation lease revenue bonds may be used to finance virtually any facility or project that can be leased to a public agency, including equipment. Historically, they have been used to finance schools, public administrative buildings, stadiums, convention centers, airport facilities, entire water distribution or sewer systems, and other similar projects.

Redevelopment Agencies. Redevelopment agency lease revenue bonds may be used to finance publicly owned buildings or facilities that are of benefit to the project area or its immediate neighborhood if no other reasonable means of financing such buildings or facilities are available to the community.

Parking Authorities. Parking authority lease revenue bonds may be used to finance parking facilities and structures.

Public Works Board. A variety of state-funded projects—instructional, research, and medical facilities, prisons, state office buildings and equipment—may be authorized by the State Legislature for financing through Public Works Board lease revenue bonds.

For a listing of the statutory references for each of these types of lease revenue bonds, see **Appendix D – Legal References – Table D-4-1.** In each case, authority also must exist for the public agency lessee to enter into the lease. A listing of the most commonly used of these statutory provisions is provided in **Appendix D – Legal References – Table D-5-1.**

POLICY CONSIDERATIONS

Generally, public lease revenue bond financing is expensive compared to general obligation bond financing and, for that reason, may be a less desirable alternative.

Historically, public lease revenue bonds have been used to finance several different types of projects:

- Projects, such as stadiums or parking facilities, which were intended directly or indirectly to pay their own way, but with respect to which revenues were either sufficiently uncertain or sufficiently indirect as to not provide an adequate basis for bondholders' security. Thus the public agencies' general fund credit was placed behind the project.

- Projects, which were permitted to be financed by general obligation bonds of local agencies or the state, but were either not sufficiently popular to obtain a favorable two-thirds vote at an election or for which timing considerations did not permit the delay attendant in calling and holding an election

- Projects, which were necessary and desirable, but for which no other method of financing reasonably existed, frequently because the financed facilities do not house activities that generate revenues—for example, the building and equipping of a fire station

For a complete discussion of the policy considerations for lease revenue bonds, see *Guidelines for Leases and Certification of Participation* (CDIAC 1993).

SECURITY AND SOURCE OF REPAYMENT

The pledged revenues for a public lease revenue bond are the payments made pursuant to the lease by the public agency lessee. The "lease" may take the form of a beneficial use and occupancy lease (payable from the general fund of the lessee), a non-appropriation lease (which also may be payable from the general fund of the lessee, subject to the right of the lessee to terminate the agreement in any fiscal year), or a special fund lease (payable solely from certain limited revenues relating to the project). These three types of lease obligations, and their security features, are discussed in more detail in this chapter in the section on **Financing Leases and Certificates of Participation.** Also, see **Chapter 4, State Constitutional Limitations – The 1879 Constitution – The Debt Limit.**

PROCESS FOR APPROVAL

Joint Powers Authorities. Under the Joint Exercise of Powers Act (Government Code Sections 6500 et seq., the "JPA Act"), two or more public agencies may agree to jointly exercise any power common to each of the contracting agencies as authorized by their legislative or governing bodies. A public agency is defined as including federal, state, and local agencies.

A JPA, created pursuant to a joint powers agreement, is an entity separate and apart from the public agencies that are parties to the joint powers agreement. The joint powers authority is required, within 30 days after the effective date of the joint powers agreement, to cause a notice of the joint powers agreement to be prepared and filed with the office of the Secretary of State.

A JPA may generally issue lease revenue bonds without an election. However, if the lease revenue bonds are issued pursuant to Article 2 of the JPA Act, the public agency lessee must approve the financing by ordinance subject to referendum. The ordinance takes effect 60 days after its date of adoption, and during this time opponents of the project may circulate referendum petitions on the ordinance. If the required number of voters signs the petition, lease revenue bonds cannot be issued until after the ordinance has been approved at an election. On the other hand, if the lease revenue bonds are issued pursuant to Article 4 of the JPA Act, no ordinance is required.

Nonprofit Corporations. Generally, after determining to finance a particular facility or project with nonprofit corporation lease revenue bonds, the first step is the creation of a nonprofit corporation under the Nonprofit Public Benefit Corporation Law (Corporations Code Sections 5110 et seq.). A group of "public spirited citizens" may form a nonprofit corporation by filing articles of incorporation with the Secretary of State. To avoid treatment of the nonprofit corporation as the "alter ego" of the public agency, the governing body of the public agency does not directly appoint members of the board of directors of the nonprofit corporation. However, board members may be subject to the approval of the governing body of the public agency.

Nonprofit corporations are often utilized in a public leaseback financing governed by Government Code Sections 54240 et seq. Such a financing is typically structured as follows:

- The public agency leases the site to the nonprofit corporation, which agrees to construct the project and subleases the site and project back to the public agency
- The project is financed with the proceeds of bonds issued by the nonprofit corporation and the bonds are payable from and secured by a lien on the rental payments made by the public agency pursuant to the sublease
- A sublease (or lease if the nonprofit corporation owns the site outright) with a term of five years or more must be approved by ordinance of the lessee, subject to referendum
- If a sufficient number of voters petition to place the matter on a ballot, and a majority of those voting oppose the leaseback, all proceedings must be terminated

Redevelopment Agencies and Parking Authorities. In each case, the lease, which provides the revenues to pay the bonds, must be approved by ordinance subject to referendum in the same manner as for nonprofit corporations.

In each of the above cases, the actual issuance and sale of the bonds is authorized by resolution of the governing body of the issuer.

State Public Works Board. Lease revenue bonds issued for a particular facility or project by the State Public Works Board must be authorized by a particular statute. Once authorized by statute, the lease, which provides the revenues to pay the bonds, must be approved by legislative or administrative action of the public agency leasing the financed facility. For example, a lease for a community college facility must be approved by resolution of the board of directors of the community college district. Similar actions are taken by the Regents of the University of California and the Board of Trustees of the California State University to authorize their leases with the Public Works Board. Finally, state departments such as the Department of General Services, the Department of Corrections, and the Franchise Tax Board may authorize the lease by administrative action. The authorization of the lease takes effect immediately and is not subject to referendum.

Following the authorization of the lease, the State Public Works Board authorizes the issuance of lease revenue bonds or bond anticipation notes by resolution approving the form and authorizing the execution of a bond indenture and the lease.

PROCESS FOR SALE

Generally, public lease revenue bonds issued by nonprofit corporations and parking authorities must be sold at competitive sale held after publication of a notice once at least ten days before the date of the sale in a newspaper of general circulation circulated within the boundaries of each public agency to be aided by the project (see Government Code Sections 5800 et seq.).

Redevelopment agency public lease revenue bonds must be sold at not less than 95 percent of par, at a competitive sale held after notice published once at least five days prior to the sale in a newspaper of general circulation published in the community.

JPA lease revenue bonds may generally be sold on a negotiated basis at a price determined by the authority after due consideration of the recommendations of the public agency lessee.

Parking authority lease revenue bonds must be sold at a price not less than 92 percent of par.

Public Works Board lease revenue bonds must be sold by the State Treasurer, either at competitive or negotiated sale and at a price as determined by the State Treasurer.

OTHER LIMITATIONS

Nonprofit Corporations. There are no statutory limitations on the maximum maturity or interest rate for nonprofit corporation lease revenue bonds, nor are there any other statutory specifications of payment terms of such bonds.

Joint Powers Authorities. The maximum interest rate is 12 percent per year. Interest may be fixed or variable, and may be payable at the times determined by the authority. The maximum maturity is 50 years.

Redevelopment Agencies. The maximum interest rate is 12 percent per year. Interest may be fixed or variable, payable at the times determined by the agency. No maximum maturity is specified.

Parking Authorities. The maximum interest rate is 12 percent per year. Interest is required to be payable semiannually. The maximum maturity is 40 years.

Public Works Board. There are no limits on either the maximum interest rate or maximum maturity. Similarly, interest may be fixed or variable and may be payable at the times determined by the board.

LEGAL AUTHORITY; ISSUERS

Generally, the California Constitution requires voter approval for issuance of long-term debt paid from the general funds of cities, counties, school districts, and the state. In a public lease revenue bond financing, the governmental lessee's obligations under the lease are designed to avoid classification as "debt" for purposes of the constitution. Therefore, voter approval is generally not necessary. See the following section on **Financing Leases and Certificates of Participation** and **Chapter 4, State Constitutional Limitations – The 1879 Constitution – The Debt Limit.**

SPECIAL FEDERAL TAX ISSUES

Except for lease revenue bonds issued by a nonprofit corporation on behalf of a public agency, lease revenue bond financings do not present many unique federal tax issues. The various limitations and requirements described in **Chapter 3, General Federal Tax Requirements**, such as limitations relating to private activity bonds, arbitrage bonds, and hedge bonds, continue to apply.

Nonprofit Corporations. In the event public lease revenue bonds are issued by a single purpose nonprofit corporation on behalf of a public entity, the nonprofit corporation's purposes and activities must comply with IRS Revenue Ruling 63-20. In addition, IRS Revenue Procedure 82-26 identifies specific circumstances and fact situations in which the tests outlined in Revenue Ruling 63-20 will be deemed met. In general, the following conditions must be met by the nonprofit corporation for interest on its bonds to be tax-exempt:

- The nonprofit corporation must engage in activities that are essentially public in nature
- The corporate income may not benefit any private person

- The governmental unit must have a beneficial interest in the corporation while the indebtedness remains outstanding

- The governmental unit must obtain full legal title to the property with respect to which the indebtedness was incurred upon retirement of the indebtedness

Furthermore, a number of special, detailed limitations and requirements are set forth in Revenue Procedure 82-26 and apply to these types of financings. These limitations and requirements do not apply to the other lease revenue bonds structures and can make this structure quite cumbersome and limiting.

SPECIAL STATE TAX ISSUES FOR NONPROFIT CORPORATIONS

Bonds issued by a nonprofit corporation on behalf of a public agency are not covered by the state constitutional exemption from taxation. Accordingly, and unlike the other lease revenue bond structures, unless a specific statute exempts the interest on such bonds, it is taxable income under state law.

SALES TAX REVENUE BONDS

DEFINITION AND PURPOSE

Sales tax revenue bonds are bonds that are payable from and secured by revenues received by the issuer from the imposition of a sales and use tax, or a transactions and use tax, on retail transactions within the issuer's boundaries. While sales tax revenue bonds may be used to finance projects that are similar in many respects to the projects financed by public enterprise revenue bonds discussed in a prior section on **Public Enterprise Revenue Bonds**, sales tax revenue bonds are useful for financing projects that will not generate revenues for some time or will not generate revenues sufficient to cover the costs of the project, such as mass transit facilities. Sales tax revenue bonds may be used for general purposes, depending on the nature of the tax and the agency collecting them. For a broader discussion of general and special taxes, see **Chapter 4, State Constitutional Limitations – The Jarvis Family of Initiatives.** Sales tax revenue bonds should not be confused with tax and revenue anticipation notes, which are discussed above in **Tax and Revenue Anticipation Notes (TRANs)**.

POLICY CONSIDERATIONS

The primary policy issues raised by proposals to issue sales tax revenue bonds relate to the use of a tax-based revenue source to finance an enterprise or system, which, although it collects revenues, cannot support itself fully from those revenues. For example, in the case of a transportation district financing, all retail buyers of goods in the district (a relatively broad spectrum of the population) are supporting a transportation system used by a smaller segment of the population. Nevertheless, the benefits of the use of public transportation—lower required expenditures on the streets and highways, lower pollution levels, etc.—benefit all of the population and may justify the use of a broadly based tax.

Basic State & Local Sales Tax* (as of January 1, 2005)

State	
General Fund	5.00%
Fiscal Recovery Fund	0.25%
Local Revenue Fund	0.50%
Local Public Safety Fund	0.50%
State Total	**6.25%**
Local	
County Transportation Funds	0.25%
City and County Operations	0.75%
Local Total	**1.00%**
Statewide Basic Rate	**7.25%**

*Source: California State Board of Equalization

LEGAL AUTHORITY; ISSUERS

To issue sales tax revenue bonds, an issuer must have the power to impose a sales tax. The California Revenue and Taxation Code authorizes local sales taxes in addition to the state's 6.25 percent sales and use tax on all retail sales within the state (the "state sales tax"). Of the 6.25 percent state sales tax, 5 percent is allocated to the state's General Fund. Of the remaining 1 percent of Statewide Sales Tax, 0.25 percent is allocated for county transportation purposes and the other 0.75 percent is allocated for city and county operations.

The imposition of a sales and use tax by local governments in an amount not to exceed, in the aggregate, 1.25 percent is authorized by Sections 7200 et seq. of the Revenue and Taxation Code (commonly referred to as the "Bradley-Burns Uniform Local Sales and Use Tax"), 0.25 percent of which sales tax is dedicated to county transportation purposes. Under the terms of Proposition 57 (approved by the voters in March 2004), 0.25 percent of the Bradley-Burns Uniform Local Sales and Use Tax rate is diverted to the State Fiscal Recovery Fund for purposes of repayment of the deficit-financing bonds issued in 2004. These local funds are replaced by a shift of property tax revenues from schools, which are reimbursed by the state's General Fund. The diversion of local sales tax revenues to the Fiscal Recovery Fund will remain in effect until the deficit-financing bonds are paid off.

With respect to the sales tax only (not the use tax), the tax imposed by a city is offset by any sales tax imposed by a redevelopment agency, the governing body of which is identical to the city council, at a rate up to 1 percent. The Community Redevelopment Law Reform Act of 1993 (commonly referred to as "AB 1290") eliminated the authority for a redevelopment agency to issue sales tax bonds.

In addition to the Bradley-Burns Uniform Local Sales and Use Tax, the imposition by certain districts authorized to impose transactions and use taxes in an aggregate amount not to exceed 1.5 percent is authorized by Sections 7251 et seq. of the Revenue and Taxation Code.

The organic acts of certain specified transportation or transit districts, cities, educational agencies and other entities provide for a transactions and use tax in excess of 1.5 percent. By definition, there may be more than one district within a county. The combined rate of all taxes imposed under Sections 7251 et seq. of the Revenue and Taxation Code within any county may not exceed 1.5 percent unless specifically authorized by legislation.

Sales Tax Districts

Any county, transit district, rapid transit district or any local transportation authority created or designated pursuant to Division 19 of the Public Utilities Code, as well as:

- ✓ Los Angeles County Transportation Commission
- ✓ Tahoe Transportation District
- ✓ San Diego County Regional Transportation Commission
- ✓ Fresno County Transportation Authority
- ✓ Tuolumne County Traffic Authority
- ✓ San Diego County Regional Justice Facility Financing Agency
- ✓ San Joaquin County Regional Justice Facility Financing Agency
- ✓ San Bernardino County Transportation Commission
- ✓ Riverside County Transportation Commission
- ✓ Orange County Regional Justice Facilities Commission
- ✓ Metropolitan Transportation Commission
- ✓ Certain other county regional justice facilities financing agencies

Sales Tax Generally

In general, the statewide sales tax applies to the gross receipts of retailers from the sale of tangible personal property, and the statewide use tax is imposed on the storage, use, or other consumption in the state of property purchased from a retailer for such storage, use, or other consumption. The statewide use tax does not apply to cases where the sale of the property is

subject to the statewide sales tax, therefore the statewide use tax is generally applied to purchases made outside of the state for use within the state or to sales between individuals for items such as automobiles. Local sales taxes are generally imposed upon the same transactions and items subject to the statewide sales and use tax, with the same exceptions. Many categories of transactions are exempt from the sales tax (see text box on **Items Exempt from Sales Tax**).

Items Exempt from Sales Tax

- ✓ Food products for home consumption
- ✓ Prescription medicine, newspapers, and periodicals
- ✓ Edible livestock and their feed
- ✓ Seed and fertilizer used in raising food for human consumption
- ✓ Gas, electricity, and water when delivered to consumers through mains, lines, and pipes
- ✓ Certain "occasional" sales
- ✓ Sales of property to be used outside the county which are shipped to a point outside the county

Action by the state legislature or by voter initiative could change the transactions and items upon which the sales tax is imposed. Such changes could have either an adverse or beneficial impact on the level of sales tax revenues. For example, a voter initiative approved in 1992 eliminated taxation for candy, gum, bottled water, and confectionery (referred to as the "snack tax").

Sales Tax Litigation

There has been a great deal of litigation regarding sales taxes in California. Historically, sales taxes have been relied on extensively for financing transportation projects. Following Proposition 13, there was an increasing reliance on sales taxes for transportation purposes, and a proliferation of local transportation authorities levying an additional half-cent sales tax in counties for such purposes. The half-cent sales taxes as levied by these authorities were approved by majority vote as general taxes under the authority of the *Los Angeles County Transportation Commission v. Richmond* case decided by the California Supreme Court shortly after the passage of Proposition 13. The imposition of these taxes through a majority vote came under attack.

On December 19, 1991, the California Supreme Court rendered its opinion in *Rider v. County of San Diego (Rider)*. The *Rider* decision invalidated a 0.5 percent retail transactions and use tax that had been imposed by the county through an authority for justice facility purposes. In *Rider*, the California Supreme Court held that taxes levied by special districts require two-thirds voter approval. Special districts are government entities created to circumvent the limitations on taxation embodied in Article XIIIA of the California Constitution, and an entity may be deemed a special district if it was created after the adoption of Article XIIIA and it is "essentially controlled" by an entity with the power to levy property taxes.

On September 28, 1995, the California Supreme Court rendered its opinion in *Santa Clara County Local Transportation Authority v. Guardino (Santa Clara).* The *Santa Clara* decision held invalid a half-cent sales tax to be levied by the Santa Clara County Local Transportation Authority because it was approved by a majority, but not two-thirds of the voters in Santa Clara

County voting on the tax. The California Supreme Court decided the tax was invalid under Proposition 62, a statutory initiative adopted at the November 4, 1986 election that required (among other matters) that any new taxes for general governmental purposes imposed by local governmental entities be approved by a two-thirds vote of the governmental entity's legislative body and by a majority vote of the voters of the governmental entity voting in an election on the tax. It also requires that any special tax (defined as taxes levied for other than general governmental purposes) imposed by a local governmental entity be approved by a two-thirds vote of the electorate of the governmental entity voting in an election on the tax.

In deciding *Santa Clara* on Proposition 62 grounds, the California Supreme Court rejected the Court of Appeals decision in *City of Woodlake v. Logan,* which had held portions of Proposition 62 unconstitutional as a referendum on taxes prohibited by the California Constitution. The Supreme Court determined that the voter approval requirement of Proposition 62 is a condition precedent to the enactment of each tax statute to which it applies, while referendum refers to a process invoked only after a statute has been enacted.

Many existing special district sales taxes that were adopted by majority vote are protected from being challenged under the *Santa Clara* decision by statutes of limitation. Moreover, Public Utilities Code Section 99550 has made the decision in *Rider* inapplicable to any action or proceeding wherein the validity of a retail transactions and use tax is contested, questioned, or denied if the ordinance imposing the tax was adopted by a transportation agency and approved by a majority of the electorate voting thereon prior to December 19, 1991.

Proposition 218 has made more definitive the voting requirements for special taxes. See the discussion in **Chapter 4, State Constitutional Limitations – The Jarvis Family of Initiatives – Proposition 218**.

PROCEDURES

Power to Issue Bonds

For transit and transportation authorities, statutory authorization for the issuance of sales tax revenue bonds is in **Appendix D – Legal References – Table D-6-1**.

Article XVI Section 18 of the State Constitution appears to prohibit cities and counties from issuing sales tax revenue bonds. Redevelopment agencies cannot issue sales tax revenue bonds because of AB 1290 (the Community Redevelopment Law Reform Act of 1993).

In addition to the express power to issue sales tax revenue bonds, many transportation and transit districts have the power to issue revenue bonds on the basis of a provision in their respective organic acts giving them the authority to exercise such power pursuant to the Revenue Bond Law of 1941 (Government Code Sections 54300 et seq.). Others have their own revenue bond provisions in their organic acts, while others have a combination of both.

A district must have more than the power to impose the transactions and use tax and the power to issue revenue bonds under the Revenue Bond Law of 1941 to be able to issue bonds secured solely by the transactions and use tax, because the Revenue Bond Law of 1941 only authorizes the pledging of tax revenues as additional security, with revenues from the "enterprise" being the main security. As a result, to issue bonds secured only by the transactions and use tax, a district must have separate statutory authorization or rely on the general pledge statute (Government Code Section 5451). See **Appendix D – Legal References – Table D-6-2** for a listing of statutory authorities for the various transportation and transit districts.

Projects That May Be Financed

For cities and counties, authorized projects include the acquisition, installation, construction, or improvement of public works or improvements, and the acquisition of lands and easements therefor.

For local transportation authorities created under the local transportation authority act, sales tax revenue bonds may be issued to finance capital outlay expenditures as may be provided for in the applicable county transportation expenditure plan. These capital outlay expenditures include:

- The construction and improvement of state highways
- The construction, maintenance, improvement, and operation of local streets, roads, and highways
- The construction, improvement, and operation of public transit systems

Transit and transportation districts other than local transportation authorities created under the local transportation authority act generally may issue sales tax revenue bonds to finance transit facilities, additions, extensions, and improvements to them, and all other facilities authorized to be acquired, constructed, or completed by the district. The statutory provisions authorizing the tax, however, may have separate limitations on the purposes for which the tax can be imposed. A listing of such code sections is in **Appendix D – Legal References – Table D-6-2**.

Process for Approval

Local Transportation Authorities. Local transportation authorities created under the local transportation authority act obtain initial authorization for the issuance of sales tax revenue bonds as part of the ballot proposition approving the imposition of a transactions and use tax by such authority under Section 7251 et seq. of the Revenue and Taxation Code. The proposition must be approved by the majority (two-thirds following *Guardino*) of the electors voting at a special election called for that purpose by the county's board of supervisors. Sales tax revenue bonds are then issued pursuant to a resolution adopted at any time by a two-thirds vote of the authority.

Transit and Transportation Districts. A majority of the districts (other than local transportation authorities created under the local transportation authority act) issue sales tax revenue bonds pursuant to the Revenue Bond Law of 1941. The process for approval by the issuer is similar to that outlined in the preceding paragraph with two key differences. First, the initiating resolution must be published a specified number of days in a newspaper in the district or, if that is not feasible, be posted in three public places in the district. Second, the proposition presented to the voters need only receive a majority vote of the governing body of the district to adopt the authorization resolution because there is no debt limit issue.

Districts issuing sales tax revenue bonds pursuant to statutory authority other than the Revenue Bond Law of 1941 may have different process requirements. Key variations are summarized in **Appendix D – Legal References – Table D-6-2**.

Process for Sale

For local transportation authorities created under the local transportation authority act, either competitive or negotiated sale is authorized. In both cases, the sales tax revenue bonds may be sold at a price below par.

For transit and transportation districts, other than local transportation authorities created under the local transportation authority act, bonds issued under the Revenue Bond Law of 1941 may be sold at competitive or negotiated sale.

Districts issuing sales tax revenue bonds pursuant to statutory authorization other than the Revenue Bond Law of 1941 may have different sale process requirements. Key variations are summarized in **Appendix D – Legal References – Table D-6-2**.

Limitations on Terms of Bonds

For local transportation authorities created under the local transportation authority act, the maximum maturity may not extend beyond the date of termination of the transactions and use tax. That date of termination may not be more than 20 years from the date the tax is imposed following the approval of the tax by the electors.

For transit and transportation districts, other than local transportation authorities created under the local transportation authority act, under the Revenue Bond Law of 1941 the maximum stated interest rate is 12 percent per year and the maximum maturity is 40 years.

Districts issuing sales tax revenue bonds pursuant to statutory authorization other than the Revenue Bond Law of 1941 may have different limits on payment terms. Key variations are summarized in **Appendix D – Legal References – Table D-6-2**.

METHOD OF REPAYMENT AND SECURITY FEATURES

Sales tax revenue bonds are limited obligations of the issuer and are payable solely from the sources described in the bond resolution. The sales tax revenue bonds are secured by a lien upon the sales tax revenues. In a "pure" sales tax revenue bond financing, such revenues will consist solely of the sales and use tax or transactions and use tax revenues received by the issuer. This is the common structure employed in sales tax issues.

Sales tax revenues are highly dependent, however, upon the economic conditions and demographic characteristics of the issuer and its service area. Fluctuations in these economic conditions and/or these demographic characteristics could cause unpredictability and instability in the stream of sales tax revenues. To ensure the interest of underwriters in purchasing the bonds, it may be necessary for the issuer to retain a consulting firm to analyze these conditions and characteristics and to project the sales tax revenues into the future.

If the analysis shows that there may be instability in the sales tax revenues, an issuer may have to designate another source of revenues for repayment of the bonds and give the bondholders a security interest in that source to make the bonds marketable. If the proceeds of the sales tax revenue bonds are being used to finance a revenue-generating enterprise, such as a transit system, a logical source of such additional revenues would be the facility.

Another source of concern with respect to sales tax revenue bonds is that the rates that may be imposed on the sales and use tax or the transactions and use tax are essentially fixed by statute and cannot be raised by the issuer during the life of the bond issue. This raises the question of quality and quantity of debt service coverage. Underwriters and potential investors will want to see provisions in the bond documents restricting new liabilities, specifically future debt issuance. A key provision will be a covenant by the issuer referred to as the "Additional Bonds Test" which restricts the issuance of additional sales tax bonds only to situations where historical revenue collections cover by a specified ratio the future maximum annual debt service. Such coverage is estimated to be an amount sufficient to protect against possible fluctuations in sales tax revenues. The Additional Bonds Test, by limiting the amount of bonds issued, insures that sales tax revenues are more likely to be sufficient to pay debt service on the outstanding bonds.

Before an issuer can impose a sales and use tax or a transactions and use tax it must enter into a contract for administration with the state Board of Equalization (BOE). The contract provides that the BOE will perform all functions incident to the administration or operation of the sales and use tax or the transactions and use tax ordinance of the issuer. The issuer must pay the BOE its costs of preparation to administer and operate the tax. In addition, the city, county, redevelopment agency, local transportation authority, district, or other entity must pay ongoing fees (determined by the BOE) to the BOE for administration of the tax. In the context of a sales tax revenue bond financing, the contract for administration is often assigned to the bond trustee and the BOE is requested to transmit sales tax revenues directly to the bond trustee.

SPECIAL FEDERAL TAX CONSIDERATIONS

The various limitations and requirements described in **Chapter 3, General Federal Tax Requirements**, such as limitations relating to private activity bonds, arbitrage bonds, and hedge bonds, continue to apply. However, sales tax revenue bonds generally will not be private activity bonds because such bonds will never satisfy the Private Payment or Security Test if the issuer of the bonds does not receive significant nonsales tax revenues with respect to the financial facilities.

REFUNDING BONDS

Sales tax revenue refunding bonds are authorized under the Revenue Bond Law of 1941, under the local transportation authority act, and by the Local Agency Refunding Bond Law (Government Code Sections 53580 et seq.). Cities and counties are, of course, subject to constitutional procedural requirements for an election.

SINGLE-FAMILY MORTGAGE REVENUE BONDS

DEFINITION AND PURPOSE

Single-family mortgage revenue bond programs assist individuals and families of low and moderate income to acquire, improve, or rehabilitate homes by providing mortgage loans with interest rates lower than the rates on conventional mortgage loans. The bonds are limited obligations of the issuer payable primarily from payments received with respect to the mortgage loans.

PROGRAMS THAT MAY BE FINANCED

A description of a typical local agency single-family mortgage bond program follows. Many variations are possible, particularly where the program is for home improvement or rehabilitation rather than home acquisition. In a typical local agency program, the issuer (through the bond trustee) uses bond proceeds to purchase mortgage loans (or mortgage-backed securities backed by mortgage loans) originated by one or more mortgage lenders selected by the issuer to participate in the program. A program may include either or both of the following elements:

- A "first-come, first-served" program in which the issuer commits to purchase a mortgage loan only if and when a lender has received an application for the loan, or

- A "forward commitment" program in which the issuer commits to lenders (and/or housing developers) for a specified period of time to purchase specified amounts of loans originated by the lenders (or on homes located in approved developments built by the developers)

The period during which the lenders can make mortgage loans and sell them to the issuer is typically 6 to 24 months long, and may be extended if certain conditions are met. The homes financed must be within the jurisdiction of the issuer.

The mortgage loans are generally 30-year, fixed-rate mortgage loans with a mortgage interest rate determined at the time of issuance of the bonds. However, issuers have designed programs with graduated payment mortgage loans and mortgage loans of less than 30 years. The mortgage interest rate for a particular program depends upon a number of factors, including the interest rates borne by the bonds, the amount of lender and developer fees or issuer contribution, and the interest rates obtained on the investment of bond proceeds prior to the purchase of the mortgage loans.

For cities, counties, housing authorities, and joint powers authorities, the mortgagor income limits are the following:

- 120 percent of median income for mortgages made for improving a home or for homes where the purchaser will be the first occupant, and
- 100 percent of median income where the mortgagor will not be the first occupant (with one-half of the monies for such purposes allocated for mortgagors whose income does not exceed 80 percent or 90 percent of median income, depending upon certain findings)

Each mortgagor must intend to occupy the home for a period of at least two years.

In addition, for the bonds to be federally tax-exempt, the additional income limits, purchase price limits, and other requirements of federal tax law must also be met (see below in this section).

Although the redevelopment law authorizes redevelopment agencies to issue single-family mortgage revenue bonds, there is no apparent advantage to using a redevelopment agency for this purpose. In fact, there are a number of significant limitations on redevelopment agency programs when compared with city and county programs—for example, with certain exceptions, redevelopment agencies may only make loans within redevelopment project areas.

POLICY CONSIDERATIONS

The primary policy consideration for a single-family mortgage revenue bond program, as for any program that finances a private activity, is whether the activity proposed to be financed merits governmental support. Bonds can be used to assist or encourage any or all of the following:

- Housing construction generally
- The construction of particular types of housing
- The construction of particular housing developments
- Home improvement and rehabilitation
- Owner-occupied housing as opposed to rental housing
- Housing affordability for low- and moderate-income families

In each case, the limitations placed on tax-exempt single-family mortgage revenue bonds by federal law will affect the ability of the issuer to accomplish its objectives.

In some cases, the viability of a program may be dependent upon the issuer committing some of its own monies to the program to make it work. Although single-family mortgage revenue bond programs are generally intended to be administered by the private parties involved (the bond trustee, the mortgage lenders, and the mortgage servicers) and are not supposed to be a burden upon the issuer or its general fund, such programs do generally require some attention from the issuer. Issuer involvement can include efforts such as helping to conduct an initial training and

information session for lenders and developers, fielding questions to be answered by bond counsel or the investment banker, and troubleshooting when a problem arises (e.g. when one of the private parties makes a mistake).

SECURITY AND SOURCES OF PAYMENT

California law requires local agency single-family mortgage revenue bonds to be limited obligations of the issuer, payable solely from program revenues and various reserves held as security for the bonds. Bonds are paid primarily from mortgage loan payments and prepayments, mortgage insurance proceeds, and investment earnings on funds held under the indenture.

The mortgage loans (or mortgage-backed securities backed by mortgage loans) are owned by the bond trustee (on behalf of the issuer) to secure payment of the bonds. Mortgage lenders generally service the mortgage loans they originate, although the issuer may engage a master servicer. Mortgage lenders are permitted to collect from mortgagors a loan origination fee and a loan-servicing fee. Mortgage lenders may be required to pay a fee to participate in the program and each developer is usually required to pay a commitment fee for the bond proceeds reserved for the purchase of mortgage loans on homes built by the developer. Developer fees (and in some instances lender fees) are essential to the economics of a bond program and are sometimes supplemented by an equity contribution from the issuer’s own funds.

Mortgagors are generally required to maintain mortgage insurance and standard hazard insurance. Mortgage insurance protects the bondholders and the issuer against losses resulting from payment defaults on a mortgage loan and may be in the form of Federal Housing Authority (FHA) insurance, Veterans Administration (VA) guarantee or insurance provided by a private insurance company (private mortgage insurance or PMI). Mortgage-backed securities are commonly guaranteed by the Federal National Mortgage Association, the Government National Mortgage Association, or the Federal Home Loan Mortgage Corporation.

PROCESS FOR APPROVAL

General

Local agency issuers must establish a home mortgage financing program by ordinance prior to issuing single-family mortgage revenue bonds and also must enact rules and regulations governing lender participation in their programs and the qualifications of mortgagors, mortgage loans, and homes.

Unless otherwise required by the charter of a charter city, bonds may be authorized to be issued and the various other agreements to be entered into may be authorized, by resolution of the governing body of the issuer.

Volume Cap

As described in **Chapter 3, General Federal Tax Requirements**, single-family mortgage revenue bonds are required to obtain an allocation of volume cap from the California Debt Limit Allocation Committee (CDLAC). When evaluating applications from local issuers for allocations for single-family housing assistance, CDLAC's current procedures consider the following matters:

- The potential for special program implementation by local issuers
- The need for competition between the California Housing Finance Agency (CalHFA) and local issuers
- The relative past performance of CalHFA and local issuers
- The proportionate amount of single-family allocation remaining for a county (based on the county's population in relation to the total state population) after subtracting the CalHFA reservation allocable to that county
- When there is more than one local single-family issuer in a county, each local issuer's share of the allocation shall be based upon the population served by each issuer at the time of application, or as agreed upon by the local issuers in that county
- With respect to any remaining single-family allocation, the extent to which lower income households will be served and the extent to which new construction or substantial rehabilitation will be financed
- With respect to programs using "forward commitments" to developers, the draw-down schedules and the programs' ability to fully use allocations

In a competitive environment, other public purpose factors specified by the CDLAC procedures may also be considered. The CDLAC procedures are normally updated each year. See **Appendix A – Working with State Agencies** for more information.

PROCESS FOR SALE

Single-family mortgage revenue bonds may be sold at competitive or negotiated sale and the resolution authorizing the issuance of the bonds may delegate to officials of the issuer the power to approve the final principal amount, maturity schedule, interest rates, and other terms, all within specified limits.

OTHER LIMITATIONS ON TERMS OF BONDS

For cities, counties, and joint powers authorities, there is no maximum bond issuance amount specified by state law, and no maximum interest rate. Variable interest rates are permitted. The maximum maturity for bonds issued is 45 years.

For redevelopment agencies, there is no maximum bond issuance amount specified by state law and no maximum interest rate. Variable interest rates are permitted and the maximum maturity for bonds issued is 50 years.

For housing authorities, there is no maximum bond issuance amount specified by state law. The maximum interest rate is 12 percent per year and the maximum maturity is 45 years.

LEGAL AUTHORITY

See **Appendix D – Legal References – Table D-7-1** for a list of statutes applicable to local agencies authorized to conduct home mortgage financing programs through the issuance of bonds.

SPECIAL FEDERAL TAX ISSUES

Federal tax law contains a number of requirements applicable to single-family mortgage revenue bond programs for the bonds to be tax-exempt. Restrictions on mortgage loans and mortgagors include the following:

- A principal residence requirement
- A first-time home-buyer requirement
- A residence acquisition cost limitation
- A mortgagor income limitation, and
- A new mortgage requirement

These requirements must be satisfied with respect to each mortgage loan purchased with bond proceeds and must be satisfied by any purchaser of a home who desires to assume an existing bond-financed mortgage loan. Program-wide limitations include a targeted area set-aside requirement, arbitrage restrictions, and volume cap allocation requirements.

To satisfy the residence requirement, a home financed must be a single-family residence that is, or will within a reasonable time become, the principal residence of the mortgagor. No more than 15 percent of the total area of the residence may be used in a trade or business.

The first-time home-buyer requirement is satisfied if:

- The mortgagor did not own his or her principal residence within the preceding three years, or
- The home is in a "targeted area"

Targeted areas are census tracts in which 70 percent of the families have incomes that are not more than 80 percent of statewide median family income and certain census tracts designated as areas of chronic economic distress.

The acquisition cost requirement is satisfied if the acquisition cost of a home does not exceed 90 percent (110 percent if the home is in a targeted area) of the average purchase price in the metropolitan statistical area.

The income requirement is satisfied with respect to a home that is not in a targeted area if the mortgagor's family income does not exceed 115 percent (100 percent in the case of one- or two-person families) of the greater of the median gross income in the metropolitan statistical area or the statewide median gross income. For two-thirds of the financing for homes in targeted areas, the mortgagor's family income may not exceed 140 percent (120 percent in the case of one- or two-person families) of the applicable median family income. There is no federal law income limitation with respect to the balance of homes in targeted areas.

The new mortgage requirement is satisfied if the mortgage loan is not for refinancing (other than refinancing of temporary initial financing or refinancing in the case of certain rehabilitation loans).

Additional special rules apply with respect to the financing of qualified home improvement loans, qualified rehabilitation loans, and loans for certain homes in federally designated disaster areas. These provide relief from one or more of the first-time home-buyer requirements, the acquisition cost limits, and the income limits but contain certain additional requirements.

To satisfy the targeted area set-aside requirement, the issuer must reserve for a one-year period, for the purchase of mortgage loans with respect to homes in targeted areas, an amount equal to 20 percent of the lendable proceeds of the bond issue (or, if less, an amount equal to 40 percent of the average annual aggregate principal amount of mortgages made in targeted areas during the three preceding calendar years).

For the arbitrage requirement to be satisfied, the effective rate of interest on the mortgage loans may not exceed the yield on the bond issue by more than 1.125 percentage points. In determining the effective rate of interest on the mortgage loans, commitment and origination fees paid by the mortgagor or the seller of the home are taken into account. No adjustment to bond yield is permitted for underwriters' discount, costs of issuance, or administrative costs. Unless the issuer contributes money of its own, these costs and mortgage pool insurance and special hazard insurance premiums (if any) must be recovered within the permitted 1.125 percent spread. Arbitrage earnings on nonmortgage investments must be rebated to mortgagors or to the federal government. Costs of issuance (including underwriter’s discount) funded with bond proceeds may not exceed 2 percent of the proceeds of the bond issue (3.5 percent if the amount of the bond issue is less than $20 million).

Single-family mortgage revenue bonds are private activity bonds and, therefore, as described in the discussion regarding qualified private activity bonds in **Chapter 3, General Federal Tax Requirements**:

- Issuers must obtain a volume cap allocation from CDLAC
- The requirement for public approval following notice and public hearing (the Tax and Equity Fiscal Responsibility Act of 1982, the "TEFRA" requirement) must be satisfied, and
- Certain information must be reported after bond issuance

In addition, issuers must submit to annual reports to the IRS that contain data with respect to the beneficiaries of bond programs (i.e. the mortgagors).

Finally, if a mortgagor sells the home within 10 years, a portion of the subsidy provided by tax-exempt financing may be subject to recapture by the federal government.

TAX ALLOCATION AND OTHER REDEVELOPMENT BONDS

DEFINITION AND PURPOSE

In general, a redevelopment agency created by a city or a county may issue bonds for any of the corporate purposes of a redevelopment agency. These purposes include the acquisition of real property, the development of any real property whether owned or acquired as a building site, the construction or reconstruction of streets, highways, and sidewalks, and the installation of public utilities, all for the purpose of redevelopment of blighted areas within the jurisdiction of the agency.

As a general rule, an agency cannot itself construct or finance the construction of buildings but must instead sell or lease property for private development. Under some circumstances (see Health and Safety Code Section 33445) an agency may construct buildings that are to be publicly owned. Agency bonds may be made payable from any revenue source available to the agency, including the portion of ad valorem taxes on property in the redevelopment project area in excess of the taxes relating to the value of such property at the time of approval of the redevelopment plan. This excess portion is sometimes called the tax increment or tax allocation.

The Community Redevelopment Law Reform Act of 1993 ("AB 1290") comprehensively examined and substantially changed the manner in which redevelopment agencies operate in California. The most significant problem areas addressed by AB 1290 were:

- The unlimited duration of most redevelopment plans
- The use of redevelopment authority and financing capabilities for general economic development purposes rather than the elimination of blight
- The use of redevelopment resources to compete for sales tax generating businesses, and
- The inability of redevelopment agencies to properly and expeditiously spend redevelopment funds to generate or rehabilitate low and moderate income housing in the community

The changes made by AB 1290 apply to all redevelopment plans adopted (or amended to add new territory) on or after January 1, 1994. Some provisions apply to redevelopment plans adopted prior to that date. Determining which rules apply is sometimes complicated but it is important to review them prior to issuing bonds to ensure that the term of the debt to be issued does not exceed the limits prescribed by AB 1290. The following section will attempt to differentiate the pre- and post-AB 1290 law, however, the reader is cautioned to carefully review any redevelopment plan adopted prior to January 1, 1994 to see how its specific provisions are affected by AB 1290.

LEGAL AUTHORITY; ISSUERS

California Constitution Article 16, Section 16 and California Health and Safety Code Sections 33670 et seq. provide for the division of certain portions of property tax revenues between redevelopment projects and other taxing agencies. Health and Safety Code Sections 33640 et seq. authorize tax allocation bonds and a variety of other types of bonds secured by virtually any combination of revenues of a redevelopment agency.

A redevelopment agency also has authority to issue certain other types of debt obligations, (discussed in this chapter in the sections on **Single-Family Mortgage Revenue Bonds** and **Conduit Revenue Bonds: General**, respectively (see Health and Safety Code Sections 33750 et seq.)) and certificates of participation in leases or installment sales contracts, pursuant to its powers to acquire and dispose of real or personal property (discussed in the section on Financing **Leases and Certificates of Participation**). AB 1290 eliminates the authority for a redevelopment agency to issue sales tax bonds.

A chartered city may enact its own procedural ordinance and exercise the powers granted by statute to redevelopment agencies, including the issuance of tax allocation bonds (See Health and Safety Code Section 33204).

PROJECTS THAT MAY BE FINANCED

Health and Safety Code Section 33640 authorizes a redevelopment agency to issue bonds for any of its corporate purposes in furtherance of the exercise of any of its powers, including refunding bonds.

Some powers of a redevelopment agency may be exercised in its territorial jurisdiction, and some only in a survey area or a project area. The territorial jurisdiction of a county redevelopment agency is the unincorporated area of the county, and that of a city redevelopment agency is the territory within the city limits. A survey area is designated by a resolution making a finding that the area requires study to determine if a redevelopment project within the area is feasible. A project area is included within a survey area and is a “predominantly urbanized area” (unless the project area is included in a redevelopment plan adopted prior to 1984 and not amended after 1983) of a community that is a blighted area needing redevelopment.

Blight Determination. A blighted area is an area that is predominately urbanized. The area has a combination of statutorily described physical and economic conditions that are so prevalent and so substantial that there is a reduction in, or lack of, proper use of the area to such an extent that it constitutes a burden on the community, which cannot reasonably be expected to be reversed or alleviated by private enterprise or governmental action without redevelopment. In order to form a redevelopment project area, the legislative body of the community must hold a public hearing at which they can make a finding that blight exists in the project area. The blight determination is a critical point in the adoption of a redevelopment plan and has frequently been the subject of litigation and controversy. AB 1290 significantly tightened the blight finding

requirements in an attempt to ensure that only qualified projects were adopted through the redevelopment process.

Tax allocation revenues may only be used to finance redevelopment projects located in a project area, or projects that, though located outside of a project area, produce a special benefit to the project area and are essential to the implementation of a redevelopment plan. Examples of projects outside of a project area that may qualify for financing would include replacement housing (as a result of dislocation of project area residents), a freeway interchange (that directly feeds into a project area), and a sewer system expansion (the increased capacity of which is required for project area redevelopment).

Within a survey area, for purposes of redevelopment, an agency may acquire or lease real or personal property, including acquiring real property by eminent domain, and may sell or lease any real or personal property.

Other agency activities frequently financed by the issuance of bonds include clearing or moving buildings, developing as a building site any real property owned by the agency, and installing or constructing streets, utilities, parks, playgrounds, and other public improvements.

An agency is not generally authorized to construct buildings for residential, commercial, industrial, or other use contemplated by the redevelopment plan. However, agencies may:

- Construct buildings in connection with the relocation of displaced persons
- Construct publicly owned buildings of benefit to the project area, and if no other reasonable means of financing such building is available to the community
- Construct foundations, platforms, and other structural forms necessary for the utilization of air rights for buildings contemplated by the redevelopment plan

AB 1290 limited the financing activities of redevelopment agencies in several significant ways. To address the problems of communities competing to attract sales tax-generating businesses, AB 1290 prohibited any form of direct assistance to an automobile dealership that is or will be on a parcel of land, which has not previously been developed for urban use, and to any development that will be or is located on a parcel of land of five acres or more, which has not previously been developed for urban use and that will consist principally of a retail use that generates sales tax. In addition, AB 1290 specifically prohibits the use of tax increment to construct or rehabilitate a city hall or a county administration building. AB 1290 specifically authorized redevelopment agencies to provide assistance in connection with certain commercial building rehabilitation and the acquisition of certain industrial or manufacturing facilities or equipment. In 1996 the California Legislature further prohibited redevelopment assistance to any development or business involved in gambling or gaming.

PROCESS FOR APPROVAL

The redevelopment law provides that a redevelopment agency that was not authorized to transact business by a resolution adopted prior to September 15, 1961 must be activated by an ordinance, subject to referendum, of the legislative body of the city or county declaring a need for the redevelopment agency to function in the community. The members of the agency may be appointed or the legislative body of the community may declare itself to be the redevelopment agency.

Upon designation of a survey area and identification of one or more proposed project areas within the survey area, the planning commission of the city or county, with the cooperation of the redevelopment agency, prepares a preliminary redevelopment plan for each project area. This plan need not be detailed and will be sufficient if it contains

- A description of the project area boundaries
- A general statement of land uses
- The layout of principal streets
- Information on population densities
- A statement of proposed building standards and intensities
- A description of how the purposes of the project will be attained by conformance with the preliminary plan
- A description of how the proposed redevelopment is consistent with the community's general plan
- A description of the impact of the redevelopment upon the area's residents and the surrounding neighborhood

During the period following receipt of the preliminary plan through adoption of the final redevelopment plan by ordinance of the legislative body, the redevelopment agency and the legislative body are each required to follow a number of procedural steps, too numerous and detailed to describe here, but essentially designed to ensure that relevant information is collected and reviewed and that persons and entities with potentially adverse interest are informed and given the opportunity to present their views on the proposed redevelopment plan. In particular, local taxing agencies may be substantially affected by the proposed redevelopment plan because of lost tax revenues, and as a consequence, the redevelopment law requires that redevelopment agencies consult with affected taxing agencies regarding the allocation of taxes.

Ultimately, a redevelopment plan considerably more detailed than the preliminary plan must be prepared. The following provisions are required to be included in plans adopted prior to January 1, 1994:

- A limitation on tax dollars to be allocated to the redevelopment agency
- A time limit on financing the redevelopment project
- A time limit, not to exceed 12 years, for commencement of eminent domain proceedings to acquire property within the project area
- A limit on the amount of bonded indebtedness which can be outstanding without amendment of the plan

The legislative body must adopt the redevelopment plan by ordinance, subject to referendum.

AB 1290 imposes certain additional limitations on pre-1994 plans, as follows:

- The outside limit for incurring debt with respect to the project area cannot be greater than 20 years after adoption of the plan or January 1, 2004, whichever is later
- Redevelopment activities must terminate no later than 40 years from adoption or January 1, 2009, whichever is later
- The receipt of tax increment must terminate no later than 10 years after the date redevelopment activities terminate, except with respect to certain pre- January 1, 1994 debt and certain housing activities

AB 1290 also significantly modified the required plan provisions for plans adopted, or in connection with plan amendments adding new territory to existing project areas, on or after January 1, 1994:

- The time limit for incurring debt with respect to a project area cannot exceed 20 years from adoption of the plan
- Redevelopment activities must cease no later than 30 years after adoption of the plan
- Tax increment cannot be received later than 45 years after adoption of the plan
- The time limit for exercising eminent domain powers remains 12 years from adoption of the plan

There are no limits on the amount of debt that can be outstanding or the amount of tax increment that can be received with respect to a project area formed on or after January 1, 1994. The reason for this is that AB 1290 drastically altered the way tax increment is allocated between a redevelopment agency and other affected taxing agencies. This is discussed later in this section under **Method of Repayment and Security Features**.

AB 1290 requires that each redevelopment plan submitted by a redevelopment agency to its legislative body contains an implementation plan that describes, among other things, the specific goals and objectives of the agency, specific projects then proposed by the agency, a program of actions and expenditures proposed for the first five years of the redevelopment plan, and a description of how these projects will improve or alleviate the conditions of blight. This implementation plan must then be updated every five years, in this way linking redevelopment activities with the elimination of blight. Redevelopment plans adopted prior to January 1, 1994 also are required to adopt a series of five-year implementation plans, and the first such plan must have been adopted by December 31, 1994.

A redevelopment agency may authorize the issuance of bonds by resolution adopted by a majority of the members of the agency, subject to the approval of the legislative body of the community by resolution (city council or board of supervisors depending upon whether it is a city or county redevelopment agency).

PROCESS FOR SALE

Competitive sale is required for redevelopment agency bonds (other than refunding bonds, bonds sold to the federal government, and housing bonds).[6] The notice of sale must be published once at least five days prior to the sale in a newspaper of general circulation published in the community, or, if there is none, in a newspaper of general circulation published in the county. In addition, at least 15 days prior to the sale of an issue in excess of $1 million, the agency must publish notice of its intention to sell in a financial publication generally circulated throughout the state.

Maximum Amount; Limitations on Terms of Bonds

Redevelopment agency bonds (other than housing bonds) are subject to the following limitations:

- The maximum amount of bonds may not exceed the limit specified in the redevelopment plan, if the plan was adopted on or after October 1, 1976
- The maximum stated interest rate is 12 percent per year
- Interest may be fixed or variable, simple or compound, and may be made payable at the times specified by the agency
- Interest payable to the federal government, or on bonds guaranteed by the federal government, may be at such higher rate as is established by the federal government
- Bonds may be sold at a discount not to exceed 5 percent

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[6] The Marks-Roos Local Bond Pooling Act of 1985 (Government Code Sections 6584 et seq.) permits, under certain circumstances, the negotiated sale of redevelopment agency bonds to a joint powers authority which may in turn sell such bonds (or its own bonds secured by such bonds) to an underwriter on a negotiated basis.

- Redevelopment agencies may issue variable rate obligations, including so-called put or tender option bonds, however, the requirements that bonds be sold at competitive sale makes it difficult to use these financing methods

METHOD OF REPAYMENT AND SECURITY FEATURES

A redevelopment agency may issue bonds, payable from a variety of sources described below (however most revenue available to redevelopment agencies is traceable to tax increment revenue):

- Exclusively from the income and revenues of the redevelopment projects financed with the proceeds of the bonds, or with such proceeds together with financial assistance from the state or federal government in aid of the projects
- Exclusively from the income and revenues of certain designated redevelopment projects whether or not they were financed in whole or in part with the proceeds of the bonds
- In whole or in part from tax allocations
- In whole or in part from certain transient occupancy taxes
- From its revenues generally
- From any contributions or other financial assistance from the state or federal government
- From any combination of these sources

Tax allocations are derived as follows. First, the assessed value of the taxable property in the project area prior to adoption of the redevelopment plan is determined and becomes the "base roll." Thereafter, except for any period during which the assessed valuation drops below the base level, the taxing agencies, on behalf of which taxes are levied on property within the project area, will receive the taxes produced by the then current tax rate applied to the base roll and, after January 1, 1989, taxes produced by any increase in the tax rate to pay certain voter-approved debt applied to the entire roll. Taxes collected upon any increase in the assessed value of the taxable property over the base roll (except taxes attributable to an increase in the tax rate to pay certain voter-approved debt) are allocated to the redevelopment agency to pay indebtedness incurred to finance the redevelopment project. An agency is only entitled to these allocated tax revenues to the extent it has incurred indebtedness.

Prior to the adoption of AB 1290, the availability of tax increment to a redevelopment agency would depend in large part upon the terms of "pass-through agreements" negotiated between a redevelopment agency and the affected taxing entities for the sharing of tax increment revenue. Absent such a negotiated pass-through agreement, prior to adoption (after 1976) of a redevelopment plan providing for tax-increment financing, an affected taxing agency may

elect— and every school and community college district is required to elect—to be allocated, in addition to applicable taxes on the base roll, all or any portion of the taxes allocated to a redevelopment agency which are attributable either to any increase in the rate imposed for the benefit of the taxing agency or to any increase in the assessed value of taxable property on the base roll in the project area as a result of application of the inflation factor (not to exceed 2 percent under Article XIIIA of the State Constitution) pursuant to the California Revenue and Taxation Code. This is sometimes called the "2 percent election."

In addition, a redevelopment agency will be required, unless certain findings are made annually, to set aside 20 percent of all tax allocation annually in a low and moderate income housing fund to be used within the jurisdiction of the agency to increase, improve, and preserve the supply of low and moderate income housing. Under certain circumstances, housing set-aside revenues may be pledged as security for tax allocation bonds if proceeds of such bonds are used for housing purposes.

One of the most fundamental changes made by AB 1290 was the elimination of the fiscal review committee process and the negotiation of pass-through agreements with affected taxing agencies. While AB 1290 does not affect pass-through agreements entered into prior to January 1, 1994, it replaces the ad hoc negotiation of such agreements with a statutory formula for sharing tax increment for all project areas established on or after January 1, 1994. AB 1290 eliminates the 2 percent election and creates three overlapping tiers of payments to all affected tax on entities. These payments are expressed as a percentage of the net tax increment after making the required housing set-aside deposit (the "net tax increment"). During each year an agency receives tax increment, the agency is required to pay affected taxing entities 25 percent of the net tax increment. Beginning in the eleventh fiscal year that the agency receives tax increment, and continuing so long as the agency receives tax increment, the agency is required to pay affected taxing entities an additional 21 percent of the net tax increment generated by increases in the project area assessed value occurring after the tenth fiscal year in which the agency receives tax increment. Commencing with the 31st fiscal year and continuing through the last fiscal year that the agency receives tax increment, the agency is required to pay affected taxing agencies an additional 14 percent of the net tax increment generated by increases in the project area assessed value occurring after the 30th fiscal year in which the agency receives tax increment. Payments made to affected taxing entities are divided on the same basis as property taxes generated by the base year value are divided.

AB 1290 also provides for certain additional payments to certain basic aid school or community college districts. Basic aid districts are those that receive property tax revenues in an amount that results in their receiving only a de minimis amount of state subvention. These additional payments are calculated so that basic aid districts receive approximately 100 percent of their share of the tax increment.

The payments described above are the exclusive payments that are required to be made by a redevelopment agency to affected taxing entities during the term of a redevelopment plan.

AB 1290 provides a statutory procedure for subordination of the automatic pass-through payments to debt service on bonds issued by a redevelopment agency. In general, such a subordination can be obtained unless the affected taxing entity can show, based upon substantial evidence, that the agency will not be able to pay the debt payments and the amount required to be paid to the affected taxing entity.

In recent years redevelopment agencies have issued tax allocation bonds secured in part by a portion of the bond proceeds deposited into an escrow fund. A particular maturity of bonds (commonly called the "escrow bonds") will be associated with the deposit of monies in the escrow fund. The amounts deposited in the escrow fund are then periodically released to the redevelopment agency as tax allocations increase, in an amount sufficient to adequately secure an amount of escrow bonds equal to the amount released from such fund to the agency. Rating agencies and/or bond insurers will typically specify the terms for release of monies from the escrow fund and require that amounts on deposit in the fund be invested in a high quality investment agreement that provides a rate of return sufficient to pay interest on the escrow bonds. Any redemption of escrow bonds with funds on deposit in the escrow fund will result in the remaining bonds outstanding being adequately secured by tax allocations.

The use of escrow bonds permits an agency to issue tax allocation bonds in anticipation of future growth in tax allocations within a project area. If growth does not occur as anticipated, bondholders are nevertheless protected by the deposit and investment of amounts in the escrow fund. Escrow bond structures raise significant federal tax issues, which should be thoroughly discussed with bond counsel early in the process.

POLICY CONSIDERATIONS

Redevelopment agencies and other taxing agencies whose property tax bases overlap are in competition for the same tax revenues. This gives rise to the policy question of whether a redevelopment agency should be permitted to use all of the tax revenues in an area to eliminate blight when one result of this is to take revenue away from other deserving agencies. Since the middle of the 1970s, this fiscal conflict has resulted in the introduction of state legislation, the intent of which is to stabilize and protect the tax revenues of local agencies. Much of this legislation has become part of redevelopment law and many of the particular provisions are discussed in the preceding pages because they resulted in significant limitations on the ability of redevelopment agencies to issue tax allocation and other redevelopment bonds.

AB 1290 was by far the most significant legislation affecting the redevelopment process. As discussed previously, AB 1290 addressed redevelopment on a comprehensive basis focusing specific attention on local agency competition for tax revenues. From the perspective of the redevelopment agencies, such legislation may be seen as reducing their principal source of revenues and restricting the types and extent of redevelopment activity that may be undertaken. From the perspective of other taxing agencies, the legislation may be seen as providing a more equitable distribution of tax revenues, particularly to those taxing agencies whose public

functions may be increased considerably through the redevelopment process itself but whose principal source of revenues is still tied to a tax rate applied against an historic base year of assessed valuation. From the perspective of bondholders, any legislation that affects property tax rates (e.g. the addition of Article XIIIA to the California Constitution) or any other adjustment of tax rates by local taxing agencies affects the amount of tax allocations available to the redevelopment agency, but is not under the control of the redevelopment agency. As a result, a major factor affecting the security for tax allocation bonds is not under the control of the issuer of those bonds.

From a policy perspective, local agencies considering using tax allocation financing for a project should be aware that the money used to repay the bonds will come in part from the local agency's general fund (to the extent that a portion of the property tax increment would otherwise have been allocated to the local agency itself as a taxing agency) and from other local entities in the same geographic area.

SPECIAL FEDERAL TAX CONSIDERATIONS

Many tax allocation and other redevelopment bond financings do not present unique federal tax issues. The various limitations and requirements described in **Chapter 3, General Federal Tax Requirements**, such as limitations relating to private activity bonds, arbitrage bonds, and hedge bonds, continue to apply. In some circumstances, however, because redevelopment agency financings often relate to transactions with private business, the private activity bond limitations take a prominent role in structuring these financings.

As described in the discussion regarding private activity bonds in **Chapter 3**, **General Federal Tax Requirements**, general tax revenues (including tax allocations) are disregarded for purposes of the Private Payment or Security Test. However, property tax revenues are *not* general tax revenues, and therefore may be private payments, to the extent any special arrangement for the payment of the tax exists between the taxpayer and taxing jurisdiction. U.S. Treasury regulations provide examples of special arrangements that cause otherwise general tax revenues to become private payments. These examples include certain guarantees of payment, agreements as to minimum assessed value, and agreements not to challenge the amount of the tax. The amount of any tax revenues with respect to which such special arrangements are made are then aggregated with any other private payments—for example, payments from developers, commercial property owners, or other nonexempt persons for the purchase price of land or in the form of fees with respect to the facilities financed with the bond issue—to determine the total amount of private payments. If the present value of the private payments exceeds the present value of 10 percent of the principal of or interest on the bonds, the Private Payment or Security Test is satisfied even though such payments are not directly pledged to the payment of the bonds.

A second significant private activity bond issue is the possible characterization of tax allocation and other redevelopment bonds as satisfying the Private Loan Test. This test can be satisfied, for example, when bond proceeds are used to acquire land for redevelopment or to provide streets,

lighting, and other infrastructure land or improvements with the expectation that some or all of the land or improvements will be sold to developers pursuant to installment sales contracts.

Under the 1986 Internal Revenue Code, certain redevelopment bonds which otherwise would be private activity bonds can nevertheless be tax-exempt as "qualified redevelopment bonds." These bonds are very rarely issued, however, because of the difficulty in complying with the tax requirements. See the following text box titled **Qualified Redevelopment Bond Requirements.**

Qualified Redevelopment Bond Requirements

- ✓ At least 95 percent of the bond proceeds must be used to acquire real property located in a designated blighted area by a governmental unit with the power of eminent domain, to clear and prepare such land for development once acquired, to rehabilitate real property so acquired, and to relocate the former occupants of such property.
- ✓ No new construction may be financed.
- ✓ The bonds must be issued pursuant to a redevelopment plan adopted with respect to the blighted area.
- ✓ The blighted area may not exceed 20 percent of the value of all assessed property in the jurisdiction of the issuer.
- ✓ The blighted area must have a minimum area of 100 acres (if no more than 25 percent of the financed area is to be provided to one person, the minimum size of the blighted area may be reduced to as little as 10 acres).
- ✓ Payment of the bonds must be secured primarily by taxes of general applicability, and any incremental tax revenues attributable to the redevelopment must be reserved exclusively for debt service on the bonds.
- ✓ Any property that is acquired by the governmental unit with the proceeds of the issue and is transferred to a private person must be transferred at its fair market value.
- ✓ No special charges or fees may be assessed on owners or users of property located in the financed area.
- ✓ No proceeds of a qualified redevelopment bond may be used to provide any golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any package liquor store.
- ✓ No more than 25 percent of the proceeds may be used to provide a facility with the primary purpose of retail food or beverage services, automobile sales or services, or the provision of recreation or entertainment or used to provide an airplane, a skybox or other private luxury box, or health club facility.

TAX AND REVENUE ANTICIPATION NOTES (TRANs)

DEFINITION AND PURPOSES

Market participants generally call municipal securities short-term if they have maturities of less than three years or if they have features that shorten their effective maturities to less than three years. The municipal market includes several short-term financing vehicles. Notes such as tax and revenue anticipation notes (TRANs), bond anticipation notes (BANs), tax anticipation notes (TANs), and grant anticipation notes (GANs) provide funds for short periods. Short-term notes are repaid from the proceeds of bond issues, taxes, or revenue-producing projects.

Characteristics

Municipalities usually issue short-term notes in anticipation of collecting some form of revenue, tax, or bond proceeds. A TRAN is a combination of tax and revenue anticipation. A GAN is a popular type of municipal discount note. It is issued in conjunction with an expectation of revenue, usually from the state or federal government, and it is paid off from the receipt of the revenue. GANs would be issued prior to construction of the project, expended on the construction, and retired from the grant proceeds received as reimbursement for such project expenditures. TANs are issued in anticipation of receiving taxes payable, and are paid off from the tax receipts. BANs are issued prior to a bond issuance by a municipality. They are considered to be the riskiest short-term municipal note because they are contingent on the municipality's ability to issue bonds.

The most widely-issued note in California is the TRAN. TRANs are issued by public agencies to fund cash flow deficits in a fiscal year. Typically, they would be issued at the beginning of the fiscal year and mature at the end of such fiscal year.

Notes generally have minimum denominations of $5,000. Maturities are usually less than one year, though some have maturities of up to three years. Repayment comes from funds available on or before the maturity date. TRANs can mature in either the same fiscal year as issued or in the following fiscal year. They are reported as a fund liability in the fund receiving the proceeds.

QUALIFIED EXPENDITURES FOR TRANs

TRAN proceeds may be used and expended by the public agency for any purpose, including current expenses, capital expenditures, repayment of indebtedness, and investment and reinvestment. The proceeds of the TRANs are commonly deposited in the public agency's general fund.

POLICY CONSIDERATIONS

TRANs are primarily perceived as a cash management tool. They enable a public agency that receives revenues, such as property taxes, on an uneven basis throughout the year, to access

funds for needed expenditures in anticipation of such revenues. They "iron out" the wrinkles in the agency's cash flow revenues.

Generally, proceeds of working capital borrowings are only allowed to be spent at a time when the issuer has no money available to spend, other than a reasonable working capital reserve. Thus the process of sizing a working capital borrowing involves identifying all of the money of the issuer, both on hand and expected, that is generally available for working capital expenditures and developing a cash flow projection, typically based on prior years' actual cash flow results, that estimates the deficit and surplus periods. The size of the note borrowing is then limited to the largest actual cash flow deficit expected in the 13 months following the issuance of the notes, plus the amount of the reasonable working capital reserve. Depending on various factors, the allowable amount of the reasonable working capital reserve typically ranges between 11 percent of the largest projected deficit and 5 percent of the issuer's working capital expenditures during the fiscal year prior to the fiscal year of the borrowing. Transactions that qualify for the small issuer exception from the rebate requirement described in **Chapter 3, General Federal Tax Requirements** always qualify for the 5 percent amount.

SECURITY AND SOURCES OF PAYMENT

Short-term municipal securities can be either general obligation securities or revenue securities. General obligation securities are backed by the full faith and credit of the issuer, which uses taxes and other possible sources of income to meet debt payments. The ability to tax may be limited by law, in which case the general obligation security is called a limited tax security. Revenue securities are generally backed by revenues associated with the projects the securities finance and not by the full faith and credit of the issuers. The revenues are usually earnings generated by projects—for example, as tolls from roads or connection fees and charges paid by users of water systems. In some cases, however, the revenues are funds from specific taxes, receipts from bond sales, or transfers from the federal government.

Many districts and authorities cannot tax, so they do not have the ability to make general obligation pledges. Consequently, most of the securities issued by special districts and statutory authorities are backed by revenues from the projects the securities finance. At times, however, the securities of such districts and authorities are backed by general obligation pledges from the state or local governments that founded them.

PROCESS FOR APPROVAL

TRANs may be authorized by a simple resolution of the governing body of the local agency. If the local agency desires a trustee or fiscal agent to hold the repayment funds for the TRANs, a trust agreement or similar trust document may be used. The resolutions authorizing the TRANs may be adopted in the fiscal year prior to the fiscal year in which the TRAN is issued, however, the TRAN cannot be issued until after the commencement of the fiscal year. It is common for many TRAN borrowings to occur in July, at the beginning of the fiscal year. When a school district or community college district is issuing notes and those districts do not have fiscal

accountability status, the notes may be issued by the board of supervisors of the county containing such school or community college districts on their behalf. An exception for pooled note issues allows the school district or community college district to issue the TRAN directly, if the county prefers not to be the issuer.

PROCESS FOR SALE

Tax and revenue anticipation notes may be sold by competitive or negotiated sale subject to the limitations contained in the statutory authority pursuant to which the tax and revenue anticipation note is being issued.

OTHER LIMITATIONS ON TERMS OF BONDS

Consistent with their short-term nature, the term of the tax and revenue anticipation notes is limited to 15 months, and the amount that can be borrowed shall not exceed 85 percent of the estimated daily amount of the uncollected taxes and common revenue cash receipts and other monies of the local agency that will be available for payment of the notes and the interest thereon (Government Code Section 53858). Although the note is payable only from the revenues of a single fiscal year, the note may mature 15 months after the date of issue, and, therefore, in a subsequent fiscal year.

LEGAL AUTHORITY

Articles 7, 7.5, 7.6, and 7.7 of Chapter 4, Part 1, Division 2, Title 5 of the Government Code (Sections 53820 to 53859.08, inclusive) are the basic authorizations for the issuance of tax and revenue anticipation notes, tax anticipation notes, and grant anticipation notes by local agencies.

SPECIAL FEDERAL TAX CONSIDERATIONS

The interest income earned on most of the debt issued by states and municipalities is exempt from federal taxes. The tax exemption allows states and municipalities and whatever private entities they finance to obtain funding more cheaply than they otherwise could. It is, in effect, a subsidy from the federal government. The U.S. Congress has taken steps to limit access to the subsidy—and to prevent states and municipalities from taking advantage of it by investing the proceeds of tax-exempt securities in taxable securities that pay higher rates—by placing greater and greater restrictions on who can issue tax-exempt obligations and for what purposes. In the Tax Reform Act of 1986, Congress took steps to limit the ability of tax-exempt issuers to earn profits from investing the proceeds of tax-exempt issues in higher interest rate taxable securities. It required that such arbitrage profits be returned to the federal government.

Because working capital borrowings do not finance capital facilities, the main federal tax constraints on such borrowings are the arbitrage bond limitations. U.S. Treasury regulations generally limit the term of working capital financings to two years, although longer maturities are allowed with additional restrictions. In order to qualify for a "temporary period" (an exception to the arbitrage yield restriction limitation discussed in **Chapter 3, General Federal**

Tax Requirements) in which to invest proceeds of notes at rates in excess of the yield on the notes, all of the proceeds of the notes must be reasonably expected to be spent within 13 months of the date the notes are issued.

Typically, issuers of TRANs hope to achieve investment returns that exceed all of the costs of the borrowing. In order to retain these arbitrage profits, the issuer must satisfy an exception to the rebate requirement. The exceptions to rebate requirement are discussed in **Chapter 3**, **General Federal Tax Requirements**. Unless the transaction qualifies for the small issuer exception, the only exception from the rebate requirement available to working capital financings is the six-month expenditure exception. This exception requires all of the proceeds of the borrowing to be spent within six months of the issuance date and, for TRANs, establishes the minimum reasonable working capital reserve amount of 11 percent of the largest deficit projected in the six-month period.

U.S. Treasury regulations no longer provide specific guidance relating to GANs, but the general arbitrage bond limitations continue to apply. Therefore, it is impossible to generalize about the federal tax limitations and requirements for GANs.

TEETER PLAN PROPERTY TAX RECEIVABLES FINANCINGS

DEFINITION AND PURPOSE

In 1949, an alternative method for the distribution of secured property taxes, known as the "Teeter Plan", was enacted in California. Upon adoption and implementation of this method by a county board of supervisors, local agencies for which the county acts as "bank" (including the county) and certain other public agencies located in the county will receive annually the full amount of their share of property taxes on the secured rolls regardless of the amount of delinquencies experienced by the county in collecting such taxes. The electing county bears the risk of loss of collection and in return receives interest and the delinquent penalties. Thus the Teeter Plan provides to the participating local agencies stable property tax receipts, eliminates collection risk, and provides an electing county with potential increased revenues from the delinquent penalties and interest collection. The Teeter Plan provisions are set forth in Sections 4701-4717 of the California Revenue and Taxation Code.

POLICY CONSIDERATIONS

External or Internal Financings

Many counties have been financing the distributions of "Teetered" delinquencies through loans from their treasurers' investment pools (i.e. the investment pools maintained by county treasurers for counties and others who deposit funds with the county). This raises some issues for treasurers since these loans may have to run for as long as nine years and are likely to run, on average, three to three and one-half years. This type of maturity requires treasurers to consider whether the investment provides adequate liquidity for a treasurer's pool. Also, a treasurer must consider what interest rate or rates to charge the host county for that type of borrowing and be sure that the rate charged is a market rate for the duration and quality of the proposed loan. In other words, the treasurer should do a credit analysis for a loan to the host county just as for any other investment. Generally speaking, a treasurer should be seeking to obtain *taxable* rates of interest on loans which he or she makes since earnings on the treasurer's pool is normally not subject to income tax.

The policy consideration for the county, on the other hand, is whether it is cheaper to finance the property tax delinquencies through external or internal financing by the treasurer's pool. All other things being equal, these financings, which can be done at least in part on a tax-exempt basis, should be cheaper when done through external borrowings since a treasurer's pool should be charging a taxable market rate of interest for pool borrowings.

Duration of Financings

Another policy consideration for counties is the duration of financings if they do multi-year financings. Absent extraordinary circumstances, the financings should not extend longer than

the time necessary to collect the delinquent property tax receivables since issuers will then have lost their source of repayment. To extend the maturities out longer effectively converts the borrowings from those financing delinquent property tax receivables to those financing general working capital requirements of a county.

EXTERNAL FINANCING METHODS

TRANs

Some counties have been including the cost of financing delinquent property tax receivables in their annual TRANs financings. While this works mechanically, it is not the most efficient way to finance property tax receivables since it requires the issuer to come up with money each year for the pledge fund beyond its expected current year revenues, as property tax delinquencies can extend up to nine years. For example, if a Teeter county has $25 million in property taxes delinquent, which it must fund, and issues TRANs in an amount reflecting this, at the end of the TRANs year, it will not have received enough payment on the delinquent property taxes to fully repay the $25 million. Therefore, counties would have to find some other internal source of funds to repay the balance and refinance that with the next year's TRANs issue. Thus if a TRANs financing method is used, it will be necessary to "roll" uncollected delinquencies into future years' TRANs. For more information on TRAN financings, see the section on **Tax and Revenue Anticipation Notes (TRANs)** in this chapter. See also the section on **Federal Tax Implications** below for limits on doing tax-exempt financings to finance the carrying of delinquent property tax receivables.

Teeter Plan Bond Law of 1994

The Teeter Plan Bond Law of 1994 (Sections 54773 to 54783 of the Government Code, the "Bond Law") provides a comprehensive procedure for financings backed by "Teetered" property taxes:

- A current year's delinquencies may be financed by the issuance of bonds
- The bonds can be sold at public or private sale and repaid from the delinquent property taxes when received and "other legally available funds of the county"
- The bonds can have maturities of not exceeding seven years and, since "bonds" are defined to include commercial paper, maturities as short as one day are permissible
- While bonds may be initially issued only for the current fiscal year's delinquencies, bonds may be refunded by the issuance of refunding bonds and the provisions limiting the aggregate principal amount of bonds that may be issued in any fiscal year, to the delinquencies of that year, do not apply to refunding bonds

See the following section, **Legality of Multi-Year Teeter Borrowings Under the California Constitution** for a discussion of California constitutional issues applicable to the bonds issue under the Bond Law and other multi-year securities.

Transfer of Accounts Receivable Pursuant to Section 26220(c) of the Government Code

Section 26220(c) of the Government Code permits the assignment by a county of delinquent property taxes to secure financing of delinquent receivables whether or not a Teeter Plan is in effect in that county. The statutory authorization appears to permit multi-year commitments to repay. However, the obligation to repay under this section appears to be limited to only the property tax receivables themselves.

Judicially Validated Generic Financing

Judicial validation actions have been brought to validate the proposition that the authority to finance the transfers to local agencies of delinquent, uncollected property taxes is a necessarily implied power of a county that has elected to be governed by the Teeter Plan method of secured property tax distributions. Since this is not a well-developed theory, a county validating the constitutionality of multi-year obligations, as described below, also can validate the use of generic refunding bonds. Utilizing this theory, a county could then refund the primary obligation to transfer delinquent, uncollected property taxes to local agencies utilizing the general statutory refunding bond provisions.

LEGALITY OF MULTI-YEAR TEETER PLAN BORROWINGS UNDER THE CALIFORNIA CONSTITUTION

As indicated above, both the Bond Law and Section 26220(c) of the Government Code permit multi-year commitments backed by delinquent property taxes. Generally speaking, borrowings by a county which are repayable from the general fund, or a general fund source such as property taxes, and from more than the current year's general fund budget would require two-thirds voter approval in order to be constitutionally permissible. See **Chapter 4, State Constitutional Limitations – The 1879 Constitution – The Debt Limit** for more information on this legal limitation. Thus a multi-year borrowing payable from a county's general fund, or secured by delinquent property taxes that are not budgeted or collected in the year the debt is incurred, would ordinarily be an unconstitutional borrowing unless voter approval was obtained, absent an exception to the constitutional limitation.

One exception to the constitutional limitation on pledging future receipts of delinquent property taxes, as well as for multi-year general fund commitments, is for "obligations imposed by law." Certain counties have validated the proposition that upon the election to be governed by the Teeter Plan method of property tax distribution, there is imposed upon the electing county an obligation to make the transfer of uncollected delinquencies to local agencies (including itself) and this is an obligation imposed by law. An obligation imposed by law does not require voter approval. However, since this exception is not well-developed in the law, in particular with

respect to debt financing obligations, it may be necessary for each issuing county to conduct its own judicial validation action before undertaking any multi-year financing. If properly validated, a county could legally commit its general fund for future year payments as well as the delinquent property taxes to be collected in future years.

SALE OF TAX CERTIFICATES

Chapter 189, Statutes of 1995 (AB 946) (the "Law") established a new part (Part 7.5) of the Revenue and Taxation Code (commencing with Section 4501) that creates a power to sell tax certificates. The Law applies to Teeter and non-Teeter counties. A tax certificate is defined in the Law as being "the right to receive all amounts in respect of a delinquency in connection with secured roll property or property on supplemental roll." By following the procedures, a county may sell, at public or private sale, tax certificates for defaulted taxes no earlier than the date the property is declared in default. These sales are held by the tax collector and, except in certain limited circumstances, the price to be received for the tax certificate must not be less than the amount of taxes and assessments being assigned.

Certificates are sold for a current year's defaulted taxes together with defaulted taxes for prior years that have not been sold. Holders of tax certificates on a parcel have varying rights of first refusal to purchase a subsequent year's tax certificate on the same parcel and the holder can force the tax collector to sell the new tax certificate on the same terms and conditions as those of the outstanding certificate. Proceeds from the sale of tax certificates are deposited first into a Tax Certificate Redemption Fund in an amount equal to at least 3 percent of the proceeds from the sale, and the balance is distributed as amounts received from the collection of taxes, assessments, costs, fees, and penalties. If the amount in the Tax Certificate Redemption Fund is equal to or greater than 3 percent of the then current amount of taxes and assessments assigned under outstanding tax certificates, the excess amount shall be distributed as part of the other proceeds from the sale. The return to the investor is the difference between the amount paid for the certificate and the amount of taxes and assessments repaid, and is a taxable return. The tax collector of the county issuing and selling tax certificates is required to keep a tax certificate record very much like those of a transfer agent for registered bonds.

The Law establishes the procedures for payments to certificate holders when defaulted taxes are paid either completely or in installments. In addition, upon the occurrence of certain enumerated events, the tax collector must repay the purchase price for a tax certificate from amounts deposited in the Tax Certificate Redemption Fund. These events include such occurrences as the taxes and assessments having been paid prior to sale of the tax certificate, taxes and assessment being canceled after issuance of a tax certificate and the lien on the parcel having been removed, or upon the occurrence of waste on the property, even though without fault of the county. The county's only exposure is to make the payments out of the Tax Certificate Redemption Fund.

The Law appears more tailored to a private "factoring" type of financing with a single buyer or a limited group of buyers rather than for a conventional public offering. It is believed that the first

refusal rights might chill the bidding for subsequent delinquencies and the requirement that the tax collector receive the face amount of the defaulted taxes and assessments as the purchase price for a tax certificate, and set aside a portion of proceeds in a redemption fund, could adversely affect the overall pricing which a county could obtain as compared to other types of financings.

FEDERAL TAX IMPLICATIONS

A borrowing to finance the carrying of delinquent property tax receivables would be deemed a working capital financing and, in order to be done on a tax-exempt basis, would have to comply with the federal tax code provisions and U.S. Treasury regulations relating to working capital financings. In addition, the financing of delinquent tax receivables, which arose prior to opting in to the Teeter Plan, could probably only be financed on a taxable basis. A prospective issuer should review these matters very carefully with a bond counsel who is experienced in complex working capital financings.

CONDUIT REVENUE BONDS: GENERAL

INTRODUCTION

Certain types of nongovernmental borrowers are entitled to take advantage of tax-exempt financing through the use of conduit revenue bonds. This section of the *Primer* describes conduit revenue bonds in general and then outlines four specific types of conduit revenue bonds:

- Economic development (so-called small issue industrial development bonds)
- Educational facilities
- Health facilities
- Multifamily housing

Other, less frequently issued conduit revenue bonds not discussed in this book include, for example, bonds for solid waste projects, bonds for noneducational 501(c)(3) nonprofit corporation projects (such as museums and research facilities), and bonds for certain energy facilities (so-called two-county rule or local furnishing financings). The federal tax requirements relating to these other financings are described in the qualified private activity bond discussion in **Chapter 3, General Federal Tax Requirements**.

DEFINITION AND PURPOSES

Conduit revenue bonds are issued by a governmental agency and the proceeds are loaned to the nongovernmental borrower for purposes that are permitted for qualified private activity bonds. Borrowers can be natural persons, for-profit corporations, partnerships, and other legal entities (in the case of economic development bonds and multifamily housing bonds), or nonprofit 501(c)(3) corporations (in the case of educational or health facilities bonds and certain multifamily housing bonds).

A conduit revenue bond is an obligation issued by the governmental agency, but payable solely from the loan repayments (the "revenues") received by the governmental issuer under the loan agreement with the borrower. The governmental issuer normally has no liability for debt service on the bonds except to the extent it actually receives such revenues. In the typical structure, the loan repayments are assigned directly to the bond trustee, so that the governmental issuer never actually receives any money from the borrower but instead, the money goes directly to the trustee to be held in the trust estate for ultimate distribution to bondholders.

Many types of governmental agencies can issue conduit revenue bonds, including state financing authorities (see **Appendix A – Working with State Agencies**), chartered cities, counties, joint powers authorities, redevelopment agencies, and local housing and industrial development authorities, among others.

There are certain features that are applicable to all conduit revenue bonds, which are discussed in the following sections. Other features specific to the particular types of conduit revenue bonds covered in this *Primer* are discussed under the separate headings for each of those types of obligations.

POLICY CONSIDERATIONS

Because conduit revenue bonds do not involve the direct credit of the governmental issuer of the bonds and because they are for projects not owned or operated by the governmental issuer, the policy considerations in connection with their issuance are quite different than for governmental bonds. Most conduit issuers do have guidelines, however, concerning what types of conduit bonds they will issue and what criteria will be applied to each application for a conduit issue by a nongovernmental borrower. While these guidelines vary from issuer to issuer, most of them cover at least two basic areas—credit quality and the public purpose/benefits of the facility.

Regarding credit quality, many issuers require a minimum rating (typically at least "A") for any conduit issue, either on a stand-alone basis or as the result of obtaining credit enhancement. Exceptions are sometimes made for projects that have a particularly strong public purpose or benefit, or where additional collateral (such as a deed of trust or other security interest) is provided which strengthens the issue.

An alternative approach for otherwise worthy projects that cannot meet the minimum rating standards is to require a private placement of the bonds. This ensures that only a small number of sophisticated investors will own the bonds and helps insulate the issuer from liability for misleading disclosure and adverse publicity if the issue does run into problems. For further information regarding private placements, see **Chapter 10, Continuing Disclosure and Investor Relations Programs**.

The reason for a minimum rating requirement is that even though the governmental issuer has no legal liability to make debt service payments, the issuer believes that its good name will be tarnished if an issue it is involved with goes into default or has difficulties, even though the default is not the fault of the issuer. Moreover, a defaulted issue will inevitably drag the issuer into proceedings for a workout—or even litigation—concerning the bonds, which will cost the issuer time and effort, as well as out-of-pocket costs that may not be able to be recovered from the borrower. Setting minimum rating standards, while not a guarantee that nothing bad will happen, does insulate the issuer from the more risky transactions.

As to the facilities being financed, many issuers require that the project is not only eligible for tax-exempt financing, but that it also will meet other socially desirable goals of the issuer. For example, some issuers require a showing that the issue will create jobs, provide affordable housing (maybe even in excess of the required minimums), or assist the community in other tangible ways. The tax code and the process of allocating volume cap (discussed later in this section) implement these criteria to some extent, but many conduit issuers also impose their own requirements.

While many communities actively encourage private companies to use conduit financing, others—particularly small cities or counties—may not have the staff time or believe they have adequate expertise to supervise a conduit bond issue. Such concerns have been heightened by recent publicity about increasing federal government scrutiny of the tax law and securities law compliance by municipal bond issuers. Fortunately, in every case California law allows several types of issuers to handle conduit revenue bonds, so a project sponsor should always be able to find an appropriate conduit issuer.

PROCESS FOR APPROVAL (INCLUDING FEDERAL TAX PROCEDURAL REQUIREMENTS)

General

In general, conduit revenue bonds are approved by resolution or ordinance of the governmental issuer. They do not require voter approval in most cases. More detail about each specific type of conduit revenue bond is provided in the following sections of this chapter.

Reimbursement Resolution

In order for bond proceeds to be used to finance amounts expended on the project prior to the issuer's adoption of the resolution authorizing issuance of the bonds, the issuer would normally adopt a reimbursement resolution (or "inducement resolution") while the financing is still in the planning stages, which would allow for reimbursement of such expenditures from bond proceeds, if any, but would not obligate the issuer to issue bonds. The rules relating to reimbursement resolutions are described in the discussion titled **Use of Proceeds to Reimburse Prior Expenditures** in **Chapter 3, General Federal Tax Requirements**.

Public Hearing

Federal tax law also requires that such private activity bonds satisfy the Tax Equity and Fiscal Responsibility Act (TEFRA) requirement. The rules relating to this requirement are described in the qualified private activity bond discussion in **Chapter 3, General Federal Tax Requirements**.

Volume Cap

Under the tax code, all qualified private activity bonds, with certain exceptions, including 501(c)(3) corporations, airports, ports, and governmentally owned solid waste disposal facilities, require an allocation of volume cap. The rules relating to this requirement are described in the qualified private activity bond discussion in **Chapter 3, General Federal Tax Requirements**. Every issuer must apply to the California Debt Limit Allocation Committee (CDLAC) for a volume cap allocation. See **Appendix A – Working with State Agencies** for more information on CDLAC.

Process for Sale

Most conduit revenue bonds are sold at negotiated sale but also can be sold competitively. Generally, there are no price restrictions on the sale of conduit revenue bonds.

Other Federal Tax Considerations

For a discussion of the many requirements applicable to qualified private activity bonds generally, see **Chapter 3, General Federal Tax Requirements**.

CONDUIT REVENUE BONDS: ECONOMIC DEVELOPMENT BONDS

DEFINITION AND PURPOSE

Economic development conduit revenue bonds (EDCRBs) are a category of bonds created by special provisions of the Internal Revenue Code that allow private, for-profit companies to utilize the proceeds of tax-exempt bonds—but only if the bonds are used to finance very carefully delineated types of projects. The allowable purposes are generally for acquisition or construction of:

- Small manufacturing plants—these bonds generally are referred to interchangeably as industrial development bonds (IDBs), industrial revenue bonds, or industrial development revenue bonds
- Facilities for pollution control or abatement, particularly in connection with disposal of solid wastes—these are often referred to as pollution control revenue bonds (PCRBs)
- Certain other narrowly defined categories, such as airport or port facilities, water furnishing facilities, mass commuting facilities, and facilities for local furnishing of electricity or gas

As their common designations imply, EDCRBs are primarily used to provide below market interest rate financing for industrial development and related projects for private enterprise. EDCRBs are authorized to be issued by various state and local government entities and the benefits derived by such issuance (primarily, the federal income tax exemption for the interest), as well as the obligation to make payments sufficient to pay the bonds, are passed through to the nongovernmental borrower, with the issuer acting as a "conduit" for that purpose. EDCRBs are limited obligations of the issuer.

PROJECTS THAT MAY BE FINANCED

An overview of the different types of projects that may be financed with tax-exempt EDCRBs requires consideration of both federal tax regulations and the various provisions of state law, which have created a number of different agencies at both the state and local level, that can act as an issuer for different kinds of EDCRBs. For a list of legal authorities to issue EDCRBs, see **Appendix D – Legal References – Table D-8-1**.

With respect to each of the categories of projects described below, a "facility" can consist of land, buildings, equipment, and associated development costs.

Industrial Development Bonds (IDBs)

One active category of EDCRBs are IDBs, which are used to finance the acquisition, construction, and/or equipping of small manufacturing facilities to be owned and operated by private companies. Manufacturing facilities must be primarily involved in the assembling,

fabrication, renovation, or processing of goods or agricultural products (at least to the extent there is a change in the condition of such goods or property). A limited portion of the facility may be dedicated to ancillary uses, such as office or warehousing space. IDBs are most commonly issued by:

- Industrial development authorities (IDAs), which can be created by any city or county, and act as a subordinate entity of the city or the county
- Joint powers authorities (JPAs) made up of two or more cities or counties, which can exercise the powers of an IDA—the most active such JPA is the California Statewide Communities Development Authority, headquartered in Sacramento
- California Economic Development Financing Authority (CEDFA), a state agency with statewide jurisdiction, which operates under the auspices of the California Trade and Commerce Agency in Sacramento.

Pollution Control Revenue Bonds (PCRBs)

EDCRBs can be issued to finance projects that provide for reduction or abatement of pollution, and which are owned and/or operated by a private company. Because of federal tax law restrictions imposed after 1986, most PCRB financings now relate to facilities for the collection, treatment, processing, or final disposal of solid wastes. PCRBs also can be used to finance certain hazardous waste disposal facilities and privately owned or operated sewage facilities. In very limited situations, a small manufacturing company can use a PCRB for facilities that treat or reduce air or water pollution generated by the factory. PCRBs are most often issued by:

- California Pollution Control Financing Authority (CPCFA), a state agency with headquarters in Sacramento, which has over $4.5 billion in outstanding bonds (CPCFA has a knowledgeable staff, and has special programs to assist small businesses)
- California Alternative Energy and Advanced Transportation Financing Authority (CAEATFA), a state agency which shares staff with CPCFA—its jurisdiction is limited and it has fewer than $120 million in outstanding bonds
- JPAs

Other Types

Under federal tax laws, there are a number of other types of "exempt facility" bonds that can be issued for the benefit of private companies. The following list summarizes these other categories of EDCRBs and the most common issuers for those types of bonds:

- Facilities to furnish water to the general public
    - CPCFA

- JPAs
- Charter cities acting under their charter powers over municipal affairs

- Privately-used or leased facilities at airports and ports, provided they are owned by a governmental entity
  - Cities
  - JPAs
  - Port or airport districts or authorities
- Privately owned facilities which provide for the generation, production, or transmission/transportation of electricity or gas to a service area of a utility company, which is not greater than two counties (called "local furnishing" facilities)
  - Charter cities
  - JPAs

Policy Considerations

Since EDCRBs are conduit obligations, without any pledge of the credit or taxing power of the issuer entity, there are no questions about the proper use of public funds or resources. However, issuers do have to consider several policy questions before approving an EDCRB financing.

Statutory Purposes

Most EDCRB issuers operate under a specific grant of authority contained in state law, and so must determine that a proposed project is within the proper scope of the issuer's powers. For issuers with broadly defined authority, like a charter city, a determination must be made that some public policy benefits will accrue to the issuer or its citizens, so that it would be desirable to allow the nongovernmental borrower to reap the advantages of tax-exempt financing.

Public Benefits

In most cases, issuers look to see that some demonstrable benefits will accrue from the construction of the facilities to be funded with the EDCRB. In most cases, but most especially for IDBs, it is necessary to show that jobs will be created or retained (if the company is in danger of failing or moving out of state). Special care must be taken in demonstrating public benefits if the project involves the relocation of a manufacturing facility from one community to another within the state, unless the existing jobs can be transferred and/or there is other strong justification for the move. Most IDB issuers follow the guideline that there must be 20 jobs created or retained for each $1 million of bonds issued.

Other types of EDCRBs need to demonstrate public benefits appropriate to the nature of the financing. For PCRBs, there is normally a clear environmental benefit, plus assistance to local entities in meeting recycling goals mandated by state law (AB 939). The other facilities described above normally also can show benefits to the public deriving from the construction of needed new infrastructure.

Borrowers who are regulated public utilities (as in the case of PCRBs for utility companies or water furnishing facilities) or who serve a public function, such as solid waste disposal, also can demonstrate a benefit by assuring that the cost savings from using tax-exempt bonds are passed through to the public ratepayers who use or are served by the facilities.

Under federal tax laws, most tax-exempt EDCRBs must obtain an allocation of volume cap from the California Debt Limit Allocation Committee (CDLAC). (See **Special Federal Tax Requirements** later in this section.) In recent years, CDLAC has had much greater demand than the limited amount of cap provided each year under federal law. As a result, CDLAC has paid particular attention to demonstrations of public benefit in deciding which projects will receive allocations.

Credit Considerations

Although EDCRBs are not backed by any credit or public funds of the issuer, most such issuers believe their name on the face of the bonds exposes them to some residual risk of adverse publicity or involvement in litigation if the bond issue were to default. Therefore, most issuers insist that the bond issue must be financially sound on its own. This is most commonly accomplished by having credit enhancement from an investment-grade financial institution, or insisting that the nongovernmental borrower itself have an investment-grade credit rating from a national rating agency.

In those cases where an issuer may agree to issue nonrated, or low or below-investment-grade debt, special structures may be used (such as limiting sales of bonds to large institutional investors and requiring large minimum denominations) and special supervision carried out (by engaging legal counsel or feasibility consultants) to ensure the viability of the project and the completeness of disclosure to investors.

METHOD OF REPAYMENT AND SECURITY FEATURES

EDCRBs are limited obligations of the issuer payable solely from revenues derived from a loan agreement pursuant to which the issuer loans the proceeds to the nongovernmental borrower, subject to repayment terms which are identical to the terms of payment of the bonds. The nongovernmental borrower must agree to pay fees and costs of the issuer and the bond trustee as well. The same effect is sometimes achieved by casting the financing agreement in the form of an installment sale agreement or a lease providing for the sale or lease of the project (purchased with bond proceeds) by the issuer to the nongovernmental borrower, with the installment

purchase payments or rental payments equaling the amounts due as principal and interest on the bonds.

The financing documents will provide that the bonds are payable only from payments made by the nongovernmental borrower under the financing agreement. The EDCRB issuer will not be liable for making any payment due on the bonds from its own funds.

In addition to its general corporate pledge, the nongovernmental borrower often provides some form of additional collateral security to secure its payments under the financing agreement. The most common form of security provided by the nongovernmental borrower is a deed of trust on the project itself, and a security agreement covering equipment to be located at the project. Guaranties of the nongovernmental borrower's principals or its corporate parent or other entity related to the nongovernmental borrower also are common security devices.

Third-party credit enhancement devices also are common to secure EDCRB issues, particularly publicly marketed, as opposed to privately placed, issues with credit enhancement. Credit enhancement may take the form of a letter of credit from a highly rated bank, a bond insurance policy, or a surety bond.

EDCRBs are sometimes issued as composite issues. This means that an issuer will combine the bond offering for two or more separate private borrowers in a single Official Statement using a master letter of credit or other device to make the security for the bond uniform across all the issues. In this way, an issuer can prepare an offering large enough to make public marketing economically feasible and take advantage of economies of scale. This can be particularly beneficial to borrowers with small financing needs.

PROCESS FOR APPROVAL

Certain federal tax and state law procedural requirements apply to all EDCRBs, regardless of the issuer. Of course, if the financing is not intended to be tax-exempt, the federal tax law requirements are irrelevant. Additional procedural requirements are imposed on certain EDCRB issuers by their respective authorizing statutes.

Federal Tax Law Procedural Requirements

The tax code requires that procedural requirements relating the TEFRA requirement and volume cap allocations must be satisfied for EDCRBs to be qualified private activity bonds. Facilities for airports and ports that are required to be owned by public agencies and public agency-owned solid waste disposal facilities do not require volume cap allocations. The requirements are described in the qualified private activity bond discussion below entitled **Special Federal Tax Requirements**.

State Law Procedural Requirements

Each issuer of EDCRBs discussed elsewhere in this section has its own set of legal requirements under its governing laws, as well as its own regulations or procedures. The *Primer* will not attempt to review them all in detail. As a generalization, however, most EDCRB financings follow a similar course, which is outlined below:

- The nongovernmental borrower must file an application with the issuer that generally describes the proposed project and financing. The issuer may charge application or other fees.

- The issuer will either accept or reject the application

- Upon acceptance, the issuer adopts a resolution stating its intention to finance the project. This is the reimbursement resolution for federal tax purposes.

- In the case of IDBs issued by IDAs or JPAs, the state law has additional detailed procedural requirements, including publication of local notice, and review and approval of the issuer's inducement resolution by the IDA's "sponsor" governmental body, and approval by a state agency called the California Industrial Development Financing Advisory Commission

- Following the inducement resolution, the project sponsor must complete all the legal and economic steps needed to be able to start construction of the project, including environmental reviews, contracts for engineering, design, and construction of the project, obtaining any supply or output contracts, and obtaining credit enhancement in most cases. Once the legal and financial package is complete, which will allow a bond issue to be successfully marketed, the final steps in financing take place. This intermediate development period can range from a few months to several years, and many projects never get out of this phase even if they obtain an inducement resolution.

- A few months before planned bond issuance, the issuer applies to CDLAC for volume cap and arranges for a TEFRA hearing

- Once all the financial terms of the bonds are set, usually around the time of CDLAC action, the issuer adopts a resolution to authorize the issuance of the bonds. The final resolution authorizes the general terms of the financing and approves the forms of the documents to be used in the financing.

PROCEDURES FOR SALE

As authorized by all the laws governing issuance of EDCRBs, these bonds are virtually always sold at a private sale in which the interest rate and other terms of the bonds are negotiated between the issuer, nongovernmental borrower, and underwriter. In some cases, a financial institution will act as a placement agency rather than an underwriter, but the procedures and documentation are almost identical. As is customary for negotiated sales of bonds, there is no

requirement for giving or publishing any notice of the proposed sale (except for filing the Notice of Proposed Sale with CDIAC).

Since no public credit is involved, many issuers, at least at the local level, do not participate in any substantive fashion in the sale of EDCRBs, limiting their role to, at most, review of the bond purchase contract to ensure that they are adequately indemnified against liabilities. However, in the case of state agency issuers, such as CPCFA, the State Treasurer is by law designated as the "agent for sale" of all state bonds, thus the Treasurer's office will be actively involved in the final pricing of the bonds as well as approval of the bond purchase contract.

OTHER LIMITATIONS ON TERMS OF BONDS

For IDAs and JPAs issuing IDBs, the maximum stated interest rate is 12 percent per year (except in the case of federally taxable bonds, for which the maximum is 16 percent). Most state agency issuers, like CPCFA, do not have statutory interest rate limits but set a limit in the indenture. Variable interest rate qualified and put bonds are permitted by all the issuers. The maximum amount of any IDB issue through an IDA is $10 million (except in the case of federally taxable bonds, which are subject to a per issue maximum of $50 million). Most other issuers have no specific dollar limits, however, ability to obtain volume cap is a real constraint in most instances. The maximum maturity is 40 years for IDAs and most other issuers have no limits.

For charter cities, the only limitations on the terms of bonds are those that may be imposed by the charter or bond ordinance of the particular city in question.

SPECIAL FEDERAL TAX REQUIREMENTS

The Tax Reform Act of 1986 limited the issuance of tax-exempt EDCRBs in many ways. It made EDCRBs, even if tax-exempt, unattractive investments for banks, which previously had been the major purchaser of relatively small (e.g. less than $5 million) EDCRB issues, because it denies the interest deduction, previously enjoyed by banks, of their interest expense allocable to tax-exempt bonds. Interest on all private activity bonds is in the calculation of individual and corporate alternative minimum taxes as a tax preference item, which usually adds 20 to 25 basis points to the interest rate for these bonds.

Each of the EDCRB issuers discussed in this section may issue taxable bonds for any of the projects or purposes for which they are authorized to issue bonds. The issuance of EDCRBs (which are subject to full federal income taxation although still exempt from state and local income taxation) has not been very frequent since 1986, but may be appropriate in particular circumstances.

The following section outlines a very brief description of the most important federal tax laws applicable to EDCRBs.

Introduction; Private Activity Bonds

As described in **Chapter 3, General Federal Tax Requirements**, the relevant sections of the tax code first provide that interest on bonds issued by state or local governments is not included in the gross income of the owner of such bonds for federal tax purposes. Such exemption does not apply to private activity bonds, however, unless they are qualified private activity bonds. EDCRBs are clearly private activity bonds since bond proceeds are used for private business purposes and the repayment thereof is secured by a private business. Therefore, to be tax-exempt, EDCRBs must fit into one of the categories of qualified private activity bonds. For purposes of this section, qualified private activity bonds are of two types—exempt facility bonds and qualified small issue bonds.

Exempt Facility Bonds

As described in the section on qualified private activity bond discussion in **Chapter 3**, **General Federal Tax Requirements**, exempt facility bonds are bonds of which at least 95 percent of the net proceeds are to be used to provide:

- Airports
- Docks and wharves
- Mass commuting facilities
- Facilities for the furnishing of water
- Sewage facilities
- Solid waste disposal facilities
- Qualified residential rental projects
- Facilities for the local furnishing of electric energy or gas
- Local district heating or cooling facilities
- Qualified hazardous waste facilities
- High speed intercity rail facilities
- Environmental enhancement and hydroelectric generating facilities

Qualified residential rental projects are discussed later in this chapter in the section on **Conduit Revenue Bonds: Multifamily Housing Revenue Bonds**. The tax code and U.S. Treasury regulations contain specific rules and definitions covering each of these exempt facility

categories. In the case of the first three categories listed above, a governmental unit must own the facilities.

Qualified Small Issue Bonds

Qualified small issue bonds (also referred to as IDBs) are bonds issued in an aggregate face amount of not more than $1 million, 95 percent of the net proceeds of which are to be used for the acquisition, construction, reconstruction, or improvement of land or property of a character subject to the allowance for depreciation. However, a number of categories of facilities are prohibited, as described further below. Most significantly, qualified small issue bonds are only permitted for manufacturing facilities.

The $1 million limitation on issue size may be increased to $10 million if certain requirements are met. Most issues of qualified small issue bonds are between $1 million and $10 million in size. To qualify for the $10 million limit, the sum of the following items may not exceed $10 million during the six-year period beginning three years prior to the date of issuance of the EDCRBs and ending three years after such date:

- All capital expenditures made by:
    - The nongovernmental borrower or any related person for any facilities located within the political jurisdiction in which the project is to be located
    - Any other principal user of the facility being financed
    - Any person (whether or not a principal user) to benefit from the EDCRB-financed facility, plus
- The face amount of the bonds to be issued, plus
- The remaining principal amount of all prior outstanding qualified small issue bonds issued to finance facilities located in the same incorporated municipality (or in the same county but not in any incorporated municipality) as the project being financed, a principal user of which is the nongovernmental borrower for the project being financed

If this capital expenditure limitation of $10 million is exceeded, the bonds will lose their tax-exempt status from the date such limit is exceeded.

A principal user of an EDCRB financed project is generally considered to be any private user of more than 10 percent of such project. For federal tax law purposes there may therefore be more than one principal user of a project.

A single nongovernmental borrower cannot simultaneously issue a package of several qualified small issue bonds for different projects relying on a separate $10 million limit for each issue.

Additionally, a single project cannot be divided into condominium units and financed with separate issues for unrelated nongovernmental borrowers.

A nongovernmental borrower may not be the beneficiary of a qualified small issue bond financing if the total amount of all private activity bonds allocated to such nongovernmental borrower, plus the amount of the proposed issue, will exceed $40 million.

Requirements Applicable To All Private Activity Bonds

As described in the qualified private activity bond discussion in **Chapter 3, General Federal Tax Requirements**, all qualified private activity bonds, including exempt facility bonds and qualified small issue bonds, are subject to the limitations described in this section.

Any private activity bond will cease to be a qualified private activity bond and will lose its tax-exempt status during any period in which such bond is held by a "substantial user" of the EDCRB-financed facility or by a "related person" of such substantial user.

The average maturity of an issue of qualified private activity bonds may not exceed 120 percent of the average reasonably expected economic life of the facilities being financed with such issue.

Twenty-five percent or more of the net proceeds of a qualified private activity bond issue may not be used directly or indirectly for the acquisition of land or any interest therein and no part of the net proceeds of any such issue may be used for the acquisition of previously used property or any interest therein. The latter restriction does not apply, however, with respect to any building (and equipment) if rehabilitation expenditures with respect to the building are at least equal to 15 percent of the cost of acquiring such a building (and equipment) financed with the net proceeds of the issue.

No more than 2 percent of the aggregate face amount of any qualified private activity bond issue may be used to finance the costs of issuance thereof.

CONDUIT REVENUE BONDS: EDUCATIONAL FACILITY BONDS

DEFINITION AND PURPOSE

Educational facility conduit revenue bonds are debt instruments issued by a governmental entity to provide below market interest rate financing of facilities for private higher educational institutions operated by nonprofit corporations or trusts.

LEGAL AUTHORITY; ISSUERS

The California Educational Facilities Authority Act (Sections 94100 et seq. of the Education Code) authorized the California Educational Facilities Authority (CEFA) to issue educational facility conduit revenue bonds.

Charter cities, under their constitutional powers concerning municipal affairs, may issue educational facility revenue bonds, provided the city's charter contains appropriate provisions authorizing the issuance of such bonds. If a charter city were to exercise this power, the considerations demonstrating that the financing is a municipal affair, relating to process, concerning the security for the bonds and relating to the federal tax exemption would be substantially identical to those considerations for hospital/health care facility conduit revenue bonds.

See **Appendix A – Working with State Agencies** for a description of CEFA and its programs.

POLICY CONSIDERATIONS

CEFA issues revenue bonds to assist private nonprofit institutions of higher education in the construction and expansion of nonsectarian educational facilities and to assist students of both private and public institutions of higher education within the state in financing their costs of attending such institutions. CEFA may issue bonds to refund existing bonds, mortgages, or other obligations incurred by private colleges for the acquisition or construction of educational facilities. CEFA also may issue bonds to refund its own bonds.

ELIGIBLE FACILITIES

For purposes of CEFA bond issues, facilities which may be financed include structures suitable for use as a dormitory, dining hall, student union, administration building, academic building, library, laboratory, research facility, classroom, or health care facility, as well as other related structures, facilities, and equipment required or useful for the instruction of students, the conducting of research, or operation of the institution. Eligible facilities do not include any facility used or to be used for sectarian instruction or as a place for religious worship.

STUDENT LOANS

CEFA also may finance student loan programs. Student loan means any loan having terms and conditions acceptable to CEFA that is made to finance or refinance the costs of attendance at any private nonprofit institution of higher education, or a public college provided that the college is approved by CEFA and the loan is originated pursuant to a program approved by CEFA.

OTHER LIMITATIONS

CEFA's bonds may bear interest at a rate or rates specified in the documents of issuance, but may not exceed statutory usury limits. Bonds may not mature later than 50 years from their date of issuance. Variable interest rates, put options, and commercial paper bonds are feasible under the CEFA statute.

SPECIAL FEDERAL TAX LIMITATIONS

Educational facility conduit revenue bonds for nongovernmental entities will be exempt from federal income taxation only if they are qualified Section 501(c)(3) bonds. A detailed discussion of qualified 501(c)(3) bonds is in **Chapter 3, General Federal Tax Requirements**.

Conduit Revenue Bonds: Hospital and Health Care Facilities; Certificates of Participation

Definition and Purpose

Hospital/health care facility conduit revenue bonds are debt instruments issued by a governmental entity (the issuer) to provide tax-exempt interest rate financing for general acute care hospitals and other health care facilities that are owned and operated by nonprofit corporations. The issuer of these bonds acts as a conduit, issuing bonds and lending the proceeds thereof to the beneficiary (the nonprofit corporation), which makes payments to the issuer equal to the debt service on the bonds. The bonds are limited obligations of the issuer. As described in this section, hospital and health care facilities financings also may be accomplished through the delivery of certificates of participation.

Legal Authority; Issuers

County/Health Care District Financings

In cases where the hospital or health care facility is owned and operated by a governmental entity (such as a county or health care district), such entities have the statutory power to issue bonds directly, without the necessity for a conduit financing. A complete description of this financing instrument type is beyond the scope of this *Primer*.

California Health Facilities Financing Authority

The California Health Facilities Financing Authority Act (Sections 15430 et seq. of the Government Code, the "CHFFA Act") authorizes the California Health Facilities Financing Authority (CHFFA) to issue hospital and health care conduit revenue bonds. See **Appendix A – Working with State Agencies** for a description of CHFFA and its programs.

Charter Cities

Under its constitutional powers concerning municipal affairs, a charter city also may issue hospital/health care conduit revenue bonds to finance hospital or other health care facilities to benefit its residents, unless its charter limits or restricts that power. Charter cities exercise this power under a bond ordinance or resolution adopted by the city council.

Joint Powers Authorities

Under the Joint Powers Act (Sections 6500 et seq. of the Government Code) and in accordance with the stated purpose and powers provided in the applicable joint exercise of powers agreement, joint powers authorities (JPAs), composed of cities and counties that possess the common power to purchase and sell property for public purposes, may finance hospital/health care facilities through certificates of participation financings. With this structure, the nonprofit

corporation sells its property to the joint powers authority pursuant to an installment purchase agreement. In consideration for this sale, the JPA sells the same property back to the nonprofit corporation pursuant to an installment sale agreement. Pursuant to the installment sale agreement, the nonprofit corporation will make payments to the bond trustee, as assignee of the JPA, in satisfaction of the JPA's installment payment obligations under the installment purchase agreement. The financings also may be structured as lease-leaseback financings.

PROJECTS THAT MAY BE FINANCED

California Health Facilities Financing Authority

The CHFFA Act authorizes the issuance of hospital and health care facility conduit revenue bonds for the purposes of financing and refinancing the construction, expansion, remodeling, renovation, furnishing, or equipping of the types of facilities listed in the Act, including:

- General acute care hospitals
- Acute psychiatric hospitals
- Skilled nursing facilities
- Life care facilities
- Intermediate care facilities
- Outpatient facilities
- Facilities for the developmentally disabled
- Community clinics
- Adult day health centers

CHFFA also may issue bonds to refund bonds issued for such purposes.

Charter Cities

The city charter and the bond ordinance or resolution of a charter city determine the limitations imposed by that city on its issuance of hospital and health care facility conduit revenue bonds. In determining whether a charter city may proceed with a particular financing, it is necessary to assess whether the financing of that facility will constitute a "municipal affair." To make this determination, the services provided by the facility, and the extent to which patients at the facility are residents of the city, must be analyzed. Generally, the facility must be located within the city limits, although a facility located immediately adjacent to a city and providing significant health care services to the residents of the city may be financed.

To ensure that a municipal affair is advanced by the financing, it is necessary for the city and the hospital to enter into an agreement pursuant to which the hospital agrees to provide certain specified services to the city and its residents. In certain situations, such as a sole provider in a rural area, it may be appropriate for the hospital to agree to provide basic services as an acute care hospital. In other instances, such as a large medical center in an urban area, it may be necessary for the hospital to enter into an agreement to provide specified services to the city.

Charter cities may finance the same types of projects as are described above for CHFFA.

Joint Powers Authorities

Unless otherwise limited by its joint exercise of powers agreement or the resolution under which the certificates of participation will be delivered, a JPA may finance the same types of projects as charter cities and CHFFA.

METHOD OF REPAYMENT AND SECURITY FEATURES

Hospital and health care facility conduit revenue bonds or certificates of participation are payable solely from the loan or installment payments made by the hospital/health care facility beneficiary of the issue. Debt service on the bonds may be secured in addition by bond insurance, a letter of credit from a bank, a deed of trust on hospital property, or a guarantee by a parent organization, or other similar devices.

PROCESS FOR APPROVAL

All of the conduit financings described in this section require a Tax and Equity Fiscal Responsibility Act of 1982 (TEFRA) hearing to be exempt from federal income tax. As described in the qualified private activity bond discussion in **Chapter 3, General Federal Tax Requirements**, the bonds or certificates of participation must be approved by an appropriate elected official or body after a public hearing has been conducted (the TEFRA requirement). For a CHFFA issue, CHFFA holds the public hearing in Sacramento, and the State Treasurer acts as the "applicable elected representative" of the State of California. For a charter city, the public hearing will customarily be held either by the staff or in front of the city council and the city council will approve the bonds for this purpose. If the mayor is elected at large in the city, the mayor may approve the bonds for this purpose. For JPAs, a TEFRA hearing must be held in each city or county where the proceeds of the certificates of participation will be used and approved by the city council or county board of supervisors, as applicable.

In addition to the federal tax law requirement for a TEFRA hearing, CHFFA, the charter city, and the joint powers authority must approve the financing and the execution of the financing documents. For charter cities and JPAs, the charter or the joint exercise of powers agreement and the bond ordinance or resolution may impose additional procedural requirements on the issuance by the city or JPA of hospital and health care facility conduit revenue bonds or certificates of participation.

PROCESS FOR SALE

California Health Facilities Financing Authority

Conduit revenue bonds issued by CHFFA may be sold by the State Treasurer by competitive or negotiated sale, after giving due consideration to the recommendation of the applicable nonprofit corporation, upon such terms and conditions as CHFFA shall determine. The CHFFA Act allows the State Treasurer to sell bonds to be issued by CHFFA at a price below the par value thereof, provided that, with certain exceptions, the discount on any such bonds shall not exceed 6 percent of the par value.

Charter Cities

Unless otherwise limited by its charter or the bond resolution or ordinance under which the bonds will be issued, a charter city may sell its bonds by competitive or negotiated sale, within whatever price limits are approved by the city council.

Joint Powers Authorities

Unless otherwise limited by its joint exercise of powers agreement or the resolution under which the certificates of participation will be delivered, a JPA may sell its bonds by competitive or negotiated sale, within whatever price limits are approved by such JPA.

OTHER LIMITATIONS ON TERMS OF BONDS

California Health Facilities Financing Authority

The CHFFA Act limits the terms of bonds issued by CHFFA to 40 years. Otherwise, CHFFA may issue its bonds on any terms that are approved by CHFFA. Variable interest rates, put bonds, and commercial paper may all be feasible.

Charter Cities

Unless otherwise limited by its charter or the bond ordinance or resolution under which the bonds will be issued, the terms of charter city hospital and health care facility conduit revenue bonds may be quite flexible, subject to the approval of the city council. As with CHFFA, variable interest rates, put bonds, and commercial paper may all be feasible.

Joint Powers Authorities

Unless otherwise limited by its joint exercise of powers agreement or the resolution under which the certificates of participation will be delivered, the terms of hospital and health care facility conduit revenue certificates of participation may be quite flexible, subject to the approval of the JPA. As with CHFFA, variable interest rates, put bonds, and commercial paper may all be feasible.

SPECIAL FEDERAL TAX CONSIDERATIONS

Conduit revenue bonds issued for hospitals and other health care facilities owned and operated by nongovernmental entities will be exempt from federal income taxation only if they are qualified Section 501(c)(3) bonds. A detailed discussion of qualified 501(c)(3) bonds is in the qualified private activity bond discussion in **Chapter 3, General Federal Tax Requirements**.

CONDUIT REVENUE BONDS: MULTIFAMILY HOUSING REVENUE BONDS

DEFINITION AND PURPOSE; ISSUERS

Multifamily housing revenue bonds are issued to finance the acquisition, construction, rehabilitation or development of, or to refinance rental housing developments (apartment buildings) by private developers. Generally, all or a portion of the units in the housing development must be reserved for occupancy by individuals and families of very low, low, or moderate income. The advantages to developers include below market interest rates and other features not available in the conventional multifamily mortgage market, such as long-term fixed rate financing.

Multifamily housing revenue bonds may be issued by cities, counties, joint powers authorities (JPAs), redevelopment agencies, and housing authorities.

PROJECTS THAT MAY BE FINANCED

Any multifamily rental housing development may be financed, provided that various restrictions relating to the income of tenants and rental of units, depending upon the issuer of the bonds, are satisfied. The following paragraphs summarize certain of these requirements.

Occupancy Requirements and Income Limits

Under the statute applicable to cities and counties, which also applies to JPAs, the issuer must elect to have either 20 percent of the units occupied by tenants whose income does not exceed 50 percent of area median income, or 40 percent of the units must be occupied by tenants whose income does not exceed 60 percent of area median income, all for the period required by, and determined in accordance with the definitions set forth under the federal Tax Code. In projects financed by cities, counties, and JPAs, the units occupied by low income households must be of comparable quality and offer a range of sizes and number of bedrooms comparable to those available to other tenants. It is not clear whether these requirements apply to charter cities issuing bonds under their charter powers.

The general rule for housing authorities and redevelopment agencies under state law is that at least 10 percent of the units in a project must be set aside for tenants of very low income (50 percent or less of area median income), and another 10 percent of the units must be set aside for tenants of low or moderate income (80 percent or less of area median income) until the bonds are retired.[7] In each case the figure for median income is adjusted for family size. In projects financed by housing authorities (but not redevelopment agencies), the income of tenants must be redetermined every two years, and if any increase in a tenant's income would result in the project

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[7] See also **Other Federal Tax Considerations** discussion later in this chapter.

no longer complying with the requirements described above, the next available unit must be rented to an individual or family whose income meets the qualifying level.

In projects developed by any private or public entity (other than the redevelopment agency) specifically in order to replace units removed from the housing market because of a redevelopment project, at least 15 percent of the units must be available at affordable housing cost to persons and families of low or moderate income (120 percent of area median income), and not less than 40 percent of these units must be available at affordable housing cost and occupied by very low income households. This requirement increases to 15 percent the very low income set-aside requirement, which would otherwise be only 10 percent for multifamily housing projects in redevelopment areas. Note also that projects for this purpose financed by a redevelopment agency must provide at least 30 percent of the units at affordable housing cost to low or moderate income households, and half of these units must be available to very low income households.

Under the Tax Code, for the issuance of tax-exempt bonds at least 40 percent of the units in the project must be set aside for families whose income does not exceed 60 percent of area median income, or 20 percent of the units must be set aside for families whose income does not exceed 50 percent of area median income, in each case adjusted for family size. Income levels, in each case, are to be redetermined annually. If, as a result of an increase in any tenant's income or as a result of a reduction in the tenant's family size, the tenant's income is more than 140 percent of the qualifying limit, the next available unit must be leased to qualifying tenants. A developer may elect to set aside 15 percent of the "low income" units for tenants whose income does not exceed 40 percent of area median, in which case a tenant's income may increase to 170 percent of the qualifying limit before that tenant's unit ceases to qualify. If the developer makes this election, the project is subject to rent limits as described below.

Rent Limits

Projects financed by housing authorities and redevelopment agencies are subject to state statutory rent limits applicable to the 10 percent of the units required to be set aside for very low income households. The general rule is that the rent paid by the tenant (excluding any supplemental rental assistance from the state or federal government or other public agencies) for any unit may not exceed 30 percent to 50 percent of area median income, adjusted for family size in accordance with Table 6-3. In the case of projects financed by cities, counties, and joint powers authorities, rents paid by tenants of the set-aside units are limited to 30 percent of the applicable income limit (50 percent or 60 percent of area median income) selected by the issuer as described above.

There are no rent limits under federal tax law, unless a developer elects to set aside 15 percent of the low income units for tenants whose income does not exceed 40 percent of area median, in which case the rent charged for all low income units may not exceed 30 percent of the income limit and may not exceed one-third of the average rent charged for other units in the project.

Table 6-3
Rent Limits Adjustments for Projects Financed By Redevelopment Agencies and Housing Authorities

Size Of Unit	Assumed Size of Occupying Family
Studio	1 person
1 bedroom	2 people
2 bedrooms	3 people
3 bedrooms	4 people
4 bedrooms	5 people

Term of Restrictions

Under state laws applicable to housing authorities and redevelopment agencies, both the income limits and the rent limits must remain in effect until the bonds are retired. Under state law applicable to cities, counties, and joint powers authorities, and under federal tax law, the income limits must generally remain in effect for the "Qualified Project Period," which period is the longer of 15 years, or so long as any bonds remain outstanding, or so long as the project (as opposed to individual tenants) receives assistance under the federal "Section 8" rent subsidy program.

Other Requirements

The restrictions applicable to multifamily housing projects financed by general law cities, counties, and JPAs must be set forth in a regulatory agreement, which must be recorded in the records of the county where the project is located. Moreover, following the expiration or termination of the Qualified Project Period, with respect to projects financed with the proceeds of bonds issued by a city, county or JPA, other than a termination due to a foreclosure or similar involuntary transfer, units reserved for low income tenants must remain available to any eligible tenants occupying such units at such time, at a rent not greater than the amounts described in **Rent Limits** above, until the earliest of:

- The household's income exceeds 140 percent of the maximum eligible income specified earlier in this section
- The household voluntarily moves or is evicted for good cause
- Thirty years after the date of the commencement of the Qualified Project Period, or
- The owner pays the relocation assistance and benefits to households as provided under state law

In addition, the statute applicable to general law cities and counties prohibits the syndication of new or existing multifamily rental housing without the written approval of the city or county. Such approval may be given only upon the making of certain findings, essentially to assure that the project will continue to comply with the law.

Projects financed by redevelopment agencies must be located in a redevelopment project area, unless the units in the project are "committed, for the period during which the loan is outstanding, for occupancy by persons or families who are eligible for financial assistance specifically provided by a governmental agency for the benefit of occupants" of the project or the issuer operates in a jurisdiction with a population greater than 600,000. Thus, for most projects outside a redevelopment project area, all of the tenants must be eligible for Section 8 assistance or similar financial assistance from a federal, state, or local governmental agency.

Individual issuers also may impose additional requirements, such as lower rent limits or income limits or other eligibility or project restrictions, or special compliance or reporting requirements, or various fees or other amounts to be paid to the issuer, so long as these requirements are in addition to, and not in conflict with, those imposed by state law or necessary to maintain the tax-exempt status of the bonds.

Additional Powers

In addition to the power of housing authorities to finance projects for private developers, as described above, a housing authority also may, pursuant to the same statute and subject to the same restrictions, own and operate such a project itself, as well as provide the financing to develop the project. Moreover, under the general provisions of state law relating to housing authorities, other than those described above, housing authorities may finance, own, and operate rental housing projects subject to different restrictions, including the requirement that all units in a project be rented only to persons of low or moderate income (80 percent of median income) and only at rentals "within their financial reach." Other sections specify preference categories to be applied in selection of tenants, such as displaced persons, veterans, and citizens. There is no comparable enabling legislation for projects to be financed, owned, and operated by cities, counties, or redevelopment agencies, although charter cities may have sufficient authority pursuant to individual charter provisions.

Cities, counties, and JPAs are authorized to finance, in addition to multifamily rental housing, the development of commercial property for lease, subject to certain conditions, which include:

- No more than 10 percent of the proceeds of the bonds may be used for such purpose
- The commercial property must be located on the same parcel or a parcel adjacent to the multifamily housing development, and

- Excess lease payments, determined as set forth in the state law, must be used to reduce the rents applicable to low income units within the development

SECURITY AND SOURCES OF PAYMENT

Bonds issued pursuant to the statutes listed in **Appendix D – Legal References – Table D-9-1** are revenue bonds, payable directly or indirectly from the revenues of the project or lending program. Charter cities also could finance multifamily housing through the issuance of certificates of participation, in which case the project would be subject to certain of the provisions of state law (as described below under **Legal Authority**).

Bonds are sometimes secured by a mortgage on the project, which may, but is not required to, be insured by FHA or a mortgage insurance company or other insurer. Bonds also might be payable from amounts received under a pass-through certificate, for instance from the Federal National Mortgage Association (FNMA) or the Government National Mortgage Association (GNMA), under which the issuer of the certificate agrees to pay to the issuer of the bonds the payments due on the mortgage note of the developer, whether or not such mortgage payments are received from the developer.

A more commonly used structure is one in which bonds are paid directly from amounts drawn under a letter of credit issued by a bank or savings association, which are then reimbursed by payments from the developer derived from revenues of the project. A mortgage on the project then secures both the bonds and the reimbursement obligation. Frequently, bonds supported by a letter of credit bear interest at a variable rate, and bondholders have the right to demand purchase of the bonds at any time—the purchase is made either with amounts drawn under the letter of credit or with proceeds of remarketing of the bonds to another investor.

PROCESS FOR APPROVAL

Bonds for multifamily rental housing are revenue bonds and as such do not require an election, except in the case of charter cities whose charters require such an election. Under certain circumstances, it may be necessary to obtain voter approval of the project being financed pursuant to Article XXXIV of the California Constitution, particularly if 50 percent or more of the units are to be reserved for low income tenants or if the project is to be partially of fully exempt from real property taxes.

Cities, counties, and joint powers authorities may authorize the issuance of bonds by ordinance or resolution, and housing authorities and redevelopment agencies may authorize the issuance of bonds by resolution. In the case of cities, counties, joint powers authorities, and housing authorities, the resolution or ordinance, as the case may be, must set forth a finding of public purpose and a declaration that it is being adopted pursuant to the particular authorizing statute. The resolution authorizing issuance of the bonds typically also authorizes the sale of the bonds and delegates to specified officers of the issuer the authority to sign a bond purchase agreement.

Volume Cap

Multifamily housing revenue bonds are typically issued as qualified private activity bonds. Therefore an allocation of volume cap is required. The California Debt Limit Allocation Committee's (CDLAC) current policies for allocating volume cap provide top priority to multifamily housing projects. In evaluating multifamily housing projects in connection with applications for volume cap, CDLAC's current procedures ask the following questions:

- Are more than the statutorily required number of units restricted for very low or low income households?
- Are rents restricted at a lower level than the statute requires?
- Are the income or rent restrictions required to remain for a period of time longer than the statute requires?
- Does the project provide protection for tenants at the time the units are converted to market rate rents?
- Are the issuer and/or applicant participating financially in the project?
- Does the project respond to needs resulting from a natural disaster?
- Does the project meet other clearly defined local, regional, or statewide goals?

To the extent these questions can be answered affirmatively, the project will have a better chance of receiving favorable consideration by CDLAC. The CDLAC guidelines and procedures are normally updated each year. See **Appendix A – Working with State Agencies** for more information.

LIMITATIONS ON TERMS OF BONDS

Bonds of cities, counties, JPAs, and housing authorities must mature not later than 45 years from their dates of issuance, and bonds of redevelopment agencies must mature not later than 50 years from their dates of issuance. The interest rate on bonds of housing authorities may not exceed 12 percent per year and bonds of cities, counties, JPAs, and redevelopment agencies are not subject to any specific interest rate limitation. The statutes governing the terms of multifamily housing bonds issued by all issuers are sufficiently broad to permit variable interest rates and put bonds. Commercial paper also would be permitted under each of the statutes.

LEGAL AUTHORITY

Cities, counties, joint powers authorities, housing authorities, and redevelopment agencies may issue multifamily housing revenue bonds. See **Appendix D – Legal References – Table D-9-1** for a list of statutory provisions authorizing the issuance of multifamily housing revenue bonds.

In addition, charter cities may issue such bonds pursuant to their powers under the California Constitution and their respective charters, subject to any restrictions imposed by such charters and subject to certain requirements set forth in Sections 52097.5 and 52098 of the Health and Safety Code.

Under the laws governing the issuance of multifamily housing revenue bonds by cities, counties, JPAs, and redevelopment agencies, such issuers are authorized to use bond proceeds to make or acquire construction loans and mortgage loans to finance multifamily rental housing. The statute governing housing authorities is broader, and would permit a housing authority to purchase, sell, lease, own, operate, or manage a project itself as well.

OTHER FEDERAL TAX CONSIDERATIONS

In addition to the federal tax law requirements described above relating to occupancy requirements and volume cap, all of the other requirements and limitations for qualified private activity bonds apply to the issuance of bonds for multifamily rental housing. To the extent such bonds are not private activity bonds, for example in the case of governmentally owned and operated housing, or to the extent such bonds are qualified 501(c)(3) bonds, for example in the case of 501(c)(3) corporation owned and operated housing, only the limitations applicable to such types of financings apply. All of these various requirements are described in **Chapter 3, General Federal Tax Requirements**.