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Towns and Borrowing

By Rebecca Otto, State Auditor

A town may need to borrow money from time to time because of emergencies or unexpected expenses. In addition, equipment purchases, capital improvements, and other large projects may require long-term financing. The Office of the State Auditor recently released the new Statement of Position Towns and Borrowing. This article has the majority of the Statement of the Position in it. It is intended to be an educational resource for towns and should not be used to make a borrowing decision. Before making a decision to borrow, a town should consult with an attorney or other professional.

Authority to Borrow

A town has no authority to borrow money unless state law specifically allows it and the town follows the steps required by state law. The name of a transaction or document used, i.e., calling it a loan, warrant, certificate, or agreement, will not change this basic concept. The authority of a town to incur indebtedness is granted by statute.

Procedures

The process of borrowing is governed by a relatively complex set of state statutes. Although there are exceptions, generally before a town can borrow money, it must have approval from a majority of the electors voting on the question. If a town is pledging its full faith and credit for repayment of borrowed money, the town board must adopt a proper resolution and file the resolution with the county to ensure collection of the appropriate property tax levy. For general obligation bonds, the initial levy, together with special assessments and other revenues pledged, must be at least five percent more than necessary to make payments on the debt.

The interest paid by towns on the bonds they issue may not be taxable as income to the bondholder. This status makes the bonds advantageous to the bondholder and saleable for the town. To qualify for this tax advantage, certain federal regulations, including disclosure requirements, may apply.

Bonds Generally

Bonds are promises to pay issued by a government usually to finance large construction projects or equipment purchases. When a bond matures, the principal is returned to the investor. Bond maturity periods vary depending on the particular bond. Usually, investors receive interest payments at specific times until the bond matures.

Towns may issue bonds only for those purposes authorized by the legislature. Authorized purposes range from snow removal equipment to improving nursing homes. Large improvements, such as streets, sewer systems and tree planting, may also be financed with bonds, as authorized by law. The different types of bonds include:

<u>General Obligation Bond</u>: This type of bond promises the full faith and credit of the town to payment of the principal and interest. In issuing it, a town promises all of its assets and resources, including its power to tax, to make payments. It is the safest debt from the point of view of the bond purchaser and should result in the lowest interest rate.

An improvement bond, used to finance large improvements, is a general obligation bond when the full faith and credit of the town is pledged to it. If the full faith and credit of the town is not pledged to the obligation, acceptable financing for improvements may include a revenue bond or an assessment revenue note.

<u>General Obligation Revenue Bond</u>: In issuing this type of bond, a town pledges the revenues of a facility or other source of revenue to pay principal and interest with the additional agreement that the town will use its power to tax to make up any shortfall.

<u>Revenue Bond</u>: With this type of bond, a town's only obligation is to pay principal and interest from the revenues described in the bond agreement. The town has no obligation to tax or to use any other funds.

In addition to the types of bonds that can be issued, there are various general restrictions on the issuance of debt. The major restrictions include:

- The total amount of debt issued by the town cannot exceed three percent of the market value of all the property in the town. This is called the "net debt" restriction. There are a number of debt issues excluded from the net debt restriction found in Minn. Stat. § 475.51, subd. 4.
- The bond or obligation must be approved by a majority of the electors voting on the question.
- The bond or obligation must be sold at a competitive sale.

Note that there are many exceptions to these general restrictions.

Other Specific Types of Borrowing

Loans

Short-term town borrowing is not as simple as going to the local bank and requesting a loan. Minnesota law does not allow towns to borrow money from a local bank merely by filling out standard bank forms.

A town, however, may borrow directly or indirectly an amount not to exceed $450,000, from an agency of the U.S. Department of Agriculture. This money is available for the construction, repair, or acquisition of a town hall, a fire hall, fire or rescue equipment, a library, or a childcare facility if otherwise authorized by law. The loan is to be in the form of a note secured by a mortgage on the property. In addition, the town may pledge its full faith and credit or pledge the revenues, if any, generated by the facility or the equipment. Approval of voters is not required for the issuance of the note. This obligation is not included when computing net debt of the town.

Temporary Improvement Bond

A temporary improvement bond is a bond issued in anticipation of the issuance of an improvement bond. The bond must mature within three years of its date of issuance.

Certificate of Indebtedness

A certificate of indebtedness is a general obligation bond subject to certain special rules. No election is needed to authorize its issuance. However, if the amount of the certificate exceeds 0.25 percent of the town's market value, the town board's resolution to issue a certificate must be published in a newspaper of general circulation of the town at least ten days before the certificate is issued. A referendum can be demanded if enough voters sign a petition. A certificate's term is limited to no more than ten years.

Specific authority to issue a certificate of indebtedness must be provided by statute. Urban towns, for example, may issue certificates of indebtedness within debt limits to purchase street maintenance equipment and fire and street construction. Any town, however, may issue bonds to purchase the same type of equipment.

If a town determines that its funds are insufficient to meet expenses during a fiscal year because of a natural disaster or other public emergency that requires extraordinary expenditures, the town may issue a certificate of indebtedness. The certificate must mature within three years. The interest rate must not exceed that prescribed by statute. A certificate may be issued without advertising for bids on terms and conditions determined by the town board. Payments on the certificate and interest are to come from taxes levied within existing limitations or from other revenue.

If, during a fiscal year, receipts are reasonably expected to be reduced below the amount provided in the town's budget and are not enough to meet expenses incurred or to be incurred during the fiscal year, a town board may authorize and sell certificates of indebtedness. The certificates must mature within two years of the end of the fiscal year. The maximum principal amount of the certificate is limited to the expected reduction in receipts plus the cost of issuance. These certificates may be issued in the manner and on the terms the town board determines by resolution.

Lease-Purchase Agreement

A town may enter into a lease-purchase agreement. Usually, the town retains the right to acquire the property at the end of the lease term for a nominal amount. A lease-purchase agreement must give the town the right to terminate the agreement at the end of any fiscal year during its term. Under the agreement, the lessor could be a bank, an equipment company or other private or governmental entity. A lease-purchase is subject to the Municipal Contracting Law's bidding requirements.

Order Not Paid for Want of Funds/Warrants

When a person or entity presents to the town a claim for payment, it must be in writing and itemized. It is then reviewed by the town board and, if approved, the town issues an order or check to pay the claim. If the order is then presented to the treasurer and there is not enough money to pay it, it is to be "registered" and interest will start to accrue on the amount of the order until it is paid.

Orders, sometimes called warrants, can only be issued to persons or entities that have a claim for payment against the town. They cannot be issued for the purpose of creating debt to a bank or other financial institution.

Other Debt

A town may buy personal property on a conditional sales contract and real property on a contract for deed, but the property must be paid for within five years. Purchases that cost more than 0.24177 percent of market value of the town must follow the procedure found in Minnesota Statutes, which includes publishing a board resolution to pay for the property over time, a reverse referendum petition process like that for a certificate of indebtedness and a possible election.

A reverse purchase agreement may be entered into for a period of ninety days or less to meet short-term cash flow needs.

In the event of emergency after the town meeting, but not later than October 1 of the same year, which requires work on roads or bridges within a town, the town may levy a tax for that purpose. The town board may then pledge the credit of the town by issuing town orders, not to exceed the amount of additional tax levied, in payment for the emergency work done or material used on roads within the town.

The read the complete Statement of Position, including footnotes to the relevant statutes, go to the Office of the State Auditor website at www.auditor.state.mn.us and go to "For Local Officials," and then to the "Statements of Position" tab. It will be under the heading "Borrowing and Debt."