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Capital Funding Sources and Debt Financing

Dear Reader:

The following document was created from the CTAS website (ctas.tennessee.edu). This website is maintained by CTAS staff and seeks to represent the most current information regarding issues relative to Tennessee county government.

We hope this information will be useful to you; reference to it will assist you with many of the questions that will arise in your tenure with county government. However, the *Tennessee Code Annotated* and other relevant laws or regulations should always be consulted before any action is taken based upon the contents of this document.

Please feel free to contact us if you have questions or comments regarding this information or any other CTAS website material.

Sincerely,

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Capital Funding Sources and Debt Financing

Reference Number: CTAS-1715

When dealing with funding a capital projects program, the government should consider available funding sources. Potential sources available would be 1) annual revenue, 2) an unexpected surplus of funds a county may have from a prior year, 3) earmarking certain revenues for capital projects such as park and recreation fees, 4) impact or user fees which would be specific revenues for a specific project, and 5) grants and/or donations and debt related instruments. Most capital projects use debt related instruments to fund the projects. These instruments consist of 1) capital outlay notes (CON), 2) revenue bonds, 3) capital leases, 4) special obligation bonds, and 5) general obligation bonds. The predominant debt instruments are capital outlay notes and general obligation bonds.

It is a recommended practice that governments establish a debt financing policy which considers per capital debt ratios, multi-year debt service budgets, fund balance policies, and other ratios and statistics related to debt management. Below are various terms and definitions which the government agency should be aware.

Limit on Amount of Outstanding Debt

Since nearly all services rendered by the county are required by the state and require sizeable investments in capital improvements, counties are not limited as to the amount of indebtedness. T.C.A. § 9-21-103. However, when a county's debt ratio of outstanding debt to property values exceeds the state average or a national standard recognized by firms who trade municipal bonds, the county may pay a higher interest rate or be unable to issue additional bonds. When a county faces this problem, the county's financial advisor can offer alternatives to fund proposed projects.

Bonds Issued Under Local Government Public Obligations Act of 1986

Reference Number: CTAS-1720

This act is codified in T.C.A. §§ 9-21-101 through 9-21-1017. Its purpose was to consolidate statutes pertaining to debt obligations of the county and to provide a uniform and comprehensive statutory framework authorizing any local government to issue long- term debt to fund costly capital improvement projects.

Authorized purposes for issuing notes and bonds are listed under T.C.A. § 9-21- 105(20). Also, any local government may issue general obligation bonds under this act for certain unfunded pension obligations if approved by the state funding board after receiving a recommendation by the comptroller or the comptroller's designee. T.C.A. § 9-21-127. The powers of local governments are described in T.C.A. § 9-21-107. All interest income received by investors buying notes or bonds issued under this act is generally exempt from federal income taxes, and by statute, exempt from all state, county, and municipal taxation except inheritance, transfer, and estate taxes. T.C.A. § 9-21-117. However, there are federal restrictions regarding earnings from borrowed funds, so it is important for counties to consult with a financial advisor regarding these arbitrage regulations.

All notes issued under this act must first be authorized by resolution adopted by the county legislative body and then approved by the state director of local finance, a division of the state comptroller of the treasury. Before the director of local finance will approve notes, the county must adopt a balanced budget, which must also be approved by this same director. T.C.A. §§ 9-21-403, 9-21-404.

The bonds and notes that can be issued under the Local Government Public Obligations Act are described on the pages below.

General Obligation (G.O.) Bonds

Reference Number: CTAS-1716

G.O. bonds are usually issued for buildings and other major improvements when the life of the capital improvement will last longer than 12 years. Depending on the amount to be issued in a calendar year and current Internal Revenue Service regulations, the bonds may be exempt from federal income tax. The estimated rate of interest will be from four percent to six percent at the time of the writing of this

publication. The rate will also depend on maturity of the issue and the credit rating of the issuer.

Upon the issuance of a general obligation (GO) bond, the county pledges the full faith, credit, and unlimited taxing power of the county as to all taxable property in the county or a designated portion of the county. T.C.A. § 9- 21-201. These bonds may be issued with a maturity of up to 40 years; however, investors usually prefer 15 to 20 years. T.C.A. § 9-21-213(a). Counties are generally mandated to provide various services and are given the power to provide funding for these services, with certain restrictions. Under this act, registered voters may petition the county for an election on the issuance of the proposed bonds. T.C.A. § 9-21-207. Also, the county legislative body may hold a voluntary election. T.C.A. § 9-21-208. Refer to T.C.A. §§ 9-21-101 through 9-21-216 or T.C.A. §§ 49-3-1001 through 49-3-1007 for school bonds.

Capital Outlay (C.O.) Notes

Reference Number: CTAS-1721

Capital outlay notes are used by local governments to fund many types of capital improvement projects. The notes may be issued initially for a period not to exceed the end of the third fiscal year following the fiscal year in which the notes were issued, then renewed for two more such periods not exceeding three years each with the approval of the state director of local finance. At least one-ninth of the original principal amount of these notes must be retired each year, unless this requirement is waived by the state director of local finance. T.C.A. § 9-21-604. Notes also may be issued for more than three but no longer than the 12th fiscal year following the fiscal year in which the notes were issued. T.C.A. § 9-21-608. Issues of 12-year notes totaling less than \$2 million may be sold at competitive sale or through the informal bid process described in the statute; notes totaling more than \$2 million must be sold by competitive sale. T.C.A. § 9-21-608. A major advantage of issuing capital outlay notes is that the service of a fiscal advisor may not be needed. The notes are subject to the same restrictions as G.O. bonds for exemption from federal income taxes. These notes may be issued under T.C.A. §§ 9-21-601 through 9-21-610 depending on the maturity.

Bond Anticipation Notes

Reference Number: CTAS-1722

If the market conditions are not favorable to issue G.O. bonds, a local government may issue bond anticipation notes not to exceed two two-year terms. These are obligations of the local government just like other bonds and notes; however, when the G.O. bonds are issued and the proceeds are received, these notes will be retired from the G.O. proceeds. These notes are subject to the same restrictions as G.O. bonds for exemption from federal income taxes. These notes are similar to construction loans in the business world. Using these notes allows the county time to wait for better interest rates or marketing conditions. These notes may be issued under T.C.A. §§ 9-21-501 through 9-21-505.

Revenue Bonds

Reference Number: CTAS-1723

If the capital improvement is for income producing services, such as water and sewer, the local government should consider the issuance of revenue bonds. When revenue bonds are issued, the income or revenues from the project are pledged to secure the debt. The debt will be retired from revenues or income from the user charges. These bonds may be issued under T.C.A. §§ 9-21-301 through 9-21-316.

Refunding Bonds - General Obligation and Revenue

Reference Number: CTAS-1724

When general obligation or revenue bonds are issued at high interest rates, they will have a callable feature allowing the county to recall the unpaid bonds or notes. In order to have funds to recall these bonds or notes, the county may issue refunding bonds. These bonds use the same pledge for security and replace the original issue with a lower rate of interest. By issuing the refunding bonds at a lower rate of interest, the county will save by paying less interest over the remaining term of the issue. General

obligation refunding bonds can be sold at a private negotiated sale under certain circumstances.

T.C.A. §§ 9-21-901 through 9-21-1017.

Grant Anticipation Notes

Reference Number: CTAS-1725

Whenever the county has a contract to receive a grant from the federal or state government, the county can issue grant anticipation notes of up to three years, or for longer specified periods with the approval of the state director of local finance, secured by the funds to be received under the grant. T.C.A. §§ 9-21-701 through 9-21-705.

Tax (Revenue) Anticipation Notes

Reference Number: CTAS-1726

Whenever cash flow is not sufficient to meet current expenses, which usually occurs as a result of inadequate accumulated fund balances, the county may issue revenue anticipation notes, subject to the approval of the state director of local finance. An important point: These notes must be paid off by June 30th of the fiscal year in which they are issued. This requirement insures against the approval of a deficit budget. T.C.A. §§ 9-21-801 through 9-21-803.

School Bonds

Reference Number: CTAS-1731

While bonds for school capital purposes can be issued under the Local Government Public Obligations Act, many school bonds are issued under the authority of the school laws. T.C.A. §§ 49-3-1001 through 49-3-1110. These bonds can be issued for almost any school capital project: to purchase property, to erect or repair school buildings, to furnish and equip school buildings, and to refund, call, or make payments of principal and interest on previously issued bonds, as well as to contribute or make grants to state education facilities within the county or in neighboring counties. T.C.A. § 49-3-1004. They may also be issued for the purchase of buses. T.C.A. § 49-3-1006.

These bonds are general obligation bonds, backed by the full faith and credit of the county and by its taxing authority. T.C.A. § 49-3-1005. Only one resolution of the county legislative body is necessary to authorize the issuance of this type of bond. T.C.A. § 49-3-1002. School bonds are not subject to a referendum upon petition as are general obligation bonds under the Local Government Public Obligation Act; however, the county legislative body has the authority to call for a referendum by resolution to ascertain the will of the people regarding the issue. T.C.A. § 49-2-101(5). But, since the county is required to provide public education according to state laws and regulations and is frequently under a mandate to correct deficiencies, such a referendum may serve no real purpose.

School bonds may be issued for a period of up to 40 years; however, market conditions often dictate that the bonds mature in 15 to 20 years.

The law requires counties containing city schools or special school districts to distribute the proceeds from a bond issue for school capital purposes on an average daily attendance basis, unless a tax district outside the city or special school district is established. T.C.A. §§ 49-3-1003, 49-3-1005. If a tax district is not established, city systems and special school districts are entitled to a proportional share of the proceeds of a school bond issue, or they may waive their rights to such a share. T.C.A. §§ 49-3-1003, 49-3-1005. If a tax district is established so that the school bonds are payable only from funds collected outside the city or special district, then the city or special school districts do not share in the proceeds. T.C.A. § 49-3-1005(b)(2). The same sharing rules now apply to capital outlay notes and bonds issued for school capital purposes under the Local Government Public Obligations Law. However, the disposition of proceeds of any capital outlay notes issued prior to January 15, 1998, without sharing is valid unless the disposition was challenged in court before January 15, 1998. T.C.A. §§ 9-21-120, 9-21-129.

Users of a project or school credit bond project financed pursuant to the Tennessee State School Bond Authority Act (T.C.A. § 49-3-1201 *et seq.*) are prohibited from making any changes to a project or program that would affect the tax-exempt status of the bonds or notes unless the change is approved by the office of state and local finance in the office of the comptroller and the Authority. Failure to get prior

approval renders the change void. T.C.A. § 49-3-1207.

Tennessee Local Development Authority Loans

Reference Number: CTAS-1727

The Tennessee Local Development Authority (T.C.A. § 4-31-101 *et seq.*) – made up of the governor, secretary of state, state treasurer, comptroller of the treasury, and commissioner of finance and administration – has statutory authority to borrow money in the name of the state and on the credit of the state, allowing it to lend funds to local governments for the following purposes:

1. Correctional facilities. T.C.A. §§ 4-31-102(5), 4-31-401 through 4-31-415.
2. Construction of sewage treatment works. T.C.A. §§ 4-31-102(5), 4-31- 401 through 4-31-415.
3. Waterworks. T.C.A. §§ 4-31-102(5), 4-31-401 through 4-31-415.
4. Energy recovery facilities. T.C.A. §§ 4-31-102(5), 4-31-401 through 4-31- 415.
5. Solid waste resource recovery facilities. T.C.A. §§ 4-31-102(5), 4-31-401 through 4-31-415.
6. Agriculture development. T.C.A. §§ 4-31-201 through 4-31-206.
7. Industrial development. T.C.A. §§ 4-31-301 through 4-31-308.
8. Rural fire protection equipment. T.C.A. §§ 4-31-501 through 4-31-516.
9. Airports. T.C.A. §§ 4-31-601 through 4-31-615.
10. Health facilities. T.C.A. §§ 4-31-201(5), 4-31-401 through 4-31-415, 4-31- 701 through 4-31-711.

In order to borrow from the state, a local government is required to pledge its allocation of state-shared taxes to the state for the annual interest and principal payments in case the county defaults on its obligation to pay.

The Tennessee Local Development Authority, in conjunction with the Tennessee Department of Education, is authorized to develop an enhancement program whereby the authority lends funds to eligible local governments for education capital outlay purposes. Each local government issuing debt under this program, as well as any local education agency for which such debt is issued, is empowered to assign or pledge to the authority for the repayment of the loan available local capital outlay funds, including the state share of the capital outlay portion of the nonclassroom component of BEP funding.

Users of capital projects financed by the Tennessee Local Development Authority, such as counties, are prohibited from making any changes to a project or program that would affect the tax-exempt status of the bonds or notes unless the change is approved by the office of state and local finance in the office of the comptroller and the Authority. Failure to get prior approval renders the change void. T.C.A. § 4-31-120.

Economic Development Bonds

Reference Number: CTAS-1732

There are several statutes that provide for commercial or industrial development within counties through the issuance of county bonds. Counties may use the Local Government Public Obligations Act to issue such bonds. T.C.A. § 9-21-101 *et seq.* However, counties frequently use the authority granted to industrial development corporations or through the Industrial Building Bond Act of 1955.

Industrial Development Corporations—Bonds

Reference Number: CTAS-1733

Most bonds for economic development at the city and county level are issued under the authority of industrial development corporations. The statutory authority for this type of bond issue is T.C.A. §§ 7-53-101 through 7-53-311. It is important to note that the Federal Tax Reform Act of 1986 limited the use of economic development bonds, which exempt interest from federal income taxation. See also T.C.A. §§ 9-20-101 through 9-20-106 for the state law on allocation of private activity bonds.

A county may authorize an industrial development corporation through a resolution of the county legislative body. T.C.A. §§ 7-53-201 through 7-53-204. Then the county legislative body appoints at least seven directors to the county-sponsored board who are responsible for authorizing all industrial development bonds and notes. T.C.A. § 7-53-301. An officer of a municipality, city manager, or other comparable chief administrative officer of a municipality may serve on the board of directors of a joint industrial development corporation, however, no other employee is eligible to serve.

The county is not liable for the principal or interest on any bonds issued through the corporation; however, the county may pledge its full faith and credit as surety on a bond issue, provided three-fourths of the county's voters approve the pledge. T.C.A. § 7-53-306. The pledge cannot exceed 10 percent of the total assessed valuation of the property of the county. T.C.A. § 7-53-307. Additionally, industrial development corporations may secure debt or obligations of their lessees. T.C.A. § 7-53-302.

After the corporation is established, a business or manufacturer desiring to move to the county or expand its facilities there contacts the industrial development board, usually through an attorney. Normally this contact is made after the business has a commitment from a financial institution to authorize the issuance of notes or bonds. Then, with the approval of the financial institution, a trustee is set up to receive the proceeds from the issue and to disburse the funds for the intended purpose. Once the project is completed, the borrower business makes regular payments to the trustee to amortize the principal and interest. The reason for issuing the bonds through a nonprofit governmental corporation is that the interest income to the lender is tax exempt. This feature will reduce the cost to the business for interest expense.

The business seeking the loan may borrow the principal through the corporation as a loan, or it may lease the property through the corporation. T.C.A. § 7-53-101. If the business borrows the principal through the industrial development corporation, then the property is owned in the name of the business, and property taxes are paid by the business as with any other commercial or industrial taxpayer. If it is a lease arrangement, the ownership of the property may be transferred to the business upon payment of the outstanding debt. In a lease arrangement through the corporation, the business does not pay real property taxes since the property is owned by the tax-exempt industrial development corporation, although the county may receive payments in lieu of property taxes. T.C.A. § 7-53-305.

Industrial development bonds may be issued for almost any industrial or business purpose as long as it complies with federal Internal Revenue regulations and T.C.A. § 7-53-101(13), and with the allocation limitation established by the state Department of Economic and Community Development under federal guidelines for income tax exempt bonds.

Industrial development corporations are required to maintain an aggregate listing of current debt, including conduit debt obligations and to file the listing with the state funding board at the end of each fiscal year. Industrial development corporations must also file notice of default on any debt obligations with the state funding board within 15 days of the default. T.C.A. § 7-53-304.

Industrial Building Bond Act of 1955

Reference Number: CTAS-1734

Bonds issued under this act are general obligation bonds of the county for which the full faith and credit and unlimited taxing power of the county are pledged in the event that rental income from the business is not sufficient to retire the debt. T.C.A. § 7-55-111. Before the bonds are issued, however, they must be approved by a three-fourths majority of the county's registered voters. T.C.A. § 7-55-107. The authority for this type of bond issue is found in T.C.A. §§ 7-55-101 through 7-55-116.

Industrial Building Revenue Bond Act

Reference Number: CTAS-1735

This act, found in T.C.A. §§ 7-37-101 through 7-37-116, allows the county to issue industrial bonds by pledging only the rental income from the business. Although there is no liability to the county, the voters must approve the issue by a three-fourths majority.

Federal Loans

Reference Number: CTAS-1728

Loans may be available to some local governments from various federal agencies, such as Farmers Home Administration. The local government is advised to check to see if such loans are available because the interest rates may be lower than the general market.

Lease/Purchase Agreements

Reference Number: CTAS-1729

Local governments may contract for the purchase of capital improvements using a contract, lease, or lease/purchase arrangement. T.C.A. § 7-51-901 *et seq.* The conditions and interest rates should be checked closely since the plan may cost more than the issuance of notes or bonds. Also, follow restrictions as prescribed in the state law authorizing the use of such agreements. Contracts should contain a "funding out" clause in the event funds are not appropriated in subsequent years. Leases for capital improvement property cannot exceed 40 years or the useful life of the project and must be approved by the county governing body. T.C.A. §§ 7-51-902 through 7-51-904. If the term of any lease exceeds five years, public notice of the meeting at which the project will be discussed must be given at least seven days prior to the meeting. T.C.A. § 7-51-904.

Recommended Practice: Use of Lease/Purchase Agreement should be carefully considered and generally not used.

The Uniformity in Local Government Lease Financing Act

Reference Number: CTAS-2479

Although the Uniformity in Local Government Financing Act became effective April 22, 2021, the terms of the Act apply to lease financing authorized by the local governing body on or after January 1, 2022, and are described below.

Pursuant to T.C.A. § 9-24-102((5), lease financing is defined as any lease under which (1) the rental payments by the public entity include an identifiable interest component; or (2) the lessee has a right to purchase the property subject to the lease price that is not based upon the fair market value of the property at the time of purchase.

Exempt lease financing is lease financing with a principal amount not exceeding \$100,000 and does not include a lease financing if the principal amount of that lease financing together with the principal amount of all exempt lease financing issued by the public entity previously in the same fiscal year exceeds (\$100,000); See T.C.A. § 9-24-102((1).

Local governments and other public entities, as defined by T.C.A. § 9-24-104, must adhere to the following requirements in connection with approving and entering into any lease financing that is not exempt:

1. Before entering any lease financing, a local government is required to get approval from the comptroller of treasury or comptroller's designee (comptroller) according to the procedures described below. Once approved by the comptroller, the proposed lease financing must be submitted to the governing body for consideration;
2. The weighted average maturity of the principal payments under the lease financing must not exceed the estimated weighted average life of the property financed through the lease financing;
3. Local governments are not permitted to enter into a lease financing concerning property unless authorized by applicable law to incur indebtedness to finance such property, and the term of any lease financing must not exceed the maximum term of debt that the local government could issue to finance the property being leased;
4. If the indebtedness of the local government is only payable according to applicable law from all or any portion of the revenues of the local government, the payments under the lease financing must only be payable from such revenues; and
5. If the lease payments under the lease financing are payable from or secured by ad valorem taxes of the local government and the term exceeds the maximum term of a capital outlay note that the local government may issue under chapter 21, part 6 of the Tennessee Code Annotated, the local government is not permitted to enter into the lease financing without adopting and publishing an initial resolution for the lease financing in the manner described in chapter 21, part 2 of the

Tennessee Code Annotated, if an initial resolution is required for the type of property being financed, and, if required by the terms of such part, undertaking an election for the lease financing in the manner required by that part.

Requesting Approval from the Comptroller — When requesting approval, a local government must submit a plan of lease financing to the comptroller of the treasury. The comptroller may request any additional information required to properly review the proposed plan of lease financing. The comptroller will evaluate each plan of lease financing based on the plan's particular circumstances and approve the plan only if a determination is made that the repayment terms are in the public's interest. The comptroller will report the approval or disapproval of the plan of lease financing to the governing body within fifteen (15) business days after receipt of the plan, and all requested supplemental documentation. T.C.A. § 9-24-104.

The governing body may act on the proposed plan of lease financing, (1) after receiving the approval of the comptroller; or (2) after the expiration of fifteen (15) business days from the date the plan of lease financing is received by the comptroller and no disapproval having been reported by the comptroller, whichever date is earlier, the governing body may take such action concerning the proposed plan of lease financing as it deems advisable in accordance with T.C.A. § 9-24-104.

All property leased by a local government is deemed property owned by the local government for purposes of and such property is exempt from taxation to the extent property owned by the local government is otherwise exempt from taxation.

Other Bonds

Reference Number: CTAS-1730

There are many other statutes that authorize the county to issue bonds. The list below includes many of them:

1. Airports. T.C.A. §§ 42-5-101 through 42-5-205.
2. Conservation of Natural Resources and Public Recreation. T.C.A. §§ 11-21-101 through 11-21-109.
3. Drainage Projects. T.C.A. §§ 69-6-101 through 69-6-1303.
4. Electrical Plants. T.C.A. § 7-52-103.
5. Electric Power Acquisition (revenue bonds). T.C.A. §§ 7-34-102, 7-34- 104.
6. Fords, Ferries and Bridges. T.C.A. §§ 54-11-101 through 54-11-308.
7. Forestry Land. T.C.A. §§ 11-23-101 through 11-23-105.
8. Garbage and Disposal Services. T.C.A. § 5-19-111.
9. Highways. T.C.A. §§ 54-9-101 through 54-9-212.
10. Housing Projects. T.C.A. §§ 7-60-101 through 7-60-217; T.C.A. §§ 13-20-501 through 13-20-614.
11. Hospitals, Metropolitan Government. T.C.A. §§ 7-57-101 through 7-57-404.
12. Levees. T.C.A. §§ 69-5-101 through 69-5-108.
13. Libraries. T.C.A. §§ 10-3-101 through 10-3-111.
14. Medical Arts Buildings. T.C.A. §§ 68-11-605 through 68-11-615.
15. Public Building Authority. T.C.A. §§ 12-10-110 through 12-10-122.
16. Recreational Land Facilities. T.C.A. §§ 11-24-103 through 11-24-110.
17. Road Improvement Districts. T.C.A. §§ 54-12-101 through 54-12-426.
18. Solid Waste Disposal. T.C.A. §§ 68-211-901 through 68-211-925.
19. Transportation System (Transit). T.C.A. §§ 7-56-101 through 7-56-109.
20. Transportation System (Rail). T.C.A. §§ 7-56-201 through 7-56-213.
21. Urban Type Public Facilities (Sewer lines, incinerators, water pipelines, and docks). T.C.A. § 5-16-106.
22. Veterans Memorials. T.C.A. §§ 58-4-208 through 58-4-218.
23. Voting Machines. T.C.A. § 2-9-111 (State Financing: T.C.A. § 2-9-112).

24. Water Supply and Waste Treatment. T.C.A. §§ 68-221-101 through 68-221-1015.

25. Watershed Districts and Projects. T.C.A. §§ 69-7-101 through 69-7-149.

Consult with a financial advisor because legal and market conditions will dictate the best method of financing the project.

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