**Re: Bonds 101: Capital Financing Methods Employed by Washington and Idaho**

**From: Laura McAloon**

**What are municipal bonds?**

Municipal bonds (often referred to as "Munis") are the mechanism through which state and local governments raise capital to finance the construction of public projects, such as schools, roads, water and sewer systems, gas and electric power facilities, firehouses, and other government-owned capital projects.

Municipal bonds are a debt instrument or loan made by the issuer (municipality) to the lender (investor) that will be paid back by a specific date (the maturity date) and pays a specific interest rate. Bonds are similar to a promissory note, which is a promise by the issuer to repay the investor the principal of the loan by the end of a fixed period of time plus interest. Most municipal bonds mature from 1 to 30 years, but can be issued for longer periods of time.

One of the first factors to consider in any debt financing is whether the local government has available debt capacity; therefore, it is recommended to consult with bond counsel on that issue due to the various issues involved in making that determination.

These materials will address the following types of municipal bonds: (1) **General Obligation Bonds**, (2) **Revenue Bonds**, and (3) **Local Improvement Districts/Assessment Bonds** under both Washington and Idaho law.

**General Obligation Bonds**

General Obligation Bonds are debt obligations of a municipality which are backed by the "full faith and credit" of the issuing municipality. This means that the government is obligated to use its unlimited taxing power to repay the debt. Local municipalities generally depend mostly on property taxes to meet debt service requirements. State governments generally depend more on revenue and income taxes.

General obligation debt counts against a jurisdiction's debt capacity since its debt pledges the "full faith and credit" of the jurisdiction to pay off the debt. In other words, any and all of a jurisdiction's taxes, revenues, and other sources of money may be used to pay off the debt.

 **(a) Idaho.**

In Idaho, all General Obligation Bonds require a supermajority voter approval. The procedure is as follows: first, the district board must provide for a resolution, which sets forth the community infrastructure and other costs and expenses approved by the district board. The resolution will provide for holding an election and two-thirds (2/3) of the qualified electors at the election must assent to the issuing of the bonds and incurring the indebtedness. I.C. 50-3108.

 **(b) Washington.**

There are two (2) types of general obligation debt in Washington: (a) **Limited Tax General Obligation Bonds[[1]](#footnote-1)** ("LTGO Bonds") and (b) **Unlimited Tax General Obligation Bonds[[2]](#footnote-2)** ("UTGO Bonds")**.**

In Washington only UTGO Bonds require voter approval. LTGO Bonds can be issued by a vote of the city council, as detailed below.

The Washington State Constitution restricts the use of General Obligation Bond proceeds for capital purposes, and the proceeds may not be used for "replacement of equipment." Wa. Const. art. VII § 2(b). General Obligation Bond proceeds may also be used for payment of incidental costs and costs related to the issuance of the bonds, such as fiscal and legal expenses, costs of obtaining bond ratings, printing and advertisement costs, necessary and related engineering, architectural, planning and inspection costs, costs of the elections, and other similar activities.

**(i) LTGO Bonds (**also known as "councilmanic bonds").

In Washington, LTGO Bonds are issued by a vote of the city council, backed by general fund revenues when voters have not been asked to pay increased property taxes. In other words, LTGO Bonds constitute non-voted debt and are issued without a vote of the taxpayers.

These may be used for any city purpose; they do not have to be for capital projects.

**(ii) UTGO Bonds**.

In Washington, UTGO Bonds are payable from voter-approved "excess levies," outside the constitutional and statutory limitations that apply to regular property taxes.

In Washington, there is a two-step approval process for UTGO Bonds. First, the local governing body adopts a resolution or ordinance submitting a bond ballot proposition to its voters; and second, the voters approve or reject the bond ballot proposition by election. The proposition must be approved by at least sixty percent (60%) of the voters within the taxing district. Wa. Const. art. VII § 2(b). In addition, the total number of persons voting in such election cannot be less than forty percent (40%) of the total votes cast at the last preceding general election. RCW 39.40.010. .

General Obligation Bonds generally have a lower interest rate and are consequently less expensive than revenue bonds; therefore, if the vote requirement is not an issue, General Obligation Bonds are the preferred method of financing.

**Revenue Bonds**

Revenue bonds are issued for a specific project and rely on dedicated revenue sources from the proposed project or facility being financed with the proceeds. Revenue Bonds are commonly issued for water, sewer, solid waste and electric facilities.

Revenue Bonds are not general obligations or "debt" (within the debt restrictions of the state constitution or statutes) and have no claim on any tax revenues for payment of debt service. Since Revenue Bonds are not backed by the "full faith and credit" of the issuer, Revenue Bonds have a slightly higher interest rate than General Obligation Bonds.

In Washington, Revenue Bonds do not require voter approval, and the amount of the debt is not legally part of the debt ceiling of the agency or locality.

In Idaho, Revenue Bonds require a simple majority voter approval. The procedure is as follows: first, the district board must provide by resolution the community infrastructure consistent with the general plan to be financed with the revenue bonds. The resolution will provide for an election, in compliance with Idaho Code 50-3112, to submit to the qualified electors of the district the question of authorizing the district to issue revenue bonds of the district to provide moneys for such community infrastructure consistent with the general plan. I.C. 50-3110.

**Local Improvement District or Assessment Bonds**

Local Improvement District Bonds ("LIDs") or Assessment Bonds are methods of financing capital improvements constructed by a city that provide a special benefit to the properties within the boundaries of the LID or special assessment district. LIDs allow for improvements to be financed and paid over a period of time through assessments on the benefitting properties. Special assessment debt may be paid off by collecting special assessments only on the specific parcels that benefit from a financed project. A typical example of an LID is installation of street improvements or sidewalks.

By separate memo, the procedure for establishing an LID in Washington and Idaho is outlined.

**Tax Exemption for Municipal Bonds**

The Internal Revenue Code does not define a Government Bond. Instead, there is a definition of a "Private Activity Bond," and two tests of whether there are private business uses to determine if the bond is governmental or private activity. A Private Activity Bond is any bond of which:

 (a) more than ten percent (10%) of the proceeds is to be used in a trade or business of a person or persons other than a governmental unit (except for not-for-profit, tax-exempt organizations); and

 (b) is to be directly or indirectly repaid from, or secured by, revenues from a private trade or business.

If a bond "fails" these two tests (i.e., the private use and repayment or security amount is 10% or less), it is a governmental bond, and the interest on the bond is tax-exempt.

Most municipal bonds have a tax advantage in that the interest earned is exempt from federal income taxes. Internal Revenue Code Section 103 provides that obligations incurred for a municipality's governmental purposes are generally tax-exempt. In other words, the interest received on municipal bonds is not subject to federal income taxes. Tax-exempt municipal bonds are usually also exempt from state income taxes in the state in which they are issued, and local bonds may also be exempt from local income taxes. Therefore, investors will accept a lower interest rate on tax-exempt issues because of the reduced tax burden.

1. . Also known as Nonvoted General Obligation Bonds. [↑](#footnote-ref-1)
2. . Also known as Voted General Obligation Bonds. [↑](#footnote-ref-2)