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Sales Tax Financing

Non-Property Secured Retail Development Improvements

Developing and revitalizing retail districts puts unique demands on both municipalities and developers. This includes the need to fund capital improvements, despite a reluctance to impose property tax costs on existing or potential retail tenants.

One frequently used solution applies sales receipts to secure municipal bonds. This can provide a considerable amount of capital, while avoiding many of the complexities and potential political challenges inherent in other development financing mechanisms. In using only sales tax revenues to secure municipal bonds, improvements made today can be financed with the revenues associated with both existing and future sales. This type of financing taps the economic activity of an area to finance needed improvements, avoiding the burden on the general property taxpayer or overlapping taxing bodies.

This brochure sets out the basic concepts underlying sales tax financing and how it can be used effectively by municipalities in partnership with developers.

What Is Sales Tax Financing?

Sales tax financing provides funding for improvements necessary to develop or redevelop a commercial area. These funds are derived from sales taxes emanating from the designated project area. In turn, these revenues can fund the improvements on a pay-as-you-go basis, or can be used to secure bonds issued by the municipality (the issuer). As security for the bonds, the issuing municipality pledges all or a portion of the sales tax generated. Importantly, this does not include other revenues emanating from the area, unless the issuer specifically chooses to include them. As a result, other municipal revenue streams can remain unchanged and may benefit from the increased economic activity.

What Do the Bonds Finance?

Sales tax revenue bonds can finance many types of development and redevelopment related costs. In general, bond proceeds can be applied toward public improvements, such as streets, sidewalks, traffic signals, highway interchanges, public parking, public landscaping, and street lights. In addition, the bonds may finance off-site improvements benefiting an area, such as storm water improvements. The applications can be based largely on project or issuer needs.

For example, bond proceeds could finance the acquisition of a blighted property through eminent domain, any associated legal expenses, demolition of the building, and any necessary site remediation and professional services associated therewith. In addition, any public infrastructure improvements would likely be eligible expenses. Importantly, improvements can be made to land owned by jurisdictions other than the issuer; this includes county, state, and federal property, with appropriate permissions. If the applied sales tax is something used across a jurisdiction, a wide range of improvements can be financed on a lower cost, tax-exempt basis. If the sales tax is established in a more specific area, typically for a specific development, the ability to issue lower cost tax-exempt debt still exists, however, for a smaller universe of project types.

How Does This Differ From TIF and Other Development Financing Tools?

Sales tax financing has many attributes that are similar to TIF bonds, special tax bonds, or other development financing tools. However, some differences make it preferable for specific uses. The main difference in these various mechanisms is found in the property tax component. As opposed to land-backed or TIF bonds, sales tax bonds are not property-tax-secured. This reduces the seniority of the lien given to debt service, in relation to private liens such as construction or mortgage loans, when compared with land- or TIF-secured bonds.

If sales tax receipts are sufficient to pay debt service for the necessary improvements, the use of sales tax financing can avoid the potential political challenges found with TIF and the additional tax due from property owners in special tax transactions. Sales-tax-backed financing also presents the potential benefit of transferring the burden of paying for improvements to consumers outside an issuer's community. Depending on location and tenant mix, the commercial activities within an area can create a regional draw, bringing customers and thus sales tax payers from outside the issuing jurisdiction.

Why Does This Type of Financing Exist?

Sales tax financing is largely driven by municipalities' need to foster and retain commercial activity within the community. With the use of sales tax to address these needs, this type of financing lends itself more to areas of retail activity, with added benefit if there is a regional consumer draw.

Similar to other development financing arrangements, sales tax bonds seek to take advantage of reasonably expected developments to finance their own improvements, minimizing the impact on the general taxpayer.

While future commercial activity is expected to bring adequate revenues to support the planned development, improvements are needed in the short term. To address this cash-flow mismatch, sales tax revenue bonds provide improvement funds in the short term and have a mechanism for new or stronger commercial activity to pay for itself in the medium to long term.

Sales Tax Financing Structures

Sales tax financing lends itself to a revenue bond structure. Typically, a municipality issues these revenue bonds for projects within their borders. The debt service on the bonds is secured only by the pledged sales taxes. This pledge can be structured across a wide spectrum of approaches, including a percentage of revenues throughout a jurisdiction, down to a percentage of sales tax receipts from a specific geographic area. Inherent to the revenue structure, the bonds are not a general obligation of the issuer and thus there is no commitment on the part of the issuing municipality beyond the pledged revenues. Sales tax revenue bonds typically are issued for 20 years, though shorter or longer structures are common.

An example of a successful sales tax financing is William Blair & Company's underwriting of the City of Bolingbrook's $47.7 million Sales Tax Revenue Bonds, Series 2005. In conjunction with a 424-acre mixed use development, including a sizable retail component, it was necessary to finance a wide range of projects. As the planned work included public improvements, the city issued bonds, secured by a 1.25% sales tax. Importantly, this plan pledged sales tax receipts from only the project area to successfully fund the development's public improvements.

Conclusion

In today's development environment, there are very few ways to develop or redevelop commercial areas without the expenditure of significant funds. The constructive application by municipalities of sales tax offers a tool for developers to partner with local governments to bring new activity to an area that might not otherwise experience the benefits. Communities and developers alike can benefit when sales tax financing bridges the financing gap to develop or improve commercial areas.

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