

Top Ten Matters Every Mello-Roos Issuer Must Know About the RMA

Special taxes levied within the boundaries of a Mello-Roos Community Facilities District (CFD) are levied pursuant to a document known as an “RMA” or, rate and method of apportionment. The RMA sets forth the term of the special tax, the basis which the tax will be levied, the various classes of property that may be affected by the tax, and the order in which the taxes will be levied or collected.

By its very nature, the RMA can either significantly complicate the levy and collection of tax, or it can simplify it. The difference is in the details. In order to assist local agencies who may be contemplating the formation of a Mello-Roos district, we have prepared these “Top Ten” matters for consideration. This material can never be a substitute for good legal, financial and tax advice, so we encourage any public agency considering the imposition of a special tax to seek such advice. This material is provided as a basic “road map” through the RMA.

1

Consider the term of the tax very carefully.

Generally, if you intend to issue bonds against the receipt of the taxes, the tax must be available well after the date established for the final maturity of the bonds. In this instance, “available” doesn’t mean that the tax is actually levied. Making the tax available permits bonded debt to be re-structured or rescheduled in the event that there is a financial dislocation by a major property owner (such as a developer) early in the development cycle.

2

Consider the “reach” of the tax very carefully also.

While there is no requirement that the level and amount of tax levied against individual properties within the CFD be proportional to the benefit received by such properties, good policy and common sense indicate that the matter of fairness and equity, both perceived and actual, should be considered before settling on whether certain properties will be excluded from taxation; for that matter, even the level of tax will come under scrutiny as well. It is generally helpful to assess the impact of the tax by referring to individual properties or classes of property in order to establish some basic sense of how the benefits and the burdens are distributed.

3

Make a plan early in the process for dealing with parcels owned by public agencies.

The adoption of Proposition 218 in 1996 changed the entire landscape for assessment and taxation of property owned by public agencies. A vital part of the Proposition 218 requires that parcels within special assessment districts that are “owned or used by any agency, the State of California or the United States shall not be exempt from assessment unless the agency can demonstrate by clear and convincing evidence that such publicly owned parcels in fact receive no special benefit.”

While this provision of Proposition 218 seems to apply to assessments, it raises a critical question about special taxes. For example, there is the matter of property that is initially held by private persons and subsequent to the formation of the CFD comes into public ownership. There is a tendency to think that the sale or transfer of such parcels to another public agency will expose the problem and that an “economic” solution will result. This doesn’t go far enough. Even if the acquiring public agency agrees to be subjected to the tax, there is the matter of enforcement. How, for example, would the public agency responsible for the CFD propose to pursue payment of the special tax or assessment in the event that the Federal government becomes the owner? The judicial foreclosure option may not be available in such a case. This is a matter for careful legal analysis.

4

Consider carefully whether “escalators” in special tax formulae are appropriate and desirable.

Often, special tax formulae will be proposed with a provision that the tax be “escalated” over time, often in a manner parallel to the permitted 2% annual increase in assessed value of the individual parcel. The justification for this is the notion that Mello-Roos districts often finance public infrastructure that provides broad benefits, and the resulting benefits begin to act more “general” than “specific” in nature. Developers often times propose escalating special taxes because the result is received bond proceeds.

While this may be tempting at first, it does present some significant policy matters for discussion. By permitting the underlying tax to escalate over time, there is a resulting “back-loading” or deferral of debt to be repaid with the special tax. This has the effect of transferring the economic cost of the financed infrastructure to later payers, typically property owners other than the initial development entity. The consequences of this can be quite large, and public agencies should carefully consider the magnitude of these consequences, since it is the later payers who will likely challenge the basis of the application of the tax. Moreover, opponents of the escalator approach point out that the deferral of repayment of principal effectively means that later payers are repaying debt on public infrastructure assets that are already aging, and the argued benefit is actual lessening as time goes by. Public agencies should consult with their special tax consultants and advisors to assess the extent of this shift if escalators are proposed.

5

Decide early whether (and how) individual parcels may pre-pay special taxes.

Inevitably, there will be some property owners that will elect to pre-pay the applicable special tax burden. Even if they are few in number, there is a disproportionate administrative burden associated with such pre-payments. For example, if an individual property owner elects to pre-pay the remaining burden of tax upon the property, how should the sponsoring public agency measure the effects of financing costs? Or, the effects on other property owners who have not paid special taxes on time, but still owe them? Finally, there is the matter of measuring the actual burden of special tax. Is it the “maximum tax” or the initial level of tax? Public agencies should carefully analyze the effects of such pre-payments, and should consider requiring examples of pre-payment calculations be included in the RMA.

6

Choose carefully the manner of categorizing individual parcels within tax classes.

In thinking about the categories of special tax, public agencies should also consider the capacity of such parcels to pay the special taxes, both as to amount and time. For example, should vacant land be taxed at the same rate as fully developed property? If tax levels are kept low during development, then there will be a corresponding shifting of burden of subsequent property owners, sometimes producing an undesirable outcome. But, if the parcel is undeveloped, can it support the economics of a tax burden at the fully developed level? Public agencies should balance the need for “fairness” in the application of the tax with the critical need to provide adequate security for the payment of the taxes, particularly when debt is used to finance the public infrastructure assets.

7

Make sure that the timing of the collection of the special tax is consistent with the promises made to bondholders for providing adequate security.

There is a danger in assuming that collections of the special tax will be both timely and sufficient to make debt service as due. For example, if debt service payments are scheduled in February, but the taxing agency doesn’t receive apportionments from its host county until January, there is a danger that delays in the remittance of all tax collections could result in invasions of the debt service reserve fund to make regularly scheduled debt service payments.

8

Make sure that the “whole picture” is considered in the application of the special tax.

Public agencies should also carefully consider the effect of taxes and burdens imposed by other levels of government that are being paid by individual property owners. These “overlapping” taxes can add up to considerable burdens. As a result, when imposing a new Mello-Roos tax, public agencies should ensure that all tax and assessment burdens are considered when setting the maximum rate of taxation in the “new” RMA.

9

Make sure that there is a provision in the RMA for “fixing” non-substantive ambiguities in the RMA that are discovered after its adoption.

Despite any agency’s most careful actions and review, there is always the possibility that facts and circumstances may change in the future. When such changes, either in law or practice occur, there is the ongoing possibility that provisions of the RMA may become ambiguous or inconsistent with policy or practice. If these ambiguities are minor, there can be considerable expense associated with obtaining taxpayer approvals for changing the RMA. Public agencies should consider delegating to the public agency’s chief executive the authority to make minor changes or interpretations, provided that bondholder security is not affected and the RMA remains consistent with applicable state law.

10

Be wary of “coverage” calculations that consider earnings on funds held by the public agency or a bond trustee when setting the amount of special tax in a particular year.

Public agencies that issue debt based on special tax collections normally offer bondholders a “coverage” factor in determining the amount of tax to levy in a given year. This coverage factor is typically 10-15% of the scheduled debt service amount. For example, if there is a scheduled debt service payment of \$100, and the bondholders have been given a coverage factor of 15%, then the amount of the a special tax levy would have to be \$115 before consideration of earnings on any funds held. The problem arises when earnings are forecast at the wrong levels. In order to avoid surprises, public agencies should consider the measurement of earnings to be applied as a “credit” against special tax requirements “in arrears” rather than prospectively.