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Department of State Treasurer

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Memorandum #1060

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TO: Local Government Officials and Certified Public Accountants

FROM: Sharon Edmundson, Director
State and Local Government Division

SUBJECT: Issues of Interest: Local Government Borrowings, Storm Water and Solid Waste Fees, Sales Tax Refunds for Schools, and Fines and Forfeitures

Issuance of Debt by Local Governments

The Fiscal Management Section has noted in its reviews of the audit reports of governmental units several improper borrowings. These borrowings fall into two major categories: 1) borrowings that, by type, are not specifically allowed by North Carolina General Statutes or 2) installment purchase contracts ("I/Ps") that have been executed without the required approval of the Local Government Commission ("LGC").

Category 1:
North Carolina is a Dillon Rule state. This means that any units of government, as defined by statute, that are subject to the governance of the State, have only the powers to do what is specifically allowed by the State, such powers generally being expressed in statute. Certain types of bonds and financing agreements, as authorized by statute, are all that are specifically allowed for municipalities, counties and other types of governmental units to use as financing vehicles. Lines of credit and borrowings that are secured with bank deposits or other assets unrelated to the financings have been noted in recent reviews of audit reports. These types of borrowings have not been provided for in the General Statutes and are invalid.

Category 2:
The following short discussion of I/Ps describes the basic character of the borrowing, the factors that make it subject to LGC approval and what the LGC must consider to approve an I/P.

1. I/Ps are contracts evidencing indebtedness for periods of from several months to twenty years. Installment denotes periodic servicing of the debt over the borrowing period. In North Carolina, utilization of I/Ps as financing vehicles by units of local government is regulated by G.S.160A-20.
2. G.S.160A-20 specifies that the only security available for this type of debt is the asset being financed. Once this collateral is exhausted, no judgment of deficiency may be levied against the debtor unit i.e., no other assets of the unit may be pledged nor may the taxing power of the unit be pledged. No vote of the people has been obtained to enable the unit to obligate more.
3. Any type of asset may be financed; from equipment to land to real estate improvements.

4. For an I/P contract to be approved by the LGC, the Commission must be able to make certain findings:
   - Contract must be necessary or expedient,
   - Contract is preferable to a bond issue,
   - Sum to fall due are adequate but not excessive,
   - Unit's debt management practices are good,
   - Increase in taxes, if any necessary for debt service are not excessive,
   - Unit is not in default.

   Depending on various circumstances, only the 1st, 2nd and 5th findings are necessary.

5. The LGC must approve an I/P if:
   - Contract is 5 or more years **and**
   - Obligates unit to pay money, even to a third party **and**
   - ALL money to be paid under contract is **greater than lesser of $500,000 or 1/10 of 1% of assessed value of property subject to taxation in unit, OR, notwithstanding the previous three criteria, involves construction or repair to fixtures or improvements to real property.** (Please note that baseball park districts and public housing authorities have a slightly different formula.)
6. LGC approval is not required if the borrowing is for motor vehicles or voting machines or if the loan is from the State, the Federal government or from an agency of either, or if the financing is entered into pursuant to the North Carolina Solid Waste Management Loan Program.
7. It must be noted that, even if LGC approval is not required, all of the other requirements of G.S.160A-20 must be complied with.

Finance officers should review their unit's outstanding debt and determine that it has been issued in compliance with the foregoing considerations. Note that in determining compliance with the statute, the original transaction, as opposed to the current remaining term and amounts due, must be evaluated. If invalid loans are determined to exist, please do not hesitate to call Biff McGilvray at 919.807.2371 to discuss the best way to remedy their invalid status.

In order to facilitate our review of units' debt issuance practices, we are asking the preparers of the financial statements to include the following information in their debt disclosures:

- Original issue date
- Original issue amount
- Terms of issuance
- Purpose of debt
- Information regarding provider of funds, particularly if funds were loaned by the State Revolving Loan Fund or the USDA.

This information will help us more readily determine if the debt is in compliance with the General Statutes.

Budgeting of Debt Proceeds

In recent months members of the staff have spoken with local government officials who were seeking LGC approval of financing for a project after contracting for and beginning the project. Before a contract can be executed that will be financed with debt proceeds, a sufficient appropriation should be budgeted in a capital project fund to enable the finance officer to preaudit that contract. If the unit adopts a multi-year capital project ordinance, the full amount of the project and the proceeds of the financing should be budgeted. If a unit adopts an annual capital projects budget, only the amount to be expended in the current year would have to be budgeted in order for the contract to be preaudited. However, by

entering into the contact the unit obligates itself to budget the full amount due in subsequent years (GS 159-13(b) (15)).

LGC approval of the financing should be obtained before a unit budgets the proceeds of a debt financing and the finance officer preaudits contracts against that budget. Failure to do so can result in a unit entering into a contract for which it does not have resources to pay or that lowers the reserves of the unit below an acceptable level. If the contract can not be completed because of a lack of funds the unit and individuals who approved the contract could incur legal liability. If a unit wants to begin the contract prior to receiving LGC approval, it should budget legally available revenues or financing sources other than debt to fund the project. The unit should be prepared to use those sources if the LGC does not approve the financing. Units that have received unit letters based upon reviews of audits or are behind in submitting audits should not assume the LGC will approve a financing simply because the unit has contracted for or begun the project.

Transfer of Storm Water and Solid Waste Fees

During our review of audited financial statements of local governments we noted that some units have been transferring storm water and solid waste fees to other funds. According to General Statutes, units may impose a storm water fee that does not exceed the costs for the collection and drainage of storm water by the unit or for providing a storm water management program [G.S. 160A-314, 153A-277, 162A-9]. If these portions of the storm water fees were transferred to compensate another fund for administrative or other costs incurred on behalf of storm water activities, the transfer should be budgeted and accounted for as a reimbursement of expenditures in the future. Failure to do so misstates expenditures for both funds.

General Statutes permit counties to impose a solid waste fee that does not exceed the costs for the collection of solid waste, for the use a disposal facility, and for the availability of a disposal facility provided by a unit [G.S. 153A-292(b)]. Cities may impose a fee for the availability of a disposal facility and such *fee for availability* may not exceed the cost of providing the facility [160A-314.1]. Also, under 160A-317(c), a city may mandate that citizens participate in a solid waste collection serviced provided by the city (if they have not otherwise contracted for solid waste collection) and may impose a fee for solid waste collection that does not exceed the cost of collection. If portions of the solid waste fees were transferred to compensate another fund for administrative or other costs incurred on behalf of the Landfill or Solid Waste Fund, the transfer should be budgeted and accounted for as a reimbursement of expenditures in the future. Failure to do so misstates expenditures for both funds. It is our understanding that transfers are permitted to repay the General Fund, or any other fund, for advances that were made when the Landfill or Solid Waste Fund was established or experienced cash flow difficulties. Transfers for other purposes are not permitted by General Statutes. We encourage units to consult with their attorney regarding these matters.

Sales Tax Reimbursements for School Construction

The LGC issued Memorandum # 1045 on November 28, 2005, to address the circumstances under which a county may claim a sales tax refunds for school construction. Please refer to that memorandum for guidance in the circumstances under which a county may claim such a refund.

Since that memorandum was issued we have been asked if there are conditions under which a school board could contract for and issue checks for payment of school construction costs and the county still claim the refund. We have conferred with the North Carolina Department of Revenue and have learned that a refund can be claimed under these circumstances if an interlocal agreement exists between the county and school board that authorizes the school board to be the county's agent for contracting for construction and paying the vendors. In order to avoid confusion, the school board must indicate that it is

entering into contracts as an agent for and on behalf of the county. Title for the assets must be in the name of the county for this agency agreement to be used.

Legislation has been introduced in both the House and Senate to reinstate the ability of local education agencies to claim sales tax refunds. However, we do not know the final outcome of those actions. We will issue more guidance on this issue if the law is changed.

Payments of Fines and Forfeitures to Schools

In 2005 the State Supreme Court issued a ruling that certain State fines, penalties, and forfeitures be remitted to the public schools in accordance with Article IX Section 7 of the North Carolina Constitution. While that ruling does not address local government revenues, it does establish guidance to help units determine if local revenue sources should be remitted to public schools under the requirements of the State Constitution.

In November, 2005 the UNC School of Government issued Local Government Law Bulletin No. 108, *Public School Funding in the Summer of 2005: North Carolina School Boards Association v. Moore*, by Shea Riggsbee Denning. That Bulletin examines whether three local revenue sources collected pursuant to State law should be remitted to the public schools. These local revenues are: penalties for failure to list or late listing of property for taxation, penalties for bad checks for payment of taxes, and interest on property taxes. The Bulletin states that a court would most likely rule that interest on property taxes would not have to be remitted to the schools. However, a court would most likely rule that the other two local revenues would have to be remitted to the schools.

Funds remitted to the schools under Article IX Section 7 of the North Carolina Constitution would not be included in the unit's budget as revenues or expenditures. The receipt and disbursement of these funds should be accounted for and reported in an agency fund. If a unit accounts for these receipts and disbursements in the General Fund during the course of the fiscal year, they should be reported in an agency fund in the audited financial statements of the unit. A county may take into account the funds a school receives from all local governments in fines, penalties, and forfeitures when determining its annual appropriation to the public schools for current expense.

Each unit should consult with its attorney and decide the appropriate treatment of these moneys. Again, the Supreme Court's ruling did not address these local revenues. Beginning in 2006, the illustrative financial statements for the City of Dogwood and for Carolina County, penalties for failure to list or late listing will be reported in an agency fund rater than in the General Fund. Penalties must be used in determining the unit's tax collection percentage because they are charged to the tax collector for collection.

In February of 2006, a Superior Court judge ruled that a municipality must remit 90% of their red light camera fines to the local schools. The municipality appealed to the State Appeals Court. That court agreed with the Superior court ruling. Again, each unit should consult with its attorney and decide the appropriate treatment of these funds.

If you have any questions or comments on any of the issues discussed in this memorandum, please contact Sharon Edmundson at (919) 807-2381.