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Developer-Funded Tax Incremental Financing: Promoting Development Without Breaking the Bank

Developer-funded tax incremental financingeliminates a municipality's risk that the tax incremental district will fail and offers developers a means of increasing project costs paid by the municipality. Lawyers can help their developer and municipal clients identify when financial and development conditions are right to structure these.

by Jesse S. Ishikawa

Tax incremental financing (TIF) is the most powerful economic development tool that Wisconsin municipalities have today. Since 1976, municipalities have used this tool to fund industrial parks, attract out-of-town businesses, promote downtown condominium projects, and even to finance construction of "big box" retail stores. While the amount of financing a municipality is willing to provide varies on a case-by-case basis, it often ranges between 10 percent and 20 percent of a project's total construction cost.

Traditionally, municipalities have used TIF to provide financial assistance to developers at the beginning of a development project. The municipality then recovers those costs in later years from the increased property tax revenues generated by the project. Several municipalities have used developer-funded tax incremental financing (developer-funded TIF) to reduce the financial risks associated with TIF. With developer-funded TIF, the developer lends money to the municipality, and the municipality then uses the money to help pay for the project. The municipality repays the loan to the developer from the increased property tax revenues generated by the project.

This article informs lawyers how developer-funded TIF can be used by both developer clients and municipal clients to promote economic development with reduced risk to the municipality.

How Tax Incremental Financing Works

The TIF process begins when a municipality[1] and a specially appointed joint review board[2] designate a parcel of land as a "tax increment district." At least 50 percent of the land area within the district must be blighted, in need of rehabilitation or conservation work, suitable for industrial sites, or suitable for mixed-use development. The municipality then expends funds, called "project costs," to improve the district.[3] Project costs can include costs of streets and utilities, real property assembly, capital improvements, clearing and grading of land, relocation payments, and environmental remediation.[4] Frequently, the project costs are provided in the form of a direct financial grant to a developer.

If things go according to plan, the expenditure of project costs will result in increased property values within the district, and hence, increased property tax revenues. All of the resulting increase in property tax revenues (the "tax increment") is paid to the municipality to the exclusion of the other jurisdictions that rely on property taxes, namely, the technical college district, the county, and the school district. This arrangement continues until the earlier of 1) the district's expiration date (which, depending on the type of district, can be from 20 to 42 years after its creation), or 2) the date the municipality has fully recovered its project costs from the tax increment.[5]

As a condition to creating the district, the joint review board must find that the development expected within the district would not occur without the use of TIF.[6] This requirement is commonly referred to as the "but for" test. The "but for" test is used to ensure that TIF assists development projects that need help but does not become a giveaway of tax dollars to private developers.[7]

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How 'Lump Sum' TIF Works

In the typical tax increment district, the municipality expends project costs to promote private development at the beginning of the development process. The project costs might be earmarked to cover the developer's land acquisition costs, relocation costs, or public infrastructure costs. Because the municipality generally provides these funds in the form of a "lump sum" payment to the developer, they are referred to in this article as "lump sum" project costs.

The amount of lump sum project costs a municipality is willing to spend is limited by 1) the municipality's underwriting, and 2) the municipality's ability to borrow.

The municipality's underwriting. The municipality needs to make sure that lump sum project costs will be recouped from the tax increment generated by the project. This means that the amount of project costs that a municipality can spend must be limited to the present value of the total tax increment to be paid over the life of the district. The municipality cannot, however, calculate this number without lots of guesswork. The municipality must try to forecast the future assessed value of property within the district, future borrowing costs, future mill rates, and future increases or decreases in the flow of tax increment resulting from changes in legislation.

To protect themselves from being caught short, municipalities often take one or more of the following measures:

• *Obtain security for repayment of the project costs*. The municipality may require a promissory note from the developer backed by a mortgage, personal guarantee, letter of credit, or other security. The promissory note will cover the gap between the actual tax increment paid over the life of the district and the actual project costs incurred.

• *Enter into an agreement with the developer to protect the taxable value of the property.* The municipality may require the developer to enter into an agreement with the municipality under which certain obligations are imposed on the developer to preserve the property's taxable value. These obligations may include: prohibiting the developer from transferring its property to tax-exempt entities; prohibiting the developer from contesting tax assessments if the contest could result in reducing the property's value below the level at which the increment will repay the project costs; requiring the developer to insure all improvements against casualty; and requiring the developer to reconstruct improvements that are damaged or destroyed.

• *Use conservative underwriting assumptions.* Rather than use the present value of the tax increment stream over the life of the district to calculate the maximum amount of available project costs, the municipality may calculate the present value over a much shorter time, such as 10 to 12 years. The municipality also may limit the amount of project costs to a percentage of the present value of the tax increment stream.

• *Take an equity position in the developer*. The municipality may enter into profit-sharing arrangements in which the municipality is treated as an equity investor. These arrangements can be structured to ensure that any profits in excess of a specified internal rate of return to the developer belong to the municipality or to ensure that any profits to the developer in excess of a negotiated amount belong to the municipality.

The municipality's ability to borrow. The amount of lump sum project costs that a municipality is willing to provide a developer also is limited by the municipality's ability to borrow. Lump sum project costs generally are financed with the proceeds of general obligation bonds backed by the municipality's full faith and credit. The Wisconsin Constitution imposes on a municipality's general obligation debt a ceiling equal to 5 percent of the equalized value of taxable property within the municipality.[8] Even without the constitutional debt ceiling, a municipality's ability to borrow will be limited by its own concern about its credit rating. Just as a disproportionately large amount of debt will depress an individual's credit rating, a disproportionately large amount of debt will depress a municipality's bond rating, which in turn will increase the municipality's borrowing costs.

How Developer-Funded TIF Works

With developer-funded TIF, the municipality borrows the funds for project costs not by issuing general obligation debt to be held by the public but by issuing limited obligation debt to the developer. In other words, the developer lends money to the municipality. The municipality uses the money to pay the project costs to help the developer's

project. The loan is evidenced by a debt instrument, or developer bond, issued by the municipality to the developer.

Under the developer bond, the municipality repays the developer out of the tax increment that is generated by the district (or specific lands within the district). The municipality's obligation is limited to the amount of tax increment actually generated. Thus, if the project doesn't generate the tax increment needed to pay off the obligation, the party at risk is the developer, not the municipality.

The Wisconsin Supreme Court has held a pledge of tax increment to be general obligation debt.[9] If the municipality is unwilling to have the developer bond treated as general obligation debt, the bond must be structured as a "moral obligation" bond. A moral obligation bond includes statements that 1) all payments payable under the bond are subject to future appropriations by the municipality, and 2) such payments are not backed by the municipality's full faith and credit.

Advantages of developer-funded TIF to the municipality. The following are advantages to the municipality of using developer-funded TIF:

• The municipality uses none of its constitutional debt capacity.

• The financial risk that the project will not generate sufficient increment is transferred from the municipality to the developer.

Advantages of developer-funded TIF to the developer. The advantages to the developer of using developer-funded TIF are less obvious. Most developers would rather receive a lump sum cash payment than a future stream of payments over a period of many years under a bond that is not backed by the issuer's full faith and credit. (In reality, because a municipality's failure to make future appropriations would negatively affect the municipality's credit rating, a default under a "subject to future appropriations" bond, even if legally possible, is unlikely.)

So why would a developer prefer to receive a bond backed by a municipality's moral pledge of future tax increment as opposed to an up-front, lump sum payment? There are several reasons, all of which have to do with getting the municipality to open its wallet a little wider.

• Because developer bonds allow the municipality to pay more project costs without burdening the municipality's budget, they allow the municipality to increase the amount of project costs that can be spent on the developer's project.

• A developer bond, by transferring all risk of insufficient tax increment to the developer, frees the municipality from its otherwise strict underwriting standards. Again, this transfer of risk should increase the amount of project costs that can be spent on the developer's project.

• The developer bond creates an asset that can be pledged as collateral to a bank or other financial institution that provides money to fund the developer's project.

Application of the "but for" test. Wisconsin Statutes section 66.1105(4)(c)(1)a. requires the joint review board to approve or deny creation of a district based on certain criteria, one of which is "[w]hether the development expected in the tax incremental district would occur without the use of tax incremental financing." As noted, this criterion is referred to as the "but for" test. What effect does the "but for" test have on developer-funded TIF?

Some might argue that if the developer has the money to purchase the developer bond, then the development will certainly occur, with or without TIF. Under this view, use of a developer bond will always flunk the "but for" test. A closer look shows that this result is not necessarily so. A development financed with a developer bond may not be otherwise economically viable. Consider the following example:

1) Due to environmental contamination, the actual cost for acquiring land and readying it for development is $20 per square foot.

2) The market rate for land in the development's neighborhood is $10 per square foot.

3) The developer seeks to borrow funds to fund the land purchase and remediation at the $20 per square foot cost.

4) No bank will lend money for the purchase and remediation in excess of $10 per square foot.

5) Therefore, the development will not occur unless the municipality is willing to provide TIF assistance of $10 per square foot.

6) The municipality issues a developer bond to finance TIF assistance of $10 per square foot.

7) The bank determines that the TIF generated from the development will be sufficient to cover payment of the debt service on the additional $10 per square foot. The bank now is willing to lend to the developer the extra $10 per square foot, provided the developer collaterally assigns the developer bond to the bank as additional security.

8) The bank would not have provided the extra $10 per square foot without the TIF assistance.

9) The development would not have occurred without the TIF assistance.

Thus, use of developer-funded TIF in the above example meets the "but for" test.

Conclusion

Developer-funded TIF offers opportunities both to municipalities and to developers. For municipalities, it offers a way to eliminate the risk that the tax increment district will fail. For developers, it offers a means of increasing the project costs provided to their developments.

Endnotes

[1]Cities, villages, and (in certain cases) towns may create tax increment districts. *See* Wis. Stat. §§ 66.1105(3), 66.1339, 66.1105(16), 60.85.

[2]*See* Wis. Stat. § 66.1105(4m). The joint review board consists of one representative each chosen by the school district, the technical college district, the county, and the municipality, and one public member.

[3]Wis. Stat. § 66.1105(4)(gm)4.a.

[4]Project costs are defined in Wis. Stat. section 66.1105(2)(f)(1).

[5]*See* Wis. Stat. § 66.1105(6).

[6]Wis. Stat. § 66.1105(4m)(c)1.a.

[7]Wisconsin Department of Revenue, *City/Village Tax Incremental Finance Manual*, Section 1.1 (2006).

[8]Wis. Const., art. XI, section 3(2).

[9]*City of Hartford v. Kirley,* 172 Wis. 2d 191, 493 N.W.2d 45 (1992).

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