COVER STORY

# Funding Capital Improvements

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*This article is intended to update a series of articles published by this author in the September 1999* Michigan Township News. *Since that time, there have been changes in the law affecting the funding of capital improvements, the most notable of which was the Revised Municipal Finance Act, which became law in 2002.*

In the course of providing services to residents, township boards are often faced with the challenge of funding capital improvements, which can vary widely—from purchasing a new computer or fire truck to building a new fire station, library or township hall, to participating in a road paving program or installing water and sewer lines.

As infrastructure ages, local officials must grapple with the issues of replacing capital assets, meeting new needs and deciding how to fund these projects—many of which require large amounts of money. This article will help township officials meet funding challenges by examining the available options for townships to pay for capital improvements. The laws that authorize townships to borrow money and issue debt instruments are also highlighted.

### *Planning Fosters Efficient Use of Funds*

Advance planning is the single best tool township officials can employ to develop an overall township strategy of when and how to acquire and fund capital improvements for which there is an identified local need. The Township Planning Act authorizes a township to adopt a capital improvement program (MCL 125.330(2)). A written capital improvement plan (CIP) should anticipate acquisitions of land, buildings and equipment for the current year, the ensuing budget year, and three or more years beyond. It allows decision-makers to simultaneously scrutinize all alternatives and establish priorities based on a rational selection process. Consequently, a township board can effectively use scarce township dollars.

While the Uniform Budgeting and Accounting Act, Public Act 2 of 1968, no longer requires townships to annually plan for capital improvements as part of the budget process—due to a 2000 amendment removing the requirement—all townships are urged to continue to do so, to adequately anticipate and plan for necessary improvements to the township.

Townships are well advised to plan for an additional three years, for a total of six years beyond the fiscal year covered by the township budget. Long-term planning is especially warranted for water and sewer utilities, and projects that require cooperation with neighboring communities, such as joint fire departments, district libraries and long-term infrastructure needs identified in the township master plan.

Section 10(1) of the Township Planning Act also mandates the township planning commission—where one has been appointed—to review and approve the "location, character and extent" of any "street, square, park or other public way, ground or open space, or public building or structure" after a master plan has been adopted (MCL 125.330(1)). This often-overlooked authority within the act is intended to ensure that these public improvements conform to the master plan and that the planning commission is aware of the improvements before they are constructed. If the planning commission disapproves a township project, a majority vote of the township board is required to override that action.

The most simple, proactive way to implement this review in townships with a master plan is to involve the planning commission in preparing the CIP by enabling planning commission members to review applicable capital projects in conjunction with the township board's financial planning process.

### *Options to Fund Capital Improvements*

There are a variety of sources available to fund capital improvements. While legal, political and economic constraints determine the most appropriate financing method, careful planning may leverage existing township revenues to meet the needs of township residents. If borrowing is required, township officials should proceed cautiously to ensure that all applicable state and federal requirements are strictly met. The following are common approaches to funding capital outlays:

**Grants.** Probably the best way to fund a capital improvement is to use federal or state grant funds, if available. Capital improvement plans may help townships successfully apply for grants. Funding entities award most grants on a competitive basis, and applicants must often prove a greater need than that of other communities seeking the grant. Having a project identified in a capital improvement plan demonstrates that the township identified the project as a priority, and that township officials have a level of professional administration and governance to carry out a project.

A directory of state-administered grant programs is available from the House Fiscal Agency. Last updated for the 2003-2004 fiscal year, this directory contains information on a variety of capital improvement programs, such as water, sewer and drain infrastructure, primarily for economic development or low-income communities; public libraries; road paving and other transportation enhancements such as bike paths; historic preservation; low-income housing; and recreational boating and park facilities. For a free copy of the directory, call (517) 373-8080, or visit www.house.mi.gov/hfa and click on "Reports," then "Publications."

**Current township funds.** Typically, the next best source of capital improvement funding is to use current township surpluses or accumu-

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## Township Debt Limits

State law limits the total amount of different types of debt townships may incur. These limits are set by reference to total township assessed valuation, state equalized valuation or taxable value as follows:

| Type of Debt | Debt Limit | Applicable to Charter Townships | Applicable to General Law Townships |
|---|---|---|---|
| Voted general obligation bonds for township buildings (MCL 41.416c) | 5 percent of assessed value | Yes | Yes |
| Voted general obligation bonds for road improvements by contract with county road commission (MCL 247.355) | 10 percent of assessed value | Yes | Yes |
| Capital improvement bonds (MCL 141.2517) | 5 percent of state equalized valuation | Yes | Yes |
| Special assessment bonds—total issued in a calendar year, unless higher amount is approved by voters (MCL 141.2505) | 3 percent of assessed value | Yes | Yes |
| Special assessment bonds—total outstanding (MCL 141.2505) | 12 percent of assessed value | Yes | Yes |
| Installment purchase agreements (MCL 123.721) | 1¼ percent of taxable value | Yes | Yes |
| Net total debt (MCL 42.14a) | 10 percent of assessed value | Yes | No |

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lated fund balances. It may be possible to fund small capital acquisitions entirely from the current budget. This pay-as-you-go method does not incur interest charges on borrowed funds or the legal and accounting costs associated with incurring debt. To fund larger capital improvements, townships can earmark surplus revenues by transferring money to a capital improvement fund or by adopting a resolution to restrict some of the general fund equity. For instance, some townships successfully pay cash for fire trucks by setting aside funds each year into a segregated fund.

**Extra-voted millages.** Some townships levy an extra-voted millage for specified types of capital improvement projects. This method is often used to fund township road paving projects or purchase fire apparatus. The money raised from a voted millage may be used to fund a pay-as-you-go program—i.e., to pave one mile of road per year or to accumulate funds over several years to fund a cash purchase of fire turnout gear, for instance. Another example is if the township cannot wait long enough to accumulate the funds necessary for a cash purchase, and if authorized by the terms of the ballot proposal, the millage revenue may be applied to pay principal and interest on a bond or an installment purchase agreement used to fund a current capital purchase.

**Special assessments.** Special assessments provide a useful method of raising money from properties that receive a special benefit from capital improvements. Townships can only levy special assessments for purposes specifically authorized by statute. For instance, the Township Public Improvement Act, PA 188 of 1954 (MCL 41.721), authorizes special assessment districts for storm and sanitary sewers, water mains, public and private roads, lighting systems, sidewalks, and other special improvements. PA 33 of 1951 (MCL 41.801) authorizes townships to levy special assessments to purchase, house or operate police or fire equipment. Other statutes authorize special assessments for dust control, erosion control structures and public transportation, to name a few. Procedural requirements vary from statute to statute, and failure to follow them may make a special assessment voidable.

Once a special assessment is levied, if it is payable in a single installment by the benefited property owners, the proceeds may be used as cash to fund capital improvements on a pay-as-you-go basis. This approach is often used to provide street lighting. Alternatively, if the special assessments are payable in multiple annual installments, a township may borrow money, pledging the special assessments as collateral to repay the bonds. In this case, the proceeds of the bond issue are used to fund the project.

**Borrowing.** In general, if a township does not have grant funds or sufficient cash on hand to pay for capital improvements, or is unable to anticipate revenue sources to generate cash, the township must consider borrowing money to fund its capital improvements.

The authority for townships to borrow money and incur debt must be provided by a specific law. According to the 1963 Michigan Constitution, Article 7, Section 17, "Each organized township shall be a body corporate with powers and immunities provided by law."

MCL 41.3 states that general law township boards or a township officer "shall not create a debt or liability against the township ... unless the creation of the debt or liability or the payment of money has been authorized by vote of the registered electors of the township or by law."

MCL 42.14a states that a charter township "(1) ... may borrow money and issue bonds on the credit of the township for the purpose of constructing or otherwise acquiring a public improvement ... (2) Bonds shall not be issued, except special assessment bonds, bonds for the township portion of local improvements, and bonds which the township board is authorized by a specific statute to issue without vote of the electors, unless approved by a majority of the electors voting at an ... election."

Charter townships are limited to the amount of net indebtedness incurred to 10 percent of the total township assessed valuation (MCL 42.14a). Net indebtedness does not include several types of bonds, including special assessment and revenue bonds. General law townships are not statutorily constrained as to the overall amount of bonded indebtedness allowed. However, separate limitations are set for certain types of financing. For example, a maximum limit of 5 percent of assessed value applies to certain general obligation bonds. For more information see "Township Debt Limits" on page 11.

### *State Regulates Borrowing*

Effective March 1, 2002, the Municipal Finance Act, which has provided guidance and state oversight on local government borrowing since 1943, was repealed and replaced by the Revised Municipal Finance Act under the terms of PA 34 of 2001 (MCL 141.2101). Like its predecessor, the Revised Municipal Finance Act directs the Michigan Department of Treasury to regulate township and other municipal borrowing, with an overriding goal of protecting state taxpayers, and the credit of the state and local municipalities.

To engage in most types of borrowing, with installment purchase agreements being a notable exception, a township must, as a general rule, be pre-qualified on an annual basis to issue municipal securities. Eligibility for "qualified status" is dependent upon compliance with statutory criteria indicative of a financially "healthy" township. See "Steps to Be Deemed 'Qualified' to Issue Bonds and Notes in Michigan" on page 13 for more information.

Municipalities that are denied qualified status are subject to a longer, more extensive case-by-case prior application review by the Department of Treasury before being approved to borrow money. This lengthier process can typically add several weeks or more to the process of issuing bonds.

Moreover, the statutory fee structure

imposed by the Revised Municipal Finance Act imposes a higher fee–a minimum of $800 and maximum of $2,000–per bond issue for a municipality that is subject to the prior approval process. In contrast, a township that attains qualified status is subject to a minimum fee of $100 for a bond issue of up to $500,000, and a maximum fee of $1,000 for bond issues of $5 million or more.

The Revised Municipal Finance Act updated and expanded the authority of townships to negotiate the sale of bonds, and to authorize township officials to approve terms of bond issues within preset limits. In addition, it authorized several new types of municipal borrowing, including capital improvement bonds and short-term notes issued in anticipation of bond proceeds and grant proceeds. The act also regulates other aspects of township borrowing, including the structure, features and method of a bond issue sale, the levy of voted debt millage, the debt retirement funds set aside to repay the loan, the transfer of surplus debt retirement fund monies after payment in full of a bond issue, and refunding/refinancing outstanding debt.

If a township fails to pay scheduled debt payments, the state treasurer has broad powers to investigate the township's fiscal affairs and develop a payment plan for the defaulted debt.

### *Federal Government Regulates Borrowing, Too*

The Internal Revenue Code of 1986 provides an indirect "subsidy" to townships by making the interest paid on township bond issues exempt from federal income tax, if the requirements of the Internal Revenue Code are met. This enables townships to borrow money at more favorable interest rates than private individuals or businesses. For instance, in April 2005, the *Bond Buyer's* index for 20-year general obligation municipal bonds varied from 4.37 percent to 4.61 percent, while, as reported in the *Wall Street Journal* on May 3, 2005, the prime interest rate at banks was 5.75 percent, and 30-year mortgage rates averaged 5.31 percent.

Federal tax law requirements are very extensive and regulate all aspects of municipal borrowing, including the amount which may be borrowed, when loans should be incurred, how townships must handle the loan proceeds before they are expended, how townships should handle money set aside to repay the loan, and how existing bond issues can be refinanced. For more information, see "Township Borrowing is Subject to Federal Tax Considerations" on page 16.

In addition to the federal tax exemption, interest on Michigan municipal bonds is also generally exempt from state income taxes.

Because township bonds and other loan obligations are securities, they are also regulated by federal securities laws. Municipal bonds, as a general rule, do not have to be registered with the Securities and Exchange Commission, like stock offerings or other corporate securities. However, a township, when proposing to borrow money, must provide all material information to the lender or potential bond purchaser that a reasonable investor may need to decide whether to invest in a township bond issue. These requirements are more extensive when a township borrows more than $1 million. For more information, see "Township Borrowing is Subject to Securities Law" on page 15.

### *Numerous Borrowing Methods Available*

Michigan law provides a number of alternative methods for general law and charter townships to finance local public improvements. There are currently more than 30 enabling statutes that authorize townships to borrow money and issue debt instruments for various types of public improvements. Township borrowing may take the form of a bond, note, installment purchase agreement or lease purchase agreement. A bond or note establishes the obligation of the township to repay a specific sum of money at a specific interest rate on specified dates.

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## Steps to Be Deemed 'Qualified' to Issue Bonds and Notes in Michigan

(1) File annual audit with the Department of Treasury within six months after close of the township's fiscal year (or, if an extension to file annual audit has been approved, within the extension period).

(2) File Municipal Finance Qualifying Statement online at https://treas-secure.state.mi.us/mfd/. A password must be requested by the township supervisor—the only township representative authorized to request such information—from the Department of Treasury's Local Audit and Finance Division at (517) 373-0660.

Once the supervisor has obtained a password, visit the above Web site, and follow the steps to complete the qualifying statement.

## Common Reasons a Township May Be Denied Qualified Status

- Failed to file audit within six months of the end of the township's fiscal year.
- Borrowed money in violation of state law (i.e., obtained a commercial loan or mortgage from a bank to finance a purchase or project, which is *not* permitted under state law).
- Delinquent taxes are greater than 18 percent of the total taxes levied by the township.
- In default on the payment of any debt.

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Typically the sources of repayment and type of collateral pledged to secure repayment are also specified.

Types of debt instruments, which may be issued by or on behalf of townships, include the following:

**General obligation bonds.** These bonds are backed by the authority to raise taxes. The Michigan Constitution and the Unlimited Tax Election Act (MCL 141.161, *et seq*) require all general obligation bonds supported by an increase in millage over allocated or charter limits to be approved by voters prior to issuance. These bonds are sometimes called "full faith and credit" bonds because they pledge tax revenues to the bond purchaser to satisfy the debt. General obligation bonds are generally viewed by potential municipal bond investors as the most secure debt instrument and, therefore, bear the lowest interest rates.

PA 116 of 1923 (MCL 41.416) authorizes general law townships to issue general obligation bonds to finance township halls, fire stations, libraries and other township public buildings. The bonds may not exceed 5 percent of a township's assessed value. PA 359 of 1947 (MCL 42.14a) authorizes charter townships to finance these same improvements.

PA 111 of 1956 (MCL 247.351) authorizes general law and charter townships to issue general obligation bonds to fund highway improvements, including bridges, drains and traffic control devices. Improvements are made by the county road commission pursuant to a contract with the township. Bonds cannot exceed 10 percent of the township's assessed value.

General obligation bonds are a good way to finance improvements if the township needs a millage increase to repay debt service on the bonds. In addition, when voters approve a ballot proposal to issue the bonds, the township board can proceed with the capital improvement project, having a high level of confidence that the project is supported by the public.

**Capital improvement bonds.** This is a new type of bond first authorized by the Revised Municipal Finance Act (MCL 141.2517). A township is authorized to issue capital improvement bonds to pay the cost of any capital improvement item provided that the principal and interest on the bonds is payable from existing sources of revenue, including currently authorized tax levies. Qualifying capital improvements include land and any item of real or personal property, which is subject to depreciation under generally accepted accounting principles.

The issuance of the capital improvement bonds is subject to a right of referendum, which is commenced by publication (in a newspaper of general circulation in the township) of an advertisement which must be at least a quarter-page in size and which states the township's intent to issue the bonds. If during the 45-day referendum period that follows the publication, petitions are signed by not less than 10 percent of registered electors residing in the township and filed with the township clerk, then the township may not proceed with the issuance of the bonds until approved by a vote of the township electors at a township election.

Capital improvement bonds may not exceed 5 percent of the state equalized valuation of the township.

**Revenue bonds.** These bonds are backed by a specific fixed revenue source, such as user fees. Typically, revenue bonds are not secured by a township's full faith and credit. The Revenue Bond Act, PA 94 of 1933 (MCL 141.101), does not require voter approval prior to issuing the bonds, unless a referendum petition is filed. The referendum period is 45 days following publication of a referendum notice, and petitions requesting an election on issuing bonds must be signed by 10 percent of the registered voters of the township. If sufficient petitions are filed with the township clerk, the bonds may not be issued until approved by voters at a township election.

Revenue bonds may be issued for many types of public improvements, including housing facilities; garbage and rubbish disposal; public water systems; sanitary and storm sewers; utility, cable television and telephone systems; parking facilities; hospitals; and bridges.

Typically, townships use revenue bonds to finance sewer or water systems that only service specified township areas. A revenue bond is excluded from the determination of the 10 percent debt limit applicable to charter townships.

Revenue bonds are a good way to finance eligible improvements without exposing the township's general fund to risk because the bonds are fully repaid by user fees. Since a township typically does not pledge its full faith and credit to back the payment of revenue bonds, these bonds often bear a higher interest rate than general obligation bonds.

Another disadvantage to using a revenue bond is that the right of referendum applies to all township residents even though the project may only benefit a portion of the township. For instance, a township may use revenue bonds to finance a sewer system

## Township Borrowing is Subject to Securities Laws

Bonds and other township obligations are subject to state and federal securities laws, enacted primarily to protect investors from being defrauded. While most municipal bonds do not have to be registered with the Securities and Exchange Commission (SEC), townships are obligated to provide all material information that a reasonable investor may need to make an investment decision.

The basic standard for information disclosure in the securities laws provides that, in connection with the purchase or sale of a security, a person shall not make any untrue statement of material fact or omit to state a material fact necessary to make the statements—in light of the circumstances under which they are made—not misleading.

In 1989, the SEC issued Rule 15c2-12, pursuant to the Securities Exchange Act of 1934, which requires townships issuing bonds of $1 million or more to prepare a formal document, called an "official statement," to disclose material information about the township and the proposed bond issue.

Bond issues of less than $1 million do not require an official statement. However, the township must provide material information that a reasonable investor may need to decide whether to invest in a township bond issue. The Municipal Advisory Council of Michigan (MAC) prepares information reports for each competitively sold Michigan bond issue. Townships may use an MAC report to distribute information about the township, but the report may not substitute for an official statement.

In 1995, SEC Rule 15c2-12 was amended to require continuing disclosure for bond issue and other obligations exceeding $1 million in principal amount. This rule is intended to protect investors who purchase municipal bonds in the secondary market, after the initial bond issue date. Subject to specific exceptions, this is an ongoing requirement for issuers and other obligated persons to provide annual financial information, operating data, notices of bond payment defaults or prepayments, and other specified events to designated information repositories.

In general, a township may be assisted by its bond attorney and financial advisor to identify and comply with applicable securities law requirements.

installed around a lake area. While only those residents who live in the lake area benefit from the improvement, any township resident can sign a petition requesting an election to vote on the bond issue.

**Special assessment bonds.** A special assessment bond is used to finance the cost of improvements for which the township has levied special assessments against specially benefited properties. Typically, this includes establishing as a special assessment district a small area of the township benefited by such improvements as a road improvement project or sewer system installation.

PA 188 of 1954 (MCL 41.721) authorizes townships to issue special assessment bonds to fund public improvements, including storm and sanitary sewers, public water systems, public and private roads, sidewalks, public parks, bicycle paths, lighting systems, and aquatic weed control. PA 33 of 1951 (MCL 41.801) authorizes townships to issue special assessment bonds to fund the purchase and housing of police and fire equipment.

While it is typical to have the township pledge its full faith and credit to further secure special assessment bonds, the bonds may not be issued for an amount greater than the special assessment roll approved for the project. A special assessment bond is subject to voter approval if it exceeds 3 percent of the township's assessed valuation.

A township that proposes to specially assess the cost of sewer improvements around a township lake may find that the size of the project causes the special assessment roll to exceed 3 percent of the township's assessed valuation—an annual limit for issuing special assessment bonds imposed by the Revised Municipal Finance Act. In this instance, rather than fund the project using special assessment bonds, which would be subject to an election to override the 3 percent limit, the township may consider using contract bonds to finance the project.

**Contract/assessment bonds.** These are bonds issued by a separate entity on behalf of the township, such as a building authority, a joint sewer and water authority, or the county. PA 31 of 1948 (MCL 123.951) authorizes a township to incorporate a building authority, which may issue bonds pursuant to a contract with the township to finance and construct public buildings, parking lots, structures, recreational facilities and stadiums. The contract between the building authority and township is subject to a right of referendum. Two or more townships may incorporate a joint building authority to finance a single project, such as a jointly funded fire station.

PA 233 of 1955 (MCL 124.281) authorizes two or more townships or other municipalities to establish a joint authority, which may issue revenue or contract bonds for sewer and water systems. Both the contract supporting the contract bonds and the revenue bonds are subject to a right of referendum.

PA 185 of 1957 (MCL 123.731) and PA 342 of 1939 (MCL 46.171) authorize a county to issue bonds for public water and sewer projects pursuant to a contract with the township. An Act 342 contract is subject to a right of referendum; however, an Act 185 contract is not. Deciding whether to request a county to issue bonds under Act 185 or Act 342 for a water or sewer project can depend on whether the township wants to avoid a referendum petition or be subject to a right of referendum. A township considering an Act 342 project subject to a right of referendum may be concerned that any voter registered in the township may sign a referendum petition or vote in an election even if the project only includes a small portion of the township to be served by a sewer system, for example.

Contract bonds are a good way to finance improvements if a township is limited by

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the 3 percent annual limit on special assessment bonds. A township can also combine several different revenue sources–such as special assessments, connection fees and debt service charges–to repay the bonds. Bonds issued by a county are particularly attractive to a township because they can generally be sold at lower interest rates than a similar township issue, thereby benefiting township residents and property owners.

Similar to contract bonds are assessment bonds issued by a county drainage district for storm sewers under the Drain Code of 1956 (MCL 280.1). The drain proceedings may be commenced by a township petition, and in turn, the township receives a drain assessment for the cost. The township can levy special assessments on benefited properties to defray the county drain assessment.

**Tax increment bonds.** Tax increment financing is a method of financing public improvements, infrastructure or other activities within a designated area or district in a community. As industrial or commercial growth occurs in the district, the assessed property valuations and property taxes increase. Subject to specified limitations, a tax increment financing authority "captures" from the local non-school taxing units the additional ad valorem property tax revenues resulting from the increase in taxable value to pay the cost of completed or future improvements, or to pay off bonds issued to finance the improvements.

Townships, within specified statutory limits, may utilize tax increment financing by establishing a downtown development authority authorized by PA 197 of 1975 (MCL 125.1651), a local development finance authority authorized by PA 281 of 1986 (MCL 125.2151), or a brownfield redevelopment authority, authorized by PA 381 of 1996 (MCL 125.2651). The specific requirements of each act must be carefully implemented to create a valid authority.

**Installment purchase contracts/agreements.** PA 99 of 1933 (MCL 123.721) authorizes townships to enter into contracts or agreements to purchase real or personal property for public purposes on an installment basis without qualification or approval under the Revised Municipal Finance Act. The installment contract is limited to 15 years or the useful life of the acquired property, whichever is less. The outstanding balance of all installment purchase contracts cannot exceed 1.25 percent of a township's taxable value. These contracts are not subject to election or right of referendum.

An installment purchase agreement or contract is a flexible way to finance real and personal property for relatively small capital acquisitions, provided that a local bank or the equipment vendor is willing to provide financing. Using an installment purchase agreement or contract to borrow money is typically more expedient and less expensive to implement than a township bond issue.

**Title retaining/secured contracts.** PA 205 of 1964 (MCL 141.451) allows townships to purchase fire trucks, apparatus and equipment by entering into title retaining or secured contracts. The contracts cannot exceed six years or the estimated useful life of the purchase, whichever is less. State qualification or approval under the Revised Municipal Finance Act is not required.

Using a title retaining or secured contract is an effective way to finance fire equipment if the equipment vendor requires that it retain title until receiving payment in full of the debt. The disadvantage is that the loan must be paid off in six years or less. In contrast, using an installment purchase agreement under PA 99 of 1933 provides the township the useful life of the equipment, if longer than six years, to pay off the debt, with a maximum of 15 years.

**Short-term anticipation note borrowing**. The Revised Municipal Finance Act added several alternative methods for townships to issue short-term notes in anticipation of permanent financing. First, a township may issue bond anticipation notes in anticipation of the proceeds of a long-term bond

## Township Borrowing is Subject to Federal Tax Considerations

A township that borrows money must comply with Internal Revenue Code requirements for tax-exempt municipal obligations. While this article reviews some of the principal requirements, townships should obtain the advice of a municipal bond attorney to comply with the numerous tax requirements that apply to most tax-exempt municipal obligations.

**Reimbursement Regulations Must Be Strictly Followed.** Using bond proceeds to reimburse township expenditures made prior to the date of the bond issue is restricted by U.S. Treasury Regulation Section 1.150-2. To preserve the right to use bond proceeds to reimburse prior expenditures, a township must adopt an "official intent," typically by resolution, no more than 60 days after making an expenditure to declare the township's intention to reimburse the expenditures from bond proceeds.

Exceptions to the official intent requirement include: (1) the costs of bond issuance or other amounts are not more than $100,000 or 5 percent of the bond proceeds, whichever is less, and

(2) certain preliminary expenditures including engineering, surveying and similar costs incurred prior to constructing or acquiring a capital project, as long as these preliminary expenditures do not exceed 20 percent of the bond's issue price. These preliminary expenditures cannot include land acquisition or site preparation costs. If a township fails to comply with the reimbursement regulations and uses bond issue proceeds to reimburse prior expenditures that do not qualify for an exemption, the township bond issue will lose its tax-exempt status.

**Qualified Tax-Exempt Obligations Often Have Low Interest Rates.** Section 265(b)(3) of the code authorizes a township to affirmatively designate its bonds or other obligations as "qualified tax-exempt" or "bank-qualified" obligations, enabling a bank to partially deduct the bank's interest expense allocated to the interest on the bonds. This makes qualified tax-exempt obligations more attractive to banks, which in turn, will typically bid a lower interest rate for these obligations. Only a township that issues less than $10 million of tax-exempt obligations in one year may certify its obligations as qualified tax-exempt obligations. Private activity bonds do not qualify for this designation.

**Townships Must Report Bond Issue Information to the IRS.** As a precondition to preserving the tax-exempt status of bonds and other debt obligations, townships are required by Section 149(e) of the code to file an informational tax return with the IRS. This is a one-time filing made after the bond issue date. Obligations smaller than $100,000 use IRS Form 8038-GC, and obligations $100,000 or larger use IRS Form

8038-G. If a township does not file the form with the IRS, the obligation loses its tax-exempt status.

**Private Activity Bonds May Not Be Tax-Exempt.** Township borrowing must be carefully analyzed to determine whether a debt obligation constitutes a private activity bond, as defined in Section 141 of the Internal Revenue Code of 1986 and the related U.S. Treasury regulations. This applies to bonds, notes and contracts issued as debt instruments. A bond issue may be considered a private activity bond if:

- More than 10 percent of the bond's proceeds are used for any private business purpose, and
- The payment of the principal and interest on more than 10 percent of the bond's proceeds is directly or indirectly secured by property used by a private business or is derived from payments in respect of property used for private business purposes.

Debt obligations characterized as private activity bonds are less likely to be issued on a tax-exempt basis for purposes of federal tax law and may have to be issued as taxable obligations, causing the township to pay a higher interest rate.

A general obligation bond issued to build a new township hall used mostly for township purposes and not leased for private use on a long-term basis is not a private activity bond. Renting the hall for per-day private events is generally permissible and does not trigger private activity bond status. However, a bond issued to build a new township hall where 50 percent of the building is leased to a business to generate rental income for the township would likely be characterized as a private activity bond. A bond issued through a township economic development corporation to build a new manufacturing facility for private business would also be a private activity bond.

**Debt Obligations That Violate Arbitrage Restrictions Lose Tax-Exempt Status.** Township bonds and other obligations must comply with the arbitrage restrictions of Section 148 of the code. These restrictions are basically intended to prevent municipalities from abusing the tax-exempt status of their bonds by investing bond proceeds in higher-yielding investments.

The arbitrage restrictions are set forth in lengthy U.S. Treasury regulations and affect the timing, amount and expenditure of bond proceeds, the investment of bond proceeds, the debt service funds collected to pay principal and interest on the bonds, and the financing or refunding of outstanding bonds. Townships that issue less than $5 million of tax-exempt obligations in a year are exempt from a requirement to rebate certain earnings on bond proceeds to the U.S. Treasury. Debt obligations that violate the arbitrage restrictions lose their tax-exempt status.

issue. The notes may be sold for a maximum term of three years and may not exceed 50 percent of the principal amount of the proposed bond issue. The notes must be paid within 60 days after the bonds are issued. Bond anticipation notes may be considered in a circumstance where the township does not have adequate funds on hand to pay consultants to design an extensive project such as a sewer system, but yet the township does not want to sell the long-term bonds until the project is designed and construction bids are received. (MCL 141.2413)

The Revised Municipal Finance Act also authorizes short-term notes to be issued in anticipation of the receipt of state or federal grants. These notes may be issued for up to 50 percent of the amount yet to be received from the grant, provided that a written grant contract has been accepted by the township board. The notes are secured by a pledge of the grant proceeds. (MCL 141.2415)

### *Recent Reforms Limit Election Scheduling Flexibility*

Certain types of township bond issues are either subject to right of referendum, which may lead to an election if sufficient petitions are signed by township voters, or must simply be approved by township voters before the bonds may be issued. Extensive reforms to the Michigan Election Laws were made in 2004, resulting in four regular election dates each year to be held in February, May, August and November. A township that wishes to submit a ballot proposal to its electors must do so at one of these regular elections.

Townships no longer have the broad discretion to schedule a special election, which, under prior election law, could be held on any day subject to approval by the County Election Scheduling Commission. One disadvantage of the new requirement to use the four election dates each year is that townships may be competing with ballot proposals submitted by overlapping units of government, such as school districts, for voter approval. This could lead to township voters picking and choosing whether to support a school bond proposal or a township bond proposal. Townships may wish to identify a regular election date when the township proposal may be the only item on the ballot.

### *Consultants Can Assist with Borrowing*

A bond attorney can help a township comply with the legal requirements for borrowing money and selling bonds, as well as provide a written legal opinion that the bonds are valid and the interest paid is exempt from federal and state income taxes. A bond attorney typically assists the township in preparing applicable resolutions, ordinances, elections, public hearing and other matters related to financing capital improvements.

A financial consultant can help a township determine the best method of financing a proposed project, file the paperwork and applications required by the Michigan Department of Treasury, and determine whether a bond issue can by insured by the municipal bond insurers or if the township should secure ratings from one or more major rating agencies. In addition, a financial consultant assists with the sale of the bonds.

With the proper assistance and planning, all townships can well provide the services and functions that their residents and community expect and deserve. ■

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