January 19, 2006

Governor Jon Huntsman, Jr.
E220 State Capitol Complex
Salt Lake City, Utah 84114

President Valentine and the Utah State Senate
W115 State Capitol Complex
Salt Lake City, Utah 84114

Speaker Curtis and the Utah State House of Representatives
W030 State Capitol Complex
Salt Lake City, Utah 84114

Re: Proposed Amendments to the Utah Sales Tax Structure

To the Governor of the State of Utah and the Honorable Members of the Utah State Legislature:

We are nationally recognized bond counsel serving the State of Utah (the *"State"*) and its counties, cities, towns and special districts (collectively, the *"Municipalities"*). In particular, we have assisted counties, cities and a public transit authority in issuing bonds that are secured by the revenues obtained from the collection of sales and use taxes (*"Sales Tax Revenue Bonds"*), levied under the Sales and Use Tax Act, Title 59, Chapter 12, Utah Code Annotated 1953, as amended (the *"Sales Tax Act"*). The Sales Tax Revenue Bonds are authorized by the Local Government Bonding Act, Title 11, Chapter 14 of the Utah Code Annotated 1953, as amended, and other applicable Utah law (the *"Bond Act"*). Since 2001, at least 28 cities, 8 counties and a public transit authority have issued, in total, approximately $1 billion of Sales Tax Revenue Bonds in 63 different series.

We understand that proposals have been made to amend the Sales Tax Act in order to eliminate or substantially reduce (i) the "local option" sales taxes (collectively the *"Local Option Sales Taxes"*) authorized under the Sales Tax Act and (ii) the sales and use tax base (the *"Tax Base"*), including by eliminating the tax on unprepared food. Eliminating or substantially reducing the Local Option Sales Taxes and the Tax Base presents significant legal issues and financial concerns relating to Sales Tax Revenue Bonds, which could result in substantial litigation involving the State and the Municipalities, technical defaults on Sales Tax Revenue Bonds by the Municipalities, bond rating downgrades, reduced marketability of the Sales Tax Revenue Bonds and impairment of a Municipality's ability to issue additional Sales Tax Revenue Bonds.

LEGAL ISSUES

VIOLATION OF STATE'S COVENANT

Under the Bond Act, certain Municipalities are authorized to issue Sales Tax Revenue Bonds. Pursuant to Section 11-14-307(3)(a) of the Bond Act, the State has pledged to and agreed with the holders of Sales Tax Revenue Bonds (the *"Bondholders"*) that the State will not alter, impair or limit sales taxes, which are devoted or pledged to the payment of Sales Tax Revenue Bonds, in a manner that reduces the amounts to be rebated to the issuing Municipality until such Sales Tax Revenue Bonds, together with applicable interest, are fully met and discharged; *provided, however,* the State may alter, impair or limit the sales taxes if and when adequate provision is made by law for the protection of the Bondholders. The State's covenant with the Bondholders is normally disclosed in any offering documents relating to the Sales Tax Revenue Bonds and is normally replicated as a contractual provision in the indenture or resolution securing the related Sales Tax Revenue Bonds (the *"Bond Documents"*).[1]

Without making adequate provision for the protection of the Bondholders (which protection presumably includes market value protection as well as payment protection), the elimination or substantial reduction of the Local Option Sales Taxes and the Tax Base would violate the State's covenant with the Bondholders, as it would result in the reduction or elimination of the amount of sales taxes rebated to a Municipality that are pledged to the payment of the Sales Tax Revenue Bonds. With the exception of setting aside sufficient funds for the payment in full of all of the outstanding Sales Tax Revenue Bonds,[2] what constitutes "adequate provision" for the "protection" of the Bondholders is unclear at this time.[3]

UNCONSTITUTIONAL IMPAIRMENT OF THE OBLIGATION OF CONTRACTS

Article 1, Section 10 of the Constitution of the United States of America and Article I, Section 18 of the Constitution of the State (collectively, the *"Contract Clauses"*) generally prohibit the State from passing any law that retroactively and substantially impairs the obligation of contracts *unless* the impairment serves an important and legitimate public interest and is a

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[1] Section 11-14-(3)(c) of the Bond Act, authorizes each city, town or county to include the State's pledge and undertaking in the Sales Tax Revenue Bonds.

[2] Full defeasance of the Sales Tax Revenue Bonds may be required to prevent a technical default on the Sales Tax Revenue Bonds because of the covenant contained in Section 11-14-307(2)(d) of the Bond Act, which states, in part: "the obligation of the legislative body to continue to levy, collect and allocate the excise tax…shall be irrevocable until the bonds have been paid in full…." This covenant is generally repeated in the Bond Documents. If the Municipality is no longer authorized to levy the applicable sales tax, *i.e.* the Local Option Sales Taxes, it will be in technical default under the applicable Bond Documents.

[3] The question has also been raised of whether the violation of the State's covenant (by the State's Legislature) may have an adverse affect on the State's "AAA" rating.

reasonable and narrowly tailored means of promoting that interest. The elimination or substantial reduction of the Local Option Sales Taxes and the Tax Base would likely substantially impair the contract with the Bondholders contained in the Sales Tax Revenue Bonds and the Bond Documents. While the fair taxation of the State's residents constitutes an important and legitimate public interest, it is questionable whether the proposed amendments satisfy the constitutional requirements, given the impact on not only the State, but the Municipalities and the Bondholders as well.

FINANCIAL ISSUES RELATING TO SALES TAX REVENUE BONDS

The proposed amendments would presumably reduce significantly, if not entirely eliminate, the sales tax revenues that have been pledged to the payment of the Sales Tax Revenue Bonds. Such a reduction decreases the ratio of revenues to debt service payable on Sales Tax Revenue Bonds (the *"Debt Service Ratio"*). Rating agencies consider the Debt Service Ratio as a key determinant of a Municipality's rating on its Sales Tax Revenue Bonds. A significant reduction in the Debt Service Ratio would provide less security for the payment of the Sales Tax Revenue Bonds and would presumably lead to a downgrade in a Municipality's bond rating. A lower rating evidences the greater risk of nonpayment of the Sales Tax Revenue Bonds and would lead to increased interest costs for future issues of Sales Tax Revenue Bonds and for all variable rate Sales Tax Revenue Bonds, and would reduce the market value[4] of currently outstanding Sales Tax Revenue Bonds. Given the general reduction in revenues, it is also possible that a Municipality's general obligation rating may be downgraded as well.

The Debt Service Ratio is a key determinant in a Municipality's ability to issue subsequent Sales Tax Revenue Bonds. Under most Bond Documents, a Municipality may only issue Sales Tax Revenue Bonds if, after giving effect to the issuance of the new issue, a certain Debt Service Ratio is maintained (generally 200% or more). Thus, the reduction in the Debt Service Ratio, or the elimination of the revenues altogether, would prevent a Municipality from issuing additional Sales Tax Revenue Bonds. Sales Tax Revenue Bonds have allowed Municipalities to lower both their cost of issuing debt and the interest cost on their debt. The loss of this option will force Municipalities to utilize other, more expensive, options for financing their capital needs.

CONCLUSION

The elimination or substantial reduction of the Local Option Sales Taxes and the Tax Base raises significant legal issues for the State. Without adequately protecting the Bondholders, the proposed amendments are likely a violation of the covenant made by the State in the Bond Act. Additionally, eliminating or substantially reducing the Local Option Sales Taxes and the Tax Base may be an unconstitutional violation of the Contract Clauses if such amendments

[4] A reduction in the marketability of outstanding Sales Tax Revenue Bonds could serve as a basis for legal proceedings by the current Bondholders against the State.

substantially impair the contract made with the Bondholders and are not narrowly tailored to accomplish the State's purpose. In addition to the legal issues faced by the State, the Municipalities themselves could face significant financial concerns in addition to the loss of the sales tax revenue, including, but not limited to, rating downgrades, increased interest costs and an inability to continue to finance their needs by issuing Sales Tax Revenue Bonds.

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