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OVERVIEW OF TYPES OF DEBT THAT MAY BE ISSUED BY THE STATE OF MONTANA AND ITS AGENCIES
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I. State Debt - State Law Issues.

A. Historical Overview.

1. 1889 Constitution, Article XIII, Section 2. The legislature shall not create any "debt or liability" which with other outstanding indebtedness exceeds $100,000 without approval by a majority of those voting at a general election.

2. Outgrowth of this provision is the indebtedness described below. In a series of cases, the Board has construed what constitutes "debt or liability." Barbour v. Board of Education, 1932. Bonds were issued to construct residence halls at State University at Missoula and School of Mines in Butte, payable from "net revenues" of operation. Was not authorized by voters and exceeded $100,000. Court held did not violate constitution. State v. Board of Examiners, 1934. "If bonds are payable from a 'special fund' they do not create debt. Since income or revenue and not taxes was pledged, no debt was created. Result of cases generally was if not payable from ad valorem property tax or a pledge of full faith and credit it was not a "debt or liability."

3. In State ex rel Diedrichs v. State Highway Commission, the Supreme Court questioned the validity of the special fund doctrine where a tax of any kind is pledged to the payment of the debt. In State ex rel Ward v. Anderson (1971), the Court went further and indicated that a pledge of any of the State's constitutional tax sources created a debt or liability under the 1889 Constitution requiring voter approval.

4. Constitutional Requirement, Article VIII, Section 8 1972 Constitution. No State debt shall be created unless authorized by a two-thirds vote of the members of each house of the legislature or a majority of the electors voting thereon.

B. Types of Debt.

1. General Obligation Bonds (Title 17, Chapter 5 Part 8). General obligation bonds (G.O. Bonds) are issued upon legislative authorization by the Board of Examiners for specified projects or programs in specified amounts. General obligation bonds constitute a pledge of the full faith and credit of the State, and the State, in issuing them, covenants to levy taxes through the life of the Bonds in amounts necessary to pay the

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principal and interest thereon. G. O. Bonds can be issued for any purpose authorized by the legislature. They have typically been used for the State's long-range building program, some water development projects; the renewable resource program; the energy conservation program; information technology or other projects for which no other specific revenue source is available for adequate payment, or where there may be a source of revenue available, but lower interest rate will be achieved if issued as general obligation. (The State's Revolving Loan Program and Renewable Resource Loan Program are good examples of this approach).

G. O. Bonds may be sold at a competitive sale or a negotiated sale as determined appropriate by the Board.

2. Special or Limited Tax Obligation Bonds. The legislature may create and impose special or limited taxes, fees and charges and authorize the issuance of one or more series of bonds secured by that tax or revenue source for a project, multiple projects or a program. The tax or charge that is pledged may be limited as to both rate and amount. Since bond holder ultimately takes the risk as to adequacy of tax or the charge, the bond authorizing documents will contain provisions limiting the ability to issue additional bonds secured by that tax or revenue and other covenants relative to security. Generally, the State would reserve the right to issue additional parity bonds (those payable on an equal basis to first bonds), subordinate bonds (payable from taxes remaining after payment of first bonds) or on conditional bonds. These limitations generally take the form of an additional bonds test. Under such authorizing legislation, the State would agree to continue to impose and collect the tax or charge until the outstanding bonds were paid.

   a. Coal Severance Tax Bonds. Title 17, Chapter 5, Part 7. Coal Severance Tax Bonds are issued by the Board of Examiners upon authorization by the legislature. Coal Severance Tax Bonds are secured by the coal tax trust receipts deposited annually in the coal severance tax bond fund, and do not constitute a general obligation secured by the State's full faith and credit.

      Thus far, coal severance tax bonds have been issued only to finance the State's Water Development Program (which program was consolidated with the Renewable Resource Program in 1993), although the coal severance tax bonds may be issued for any purpose authorized by the legislature. The coal severance tax renewable resource program bonds are also payable from loan repayments made by local governments. There are currently outstanding $52,911,282 in bonds, which amount represents 11 separate issues. Montana Code Annotated Sections 85-1-601 through 85-1-631, as amended, presently permits the issuance of no more than $250,000,000 in aggregate principal amount of coal severance tax bonds. The 2003 legislature authorized the issuance of up to $10,162,991 of coal severance tax bonds, in addition to the outstanding bonds, for the Coal Severance Tax Renewable Resource Program.

b. Highway Revenue Bonds. Title 17, Chapter 5, Part 9, M.C.A. Highway Revenue Bonds are issued by the Board of Examiners upon authorization by the legislature, secured and payable from "highway revenues" as defined in Article VIII, section 6 of the Constitution and any other revenues, taxes or receipts received by the highway department.

There is currently $150,000,000 of Highway Revenue Bonds authorized by the legislature.

3. Revenue Bonds. Revenue bonds are payable from and secured by a specific stream of revenues, other than taxes, and may include revenues of a particular program or project. This type of financing constitutes a significant portion of public finance for both the state and local governments. On a local level, sewer and water systems are financed by revenue bonds. These bonds are generally not considered "debt." Public utilities have generally been financed through the use of revenue bonds and legislation has been introduced during the last two sessions that would allow the State to issue up to $500 million of revenue bonds to acquire electrical generating facilities.

Various state agencies and boards issue "revenue" bonds that are secured by program revenues which are primarily loan repayments from borrowers to whom loans have been made.

a. University System Facility Revenue Bonds The university system finances college dormitories, student union buildings and other revenue producing facilities through the issuance of facility revenue bonds. These bonds are issued by the Board of Regents pursuant to Title 20, Chapter 25, Part 402, M.C.A. Revenue producing facilities at each unit of the university system may be considered as one, but the income derived at one unit cannot be used to discharge obligations for facilities at another. These bonds are not a debt or liability of the State. Recently, revenue bonds have been issued by the Regents to finance additions to classroom facilities, and research facilities payable from federal grants.

b. Mortgage Revenue Bonds. These bonds are issued by the State Board of Housing pursuant to Title 90, Chapter 6, Part 1 to finance acquisition of single family houses. These are obligations do not create a debt or liability of the State, but are an obligation of the State Board of Housing only, payable from program revenues.

c. Health Facility Revenue Bonds. These bonds are issued by the Health Facility Authority pursuant to Title 90, Chapter 7, Part 1. Proceeds of bonds are used to make loans to eligible health care facilities, which may be operated by not-for-profit corporations or publicly owned. The legislature has authorized the Authority to issue up to $150,000,000 of bonds. The bonds are not a debt or liability of the State.

d. Student Loan Revenue Bonds. These bonds are issued by the Montana Higher Education Student Assistance Corporation (MHESAC), a non-profit corporation designated by the Board of Regents to operate the State's student loan program pursuant to Title 20, Chapter 26, Part 11, M.C.A. The bonds are not a debt or liability of the State but are payable from the student loan repayments. The Board of Regents is authorized to guarantee the students loans from federal payments receives for that purpose.

e. Economic Development Revenue Bonds. Economic development revenue bonds or IDB's, as they have come to be known, are issued by the Board of Investments pursuant to Title 17, Chapter 5, Part 15, M.C.A. (the Economic Development Bond Act), to finance commercial, industrial, manufacturing, agricultural, hydroelectrical and other types of economic development projects. The definition of eligible Projects under the Act has been amended recently to include "any land; any building or other improvement; and any other real or personal properties considered necessary in connection with the improvement, whether or not now in existence, that must be suitable for use for commercial, manufacturing, agricultural, or industrial enterprises; recreation or tourist facilities; local, state, and federal governmental facilities; multifamily housing, hospitals, long-term care facilities, community-based facilities for individuals who are persons with developmental disabilities as defined in 53-20-102, or medical facilities; higher education facilities; electric energy generation facilities; family services provider facilities; the production of energy using an alternative renewable energy source as defined in 15-6-225; and any combination of these projects". Cities and counties may also issue the same types of bonds, and in issuing these bonds, the Board of Investment may act as a conduit financier in the same way a city or county would. The Federal Tax Code has significantly limited the ability of the State and local governments to pass on its tax-exemption to most private activity bonds, although bonds can still be exempt for state income tax purposes. Bonds issued under the Economic Development Bond Act are not obligations or debt of the State.

"Moral obligations". Under the Housing Act, the Economic Development Bond Act and the Health Facility Authority Act, the legislature while providing that bonds issued under those Acts do not constitute a debt or liability of the State nor a pledge of the faith and credit of the State, authorized the governor to place in his or her budget the amounts necessary to restore any deficiency, and request the legislature to appropriate moneys from the State's general fund to restore deficiencies in the respective reserve accounts created for the bond issues. This type of legislation has come to be known as moral make up clause or a moral obligation clause. The Montana Supreme Court, Huber v. Groff, 171 Mont. 442, 558 P.2d 424 (1976), a test case validating the Housing Act bonds upon the moral mark-up provisions and determined that the "moral obligation" of the Legislature to appropriate funds was an unenforceable pledge, purely permissive in nature and non-binding and therefore not a debt subject to the 2/3 legislative approval. The Housing Bonds have not been structured as moral obligation bonds, although authorized to be. Several issues of Health Facility Authority bonds have been issued as moral obligations.

f. Municipal Finance Consolidation Act Program Bonds. The Board of Investments has authorized the issuance of bonds under three separate bond programs to initially purchase obligations of local governments and now the programs extend to State agencies and the State. Like the other revenue bonds, the credit of the State is not pledged for the payment of the bonds. The source of payment is the repayments the loans made from bond proceeds. While the bonds themselves are not debt of the State, the underlying loans may be "debt" of the State or local borrowing entity. The Board cannot have outstanding at any one time more than $120,000,000 of its bonds, excluding refundings or bonds to purchase tax and revenue anticipation notes.

4. Double-Barreled Bonds. Some of the bonds discussed above are secured and payable from both revenues and taxes. Nature of pledge can significantly differ between issues. Reasons to combine - revenues

may be inadequate, pledging tax secures a better interest rate, disclosure difficulties, etc.

5. Tax and Revenue Anticipation Notes. The notes are authorized to be sold by the Board of Examiners, pursuant to Title 17, Chapter 1, Part 2, M.C.A., upon request of Department of Administration, in anticipation of receipt of taxes and revenues, as necessary to meet the monthly cash flow requirements of the State.

   These notes are secured by the full faith and credit of the State. The amount of notes cannot exceed the amounts appropriated under the budget for state law purposes and for federal law purposes cannot exceed the maximum cumulative cash flow deficit. Principal and interest on the notes must be paid from taxes and revenues not later than the end of the fiscal year in which notes are issued.

6. Bond Anticipation Notes. Bond anticipation notes or "BANS" may be issued by any of the issuers of the bonds described above prior to and in anticipation of selling bonds. Reasons to issue Bans as opposed to the bond: uncertainty of markets, interim construction funding, want to defer issuance of bonds.

7. Refunding Bonds. Generally speaking, bonds may be issued to refund outstanding bonds, subject to restrictions in the Code. This is generally done in order to take advantage of lower interest rates or get out from under bond covenants that may be excessively restrictive.

II. Federal Tax Implications for State of Montana Bonds.

A. In order for bonds issued by the State to be exempt from federal income tax, as well as state income tax, the bonds must comply with provisions of the 1986 Internal Revenue Code (the Code).

1. Section 103 of the Code excludes from definition of gross income interest on any state or local bond, except:

   a. any private activity bond which is not a qualified bond within the meaning of Section 141;

   b. any arbitrage bond within the meaning of Section 148; and

   c. any bond not in registered form.

   The restrictions, limitations and regulations enacted to implement this section are numerous, complicated and technical. This outline will discuss the most critical requirements in a fairly summary fashion. We will provide any additional materials or information required.

2. Procedural Requirements.

   a. Registration Section 149(a)1. The requirement that tax exempt bonds be issued in registered form has been upheld by the United States Supreme Court in South Carolina v. Baker (1988). Various States have argued the registration requirement was constitutionally invalid under (i) the Tenth Amendment and principles of federalism, and (ii) the doctrine of intergovernmental tax immunity.

   b. Federal Guarantee Prohibition Section 149(b)1. Bonds cannot be federally guaranteed if interest is to be tax exempt. There are specific exceptions for guarantees of FHA, VA, Fannie Mae, etc.

   c. Information Reporting Requirement Section 149(e)1. The issuer must file with the Internal Revenue Service an informational return for each issue of tax exempt bonds.

3. Arbitrage.

   a. Section 103(b)(2) of the Code provides that interest on any bond which is an arbitrage bond within the meaning of Section 148 is not tax exempt under Section 103(a) of the Code; and

   b. Concept of Arbitrage. The disparity between taxable and tax exempt interest rates have enabled issuers of tax exempt bonds to invest proceeds of the exempt bonds in higher yielding taxable obligations and profit from the differential. This transaction and variations of it are reasons for Section 148 and the arbitrage regulations.

      i. Prior to 1986, the Code and arbitrage regulations have generally attempted to balance between:

         (a) preventing the issuance of bonds primarily in anticipation of realizing an "arbitrage" spread, while at the same time;

         (b) not interfering with traditional financing practices of state and local government.

         That was done in three major ways:

(1) if issuer could reasonably expect at the time bonds were issued, that proceeds would not be invested at a materially higher yield than bonds, the arbitrage analysis came to an end;

(2) in the event some or all of the bond proceeds are expected to be invested in materially higher yields, "temporary period rules" allow the investment of proceeds for a temporary period (usually 1 year) if it was "reasonably expected" that bond proceeds would be expended within 3 years following the bonds, there would not be arbitrage restrictions on investment of funds; and

(3) issuers were permitted to invest up to 15% of their bond proceeds at whatever yield is available, without respect to a temporary period either as part of "reasonably required reserve" or "replacement fund," or simply representing the "minor portion."

ii. Generally speaking, the arbitrage rules are designed to prevent over issuance of bonds and early issuance of bonds.

iii. Analysis of arbitrage generally requires you to focus on:

(a) amount of bonds to be issued;

(b) size of reserve (should minimize);

(c) when will money be spent.

c. Arbitrage Rebate. Unless a bond issue meets a specific arbitrage rebate exception, the issuer must rebate to the Federal Government any arbitrage profit earned on the proceeds of the bonds. Those exceptions are:

i. Substantially all (not less than 95%) of the proceeds of the Bond (except for amounts to be applied to the payment of costs of issuance) will be used for local governmental activities of the borrower;

ii. The aggregate face amount of all "tax-exempt bonds" (including warrants, contracts, leases and other indebtedness, but excluding private activity bonds) issued by or on behalf of a borrower and all subordinate entities thereof during [2004] is reasonably expected not to exceed $5,000,000.

iii. If notwithstanding the provisions listed above, the arbitrage rebate provisions of Section 148(f) of the Code apply to the Bond, the borrower will covenant and agree to make the determinations, retain records and rebate to the United States the amounts at the times and in the manner required by said Section 148(f).

B. <u>Governmental and Private Activity Bonds</u>.

1. <u>Private Activity Bond</u>.

a. Section 141 divides state and local bonds into two categories: governmental use bonds and private use bonds. A bond is a private activity bond if it meets one of two separate tests.

i. Private Use Test:

(a) business use test - more than 5% of proceeds of issue are used for any private business use;

(b) private security or payment test payment of principal or interest or more than 5% of the proceeds of the issue is directly or indirectly secured by an interest in property used for a private business, or payments in respect of such property, or derived from payments in respect of property.

ii. Private Loan Financing Test: if proceeds of the issue are used directly or indirectly to make or finance loans to persons other than governmental units which exceed the lesser of 5% of such proceeds, or $5,000,000.

b. Qualified Private Activity Bonds may be issued as tax exempt bonds, assuming compliance with provisions of the Code for the following purposes:

i. exempt facility bond,

ii. qualified mortgage bond,

iii. a qualified veteran's mortgage bond,

iv. qualified small issue bond,

v. qualified student loan bond,

vi. qualified redevelopment bond, or

vii. qualified 501(c)(3) bond.

c. Exempt facility bonds may be issued for the following purposes, if the facility serves the public or is available to the public on a regular basis:

i. airports;

ii. docks and wharves;

iii. mass commuting facilities;

iv. facilities for furnishing of water;

v. sewage facilities;

vi. solid waste disposal facilities;

vii. qualified residential rental projects;

viii. facilities for the local furnishing of electrical, gas or energy;

ix. local district heating or cooling facilities;

x. qualified hazardous waste facilities;

xi. high-speed inner city rail facilities;

xii. environmental enhancements of hydroelectric generating facilities; and

xiii. qualified educational facilities.

2. <u>Volume Cap</u>.

a. All private activity bonds, except qualified 501(c)(3) bonds, whether issued by the state or local governments are subject to state volume cap.

b. State's cap for 2004 is greater of an amount equal to the lesser of $225 million or $75 multiplied by the state's population, with an adjustment each year for cost of living. The department of administration administers the allocation pursuant to Title 17, Chapter 5, Part 13, M.C.A. (the Allocation Act).

c. The state's volume cap is allocated among issuers in the Allocation Act, with 70% set aside for state issuers and 30% for local government issuers.

d. The state's share is allocated as follows:

Board of Examiners	4%
Montana Board of Housing	41%
Board of Investments	25%
MHESAC	26%
Health Facility Authority	4%

e. After the first Monday of September in each year, allocations become available for redistribution to other agencies, if not used;

3. Other limitations on Private activity bonds:

a. average maturity cannot exceed 120% of average reasonably expected economic life of facilities financed with bonds;

b. the bond would not be a qualified activity bond if held by a substantial user of the facility;

c. limitations on use of proceeds, restrictions on acquiring land and existing property;

d. public hearing approval; and

e. limitations on costs of issuance (2% of bond proceeds).

4. Restriction on Acquiring Existing Output Property. Section 141(d) of the Code defines a private activity bond to include any bond issued as part of an issue if the lesser of 5% or $5,000,000 of the proceeds are used by the governmental entity to acquire non-governmental output property.

Nongovernmental output property is defined as any property (or interest therein) which before such acquisition was used by a person other than a governmental unit in connection with an "output" facility.

Nongovernmental output property does not include property which is used in connection with an output facility 95% or more of which is consumed in a qualified service area of the governmental unit acquiring the property or a qualified annexed area of such unit.

Output facilities is a term used to describe electric generating, transmission and distribution facilities.