Attachment D

SPECIAL DISTRICTS: A BRIEF REVIEW FOR PROSPECTIVE HOMEOWNERS

COLORADO

Department of Local Affairs

Division of Local Government

Special Districts:
A Brief Review for Prospective Homeowners

Colorado Department of Local Affairs
1313 Sherman Street, Room 521
Denver, Colorado 80203
(303) 864-7720
www.colorado.gov/dola

INTRODUCTION

People buying real estate may have questions about Title 32, Article 1 special districts because of disclosure statements about "special taxing districts" which appear on documents related to the sale and purchase of many residential properties in Colorado. This brief review provides information about the purposes, taxing authority, and financial status of special districts to prospective residential property owners.

This document is not to be construed in any way as legal advice about special districts, in general, or about any specific district.

This document focuses on districts organized under Title 32, Article 1 of Colorado Revised Statutes. These districts provide residents with services such as ambulance, fire protection, water, sanitary sewer, health, and park and recreation services.

Common among residential communities are also metropolitan districts, which may provide multiple services, including those provided by single-purpose districts, as well as street construction and improvements, mosquito control, television relay and translation, transportation, and traffic-related safety enhancements (but not health service).

Title 32, Article 1 special districts are local governments, i.e., political subdivisions of the state, which make up a third level of government in the United States. (The federal and state governments are the other two levels.) Local governments include counties, municipalities (cities and towns), school districts, and a variety of other types of geographic and service-specific entities as described in the Colorado Revised Statutes.

Districts are created to provide services residents may desire or currently lack. While the majority of special districts draw their boundaries in unincorporated county land, increasingly, residents of a municipality may be included in one or more districts. These districts often provide a greater amount of service than a municipality or county is able or willing to provide.

As of May, 2019 there were about 2,400 Title 32, Article 1 special districts in Colorado. These are the types of districts that will be discussed in this paper; this paper will not be addressing the many other kinds of special districts and authorities created for such

things as water conservancy, housing, airports, groundwater management, soil conservation, etc.

For more information or for more DOLA technical assistance publications see the department's web site at www.dola.colorado.gov/dlg, and under Local Government Services select Research and Publications.

SPECIAL DISTRICT FINANCING

Title 32, Article 1 special districts have various financial powers, including but not limited to, the powers to tax and/or assess fees for services, and to issue municipal bonds to help pay for community improvements. At the same time, special districts must be publicly accountable, which means they must hold open meetings, properly notice all meetings, keep minutes and other records, which are open for inspection by any citizen, hold elections for its governing board of directors, adopt annual budgets, and submit to annual financial audits.

Issuing bonds is a method of borrowing money, which places the district in legal indebtedness. This debt can (generally) only be issued as the result of an election. The bonds are sold to investors who must be repaid over time with interest. Terms including interest rate and repayment period on these bonds vary but is often twenty years. The district's annual payment on the debt is called "debt service." The investors' money is used by the district to pay for necessary infrastructure such as streets, sidewalks, water treatment plants and lines, sewer treatment plants and lines, fire stations and trucks, recreation centers, golf courses, etc.

When bonds are sold to investors, the district makes a pledge to pay back the borrowed money at an agreed upon interest rate. The special district has legal authority to establish and collect property tax on the properties within its boundaries to redeem the bonds.[1] If the district has other revenues available to make the payments it may use those instead of, or as a supplement to, the property tax. An example of another type of municipal bond issued would be a Water Revenue Bond, where the district pledged revenue from water user fees/charges to pay back the bonds.

[1] **Municipal bonds** are a debt security issued by a government to finance its capital expenditures. Bonds that are secured by the district's authority to levy property taxes are called "general obligation" municipal bonds. In the event of default (e.g. failure to pay), holders of general obligation bonds have the right to compel, through mandamus or by injunction, a tax levy to satisfy the issuer's obligation on the defaulted bonds. In this paper, any mention of municipal bonds refers general obligation municipal bonds, unless otherwise indicated.

The property tax levy is the rate of tax applied to the assessed value[2] of all the property within the district's boundaries. The annual levy generates tax revenue the district will use each year to pay for providing the various services to its residents and to pay debt service. The formula is:

Mill Levy[3] x Assessed Value = Tax Dollars

For example, if the total assessed value of all property in a special district were $10,000,000 and the district's tax levy were 25.000 mills, the district would collect $250,000 in annual property tax revenue.

(25.000 mills/1,000) x $10,000,000 = $250,000

For a house with a market value of $300,000, this example mill levy would generate $536 in annual property tax revenue for the district.

(25.000 mills/1,000) x ($300,000 X 7.15%) = $'s
(.025) x ($21,450) = $536

Special district mill levies may fluctuate. Decline in a district's assessed value, for instance, would also lead to a decline in property tax revenue if the mill levy stayed the same from year to year. In this case, the district may seek a mill levy increase in order to preserve its revenue. Districts may also seek a mill levy increase to finance capital projects, but after the project is completed they may lower the mill levy to previous levels. Under Colorado's TABOR amendment (Article X, Section 20, Colorado Constitution), mill levy increases may require voter authorization.

Metropolitan districts are often established by developers to finance the infrastructure necessary to support a new subdivision. For example, streets, water and sewer lines, and other utilities must be provided to an area, which, prior to the subdivision's development, was vacant land. If all goes according to plans, construction on new homes and businesses will begin once the infrastructure has been completed. New and ongoing development increases the district's assessed value, and provides the tax base necessary to generate the revenue required to make payments on its outstanding bonds. If development within a new district occurs at the rate anticipated by the developer, the district's tax base should increase in value and mill levies can decline and still generate tax revenue sufficient to meet the bond payments. Unfortunately, this does not always come to pass due to periodic economic fluctuations.

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[2] **Assessed value** is the portion of the total market value of property that can be assessed for property taxes. In Colorado, beginning in 2020, rate of 7.15% of residential market value can be assessed for property taxes. The assessed value of a $200,000 home, for example, would be 7.15% of $200,000, which is $14,300.

[3] **Mill Levy** is the tax rate applied to a property's assessed value. The word mill is derived from the Latin word mille and is equal to one tenth (1/10) of a cent. Property Tax Mills must be divided by 1,000 to be converted into a decimal for use in calculations.

For example, in the mid to late 1980’s and early 1990’s in Colorado, approximately one dozen of the 875 special districts that were in existence at the time defaulted (e.g., failed to pay) on their bond payments. The primary reason for the defaults was that development within the districts did not occur at the rates expected by developers. Consequently, the tax bases within these districts were insufficient, at the established mill levies, for generating tax revenue necessary to meet their municipal bond payments. In situations such as these, in which development does not occur within expected time frames, the mill levies within the districts must be increased, meaning higher tax bills for property owners within the districts.

Example:

- A district's build-out (i.e., maximum growth) is planned at 2,000 homes. The infrastructure has been built and financed with municipal bonds.
- Build-out is planned to occur in ten years, needing an average of 200 homes built per year.
- The district’s annual payments on the municipal bonds are $1,070,000.
- If the development were built out with 2,000 homes, each with an average market value of $300,000 and an average assessed value of $21,450, the total assessed value of the district would be $42,900,000. (Assessed value for residential property equals 7.15% of the market value of the property.)
- The district's mill levy for debt is set at 25.000 mills, which at build-out, would yield property tax revenue in the amount of $1,072,500, sufficient to pay the annual debt service on the bonds.
- At 25.000 mills, the average annual taxes owed to the district would be roughly $536 per home.

HOWEVER,

- The real estate economy is slumping and as a result, only 1,000 homes have been built in the district after ten years.
- The market value and assessed value of each home are still $300,000 and $21,450, respectively, but with only 1,000 homes built, the total assessed value in the district is $21,450,000.
- The district’s mill levy is set at 25.000 mills, but at 50% of expected build-out, it is generating only $536,250, which will cover only half of the annual debt service payment due on the outstanding municipal bonds.
- If the district does not have alternative sources of revenue, and it wishes to avoid defaulting on its bond payments, it will have to raise its mill levy for debt to 50.000 mills in order to generate enough revenue to cover the $1,070,000 bond payment.
- At 50.000 mills, the average annual taxes owed to the district would be approximately $1,072 per home. (Keep in mind that, in addition to special district property taxes, homeowners will also owe property taxes to the

county, school district, and possibly, a municipality and other special taxing districts.)

Some developers use their own resources to finance the cost of needed infrastructure, or they may borrow money commercially, paying back the commercial loan as quickly as possible. The cost of borrowing this more “expensive” money will be reflected in an increased purchase price of the homes. Using a special district to finance the infrastructure costs of a new development can therefore be seen as a loan to the new property owners who will have a period of time to pay off the cost of the improvements instead of having to pay it "up front."

A prospective property owner would be wise to ask some questions to determine future tax liability, such as:

- How much outstanding general obligation debt does the district(s) have?
- What agreements does the district have with other districts? How much tax revenue is the district contractually obligated to transfer to other districts?
- Are the principal and interest payments on the general obligation bonds insured? Are the bonds secured with a letter of credit?
- Are the bonds rated? If so, what rating have they received?
- If the bonds are Limited Tax Obligations, what is the mill levy cap associated with the bonds?
- Does the developer hold the bonds, or, have they been issued to the public?
- What is the amount of the yearly debt service payment?
- What revenue is being used to pay the debt service?
- If a property tax is assessed for debt service, is the revenue sufficient to pay the debt service, or does some other revenue supplement it?
- If there is another revenue source (such as a developer's contribution), how much of the total payment is it?
- If that supplemental source of revenue is removed, how much will taxes increase?
- What is build-out and how close to build-out is the district? Is there a schedule of construction? What is the actual construction compared to the plan?
- What is the ratio of debt outstanding to the assessed valuation of the district? (Debt greater than 50% of assessed valuation may be considered a "red flag" to financial analysts, although the district's specific circumstances must be evaluated in each case.)
- Has other debt been authorized but not issued? When will it be issued?
- Is there a "balloon" payment associated with the debt service in a future year?
- Has the district petitioned the federal bankruptcy court for adjustment of the debt? Is there is a court order approving a plan of adjustment of the debt? What does it state about the debt service and mill levy?

Many of these questions can be answered by the districts directly. Contact information for districts, as well as district service plans, budgets, financial statements, and election information are available from DOLA's Local Government Information System (LGIS) at www.dola.colorado.gov/lgis.

SPECIAL DISTRICT RESIDENTIAL REAL ESTATE TRANSACTION DISCLOSURES

As mentioned above, a handful of special districts experienced financial difficulties in the mid/late 1980's and early 1990's, which caused some residential property tax bills to increase dramatically. In response to this problem, the state legislature passed a number of laws requiring certain disclosures to buyers of residential property, so that they would be aware that they were buying property that might be within a special district that can levy taxes and may have outstanding debt.

There are two such disclosures:

1. A purchase contract must include the language mandated by 38-35.7-101, C.R.S., which states

    SPECIAL TAXING DISTRICTS MAY BE SUBJECT TO GENERAL OBLIGATION INDEBTEDNESS THAT IS PAID BY REVENUES PRODUCED FROM ANNUAL TAX LEVIES ON THE TAXABLE PROPERTY WITHIN SUCH DISTRICTS. PROPERTY OWNERS IN SUCH DISTRICTS MAY BE PLACED AT RISK FOR INCREASED MILL LEVIES AND TAX TO SUPPORT THE SERVICING OF SUCH DEBT WHERE CIRCUMSTANCES ARISE RESULTING IN THE INABILITY OF SUCH A DISTRICT TO DISCHARGE SUCH INDEBTEDNESS WITHOUT SUCH AN INCREASE IN MILL LEVIES. BUYERS SHOULD INVESTIGATE THE SPECIAL TAXING DISTRICTS IN WHICH THE PROPERTY IS LOCATED BY CONTACTING THE COUNTY TREASURER, BY REVIEWING THE CERTIFICATE OF TAXES DUE FOR THE PROPERTY, AND BY OBTAINING FURTHER INFORMATION FROM THE BOARD OF COUNTY COMMISSIONERS, THE COUNTY CLERK AND RECORDER, OR THE COUNTY ASSESSOR.

2. At closing, the title agent/company must provide a statement disclosing pursuant to 10-11-122, C.R.S. that the subject property may be located within a special taxing district, a certificate of taxes due shall be obtained from the county treasurer, and information regarding special districts and their boundaries may be obtained from the Board of County Commissioners, the County Clerk and Recorder, or the County Assessor.

In addition, in 2009 the state legislature passed SB09-087 (amended by HB14-1164) creating additional reporting requirements for special districts including the requirement for an annual notification to the district's electors regarding a variety of information disclosures such as when the date of the next election for directors, how to obtain a self-nomination form for an elector to run for director, and information on how to request permanent absentee voter status.

The Department has been supporting special districts, counties, realtors, and residential property buyers by making the Local Government Information System (LGIS) available on its website at (www.dola.colorado.gov/lgis). The LGIS contains budgets, financial statements, service plans, election information, and contact information for special districts. DOLA's goals are to provide information that helps explain what special districts are and what purpose they serve, and to give the real estate community the basic information it may need to help residential property buyers understand the particular special districts in which they may be buying real property.

Before using the LGIS, prospective homeowners or their agents should contact the county assessor's office in which the property of interest is located to obtain the names of each taxing entity levying property taxes at the pertinent address. Access to this information is usually available on the county assessors' websites. Each taxing entity, including special districts, will have valuable filings of information accessible in the LGIS (www.dola.colorado.gov/lgis).

ISSUES TO CONSIDER WHEN ANALYZING A SPECIAL DISTRICT'S FINANCIAL CONDITION

In the following paragraphs, we have identified some issues for consideration when a prospective homeowner is reviewing special district information. It is important to remember that every situation is unique and that an apparent financial problem in one district may or may not be significant when taken in context of that special district's development situation. Any area of concern should lead to further questioning of the district's representatives.

- **Year of Organization** - If a metropolitan district was organized just prior to a recession, it is possible that the district's development was negatively affected by the economic downturn. Both real estate sales and property values can be impacted by a recession. The infrastructure (roads, water, sewer, etc.) paid for by any debt issued may have been constructed for development on a scale greater than the market could deliver during and immediately after a recession. These "development districts," which they are sometimes called, may not have achieved the goal of their service plan and can have trouble meeting their bond payments with pre-recession mill levies. Such districts may be under pressure to raise their property tax mill

levies to avoid default. This information can usually be found in the "Notes" section of districts' financial statements.

- **Current Level of Construction Compared to Planned "Build-out"** - This information is available from the special district. Knowing how near to completion the development is will help in estimating the tax burden per property. The cost of the infrastructure construction (for which the debt was issued) is apportioned per lot for repayment over a twenty-year period. When development is complete each property pays for its apportioned cost. Less than build-out means that the presently developed properties are responsible for more than their apportioned amount; they may be obligated to pay for the debt for infrastructure associated with the unsold or undeveloped properties.

- **Debt/Assessed Value Ratio** - This ratio shows a special district's ability to support debt based on the value of real property in the district. It is calculated by dividing the total outstanding general obligation debt by the total assessed value of the district. There is no percent figure which defines an absolute problem, but debt comprising more than 50% of the assessed value should prompt questions about the current rate of increase in the assessed valuation of the district since the district's organization. A related question would be "How many properties are being added to the tax roll each year?" The amount of currently outstanding debt can be found in the "Long-Term Debt Notes" of the districts' financial statements. Assessed value data is oftentimes available in the districts' budgets, or, alternatively, can be obtained from Annual Reports published on the Division of Property Taxation website (www.dola.colorado.gov/dpt).

- **Amount of Unissued Debt** - At the election to authorize indebtedness, questions were approved for the maximum funding necessary for the full development. Bonds may have been issued only for the amount of money needed at that time; for example, for the first phase of a multi-phase development. When the district issues additional bonds from the authorized debt, taxpayers may face increased payment obligations. (Under Colorado's TABOR amendment, it is unlikely that special districts will issue any debt approved prior to 1993 without submitting it for the current electors' approval.) This information is available in the "Long-Term Debt Notes" in the districts' financial statements.

- **Current Ratio** - This is a standard financial indicator used to evaluate whether or not a community is in a good position to pay those expenses due within the next year with reasonably assured assets such as cash and accounts receivable. The ratio is calculated by dividing current assets by current liabilities. Smaller, newer special districts, dependent almost exclusively on property tax, will often have weak current ratios. Questions should be asked about the nature and levels of the district's revenue sources. This information is available on the “Balance Sheet” of districts annual financial districts.

- **Are Current Revenues from Operations and the Debt Levy Sufficient to Make Debt Service and Pay for Operations?** - A review of the special district's financial statements will show whether the district's revenue from its operations, its debt levy, and other revenue sources such as fund balance, are sufficient to make the debt service. If these revenues are not sufficient, where is the needed revenue coming from? Developers will sometimes make contributions to offset the shortfall in revenue. Questions should then be asked about how much longer the contributions will continue. When will the burden of the total debt obligation be placed on the property owners?

If the information you are looking for is not available in the LGIS or from other sources mentioned in this publication, contact DOLA for assistance.