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Tax Increment Financing

A Guide to Funding Development-Related Improvements

Redevelopment poses unique challenges to both municipalities and developers. Among the most basic of these is financing the frequently significant capital costs associated with a successful redevelopment plan. When combined with the political demands placed on a municipality's precious financial resources, the ability of new development to finance itself becomes vital to project success. One solution to this is found in using revenues associated with new development to secure municipal bonds. This type of financing taps the benefits of new development, seeking to avoid the burden on the general taxpayer. This article sets out the basic concepts underlying tax increment financing (TIF) and how it can be used effectively by municipalities and developers.

What Is Tax Increment Financing?

Generally, TIF uses the revenue generated by development to finance the expenses associated with the project. This is done by capturing the revenue created by any increase in taxable valuation due to new development (the "increment") and applying it to eligible costs. Of note, the increment generated is a function of the tax rates of all the overlapping jurisdictions being applied to the increase in taxable valuation, not only that of the issuer.

One of the many eligible uses for these funds is the payment of debt service. Typically, tax increment revenue bonds are issued through a municipality, for the benefit of the TIF district. They are generally nonrated, exempt from federal income taxes, and secured by the incremental property and/or sales taxes of the development.

Incremental revenues are collected as property taxes. Thus, the underlying property is collateral and places debt service revenues in a senior lien position to private liens such as construction or mortgage loans.

What Do the Bonds Finance?

Tax increment revenue bonds can finance many redevelopment-related costs. This can include property acquisition, related professional services, site improvements, relocation and rebuilding of some public buildings, infrastructure, legal fees, and financing costs. For example, bond proceeds can 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, as part of a redevelopment plan, bond proceeds can be applied toward public improvements, such as streets, sidewalks, traffic signals, highway interchanges, public parking, public landscaping, and street lights. What constitutes an eligible project is subject to specific state statutes, but in many locales the possibilities are expansive. The underlying principle guiding the establishment of a TIF is that the planned development would not reasonably be expected to occur but for the establishment of the tax increment financing district and the development tools it allows.

Why Does This Type of Financing Exist?

TIF arose from the need by municipalities to fund improvements and other costs associated with redevelopment of blighted areas. Over time, legislative and legal definitions of "blighted" have evolved to include a broad range of community conditions making an area eligible for this type of financing. While distributing the costs of these projects among the general taxpayers can be politically challenging, taking advantage of reasonably expected developments to finance their own improvements provides an efficient and cost-effective mechanism by which to improve a targeted area of the community. Another of the guiding principles of TIF financing in general is that development pays its own way, avoiding undue burden on the general taxpayer.

While planned development is expected to bring adequate revenues to support the needed improvements, the infrastructure and other features are needed in the short term. To address this cash-flow mismatch, tax increment revenue bonds provide improvement funds in the short term and provide a mechanism for new development to pay for itself in the medium to long term.

Tax Increment Financing Structures

TIF exists in most states. While variations exist as to the particulars of structure and which level of government is responsible for TIF, the debt issuance and security features remain relatively similar. Developers should note that the laws of each state governing the eligibility of expenses, structure, and sale of these obligations will differ somewhat. Three main financing structures are commonly used: general obligation bonds, TIF revenue bonds, and developer notes.

General Obligation Bonds

One of several financing options available is general obligation bonds. Regardless of benefit or use, these are typically secured by an underlying general obligation unlimited tax pledge of the issuer's entire tax base. As a result of this pledge to pay, investors will expect less of a premium to accept the risks of a project. These risks are instead ultimately borne by the issuer's property tax payers.

Depending on the laws of a given state, debt secured by this pledge may also be counted against an issuer's general obligation debt limit, or overall amount available to address general city needs. This has the potential to bring development-related issues to compete against basic citywide infrastructure needs for scarce financing resources.

Tax Increment Revenue Bonds

Similar to other revenue bond structures, TIF revenue bonds are issued by the municipality establishing the TIF (the issuer) and are secured by specific revenue stream(s). This generally means incremental property and/or incremental sales taxes. The increment is the revenue derived from any increase in value over the base amount defined when the TIF district was initially established.

In certain situations, especially those incorporating a retail component, in addition to incremental property taxes, all or a portion of incremental sales taxes may also be pledged as security for the bonds.

An example of a successful tax increment revenue financing is the Village of Bartlett's (Illinois) Bartlett Quarry Redevelopment Project. The Village of Bartlett is about 31 miles northwest of downtown Chicago. Within an area experiencing continued commercial growth, Elmhurst Chicago Stone Company (the developer) owned a 705-acre sand and gravel extraction facility (the quarry). As the quarry reached the end of its useful life, significant public improvements were needed to redevelop the property for a viable alternate use. Part of the challenge in redeveloping the site included a considerable amount of site preparation. In part, this meant providing the 7.9 million cubic yards of earthen fill required before site grading could begin. To finance this, the village established a TIF district and entered into a redevelopment agreement with the developer.

William Blair structured a two-part financing that sought to provide funds as efficiently as possible while allowing the village and the developer the greatest flexibility. The first step included the sale of $17,360,000 taxable tax increment variable-rate demand revenue bonds, series 2000. Backed by a letter of credit, William Blair & Company successfully distributed the bonds to its seasoned investor pool.

In phase two, the TIF area began to mature from its original blighted condition to one of more sustainable commercial development and growth, although improvements were still

needed. As this occurred, the village, with the expertise of William Blair & Company, refunded the bonds with fixed-rate debt, no longer requiring credit enhancement. With the issuance of the Village of Bartlett's $25,000,000 senior lien tax increment revenue refunding bonds, series 2007, revenues from continued tax base and sales tax growth within the TIF will secure the bonds, ensuring the general taxpayer will remain unburdened by the cost of this new development, while benefiting from continued economic growth.

An additional feature incorporated into this plan of finance left the developer to provide up-front capital for many of the TIF eligible expenses. In turn, the developer was reimbursed only after the work was completed and the ability of the improvements to support financing was shown. This was done with developer notes.

Developer Notes

A variation on the use of conventional debt issuance to finance TIF improvements involves the issuance of a developer note. Especially with a TIF project in the early stages, the issuance of bonds backed by the uncertainty of only a development plan may be costly and inefficient. As a result, rather than the issuer's selling bonds to investors, a note is issued directly to the developer. Payable from future incremental revenues of the development, a developer note can be structured to finance eligible TIF expenditures and can also include an interest component. In certain circumstances, this included interest can also be federally tax exempt. This mechanism, likened more to a pay-as-you-go model, requires more capital on the part of the developer. As the project area matures and revenues become more defined, the issuer may elect to issue a TIF bond to pay off the higher-interest-rate developer note. If the note stays in place, the developer still has a mechanism to collect funds up front. At no cost to the issuer, the note can be securitized and sold to investors—a marketplace where William Blair & Company has an established practice.

The application of a developer's note and subsequent securitization is well illustrated with the $14,000,000 certificates of participation evidencing proportionate interests in payments to be made with respect to a tax increment allocation revenue note (Chicago/Kingsbury Redevelopment Project), tax-exempt series 2003A.

Following establishment of a TIF district and the Chicago/Kingsbury Redevelopment Project Area, the City of Chicago entered into an agreement with the developer to redevelop an area with both residential and commercial uses. As the developer incurred eligible costs, the City of Chicago issued developer notes to the developer for reimbursement, along with an interest component. The notes, in turn, are secured by a percentage of the incremental property taxes of the project. As the project was completed, the revenues from the development became more established and were expected to pay off the note over time.

Subsequently, in a transaction with which William Blair & Company has considerable experience, the notes were securitized and sold to our wide investor base. With William Blair & Company's years of experience and long-established investor trust, the notes were sold efficiently, providing the developer with valuable up front capital—all at tax-exempt rates.

Conclusion

There are very few ways to redevelop blighted areas without spending of significant funds. The creative use by municipalities of TIF offers a tool for developers to partner with local governments to bring renewal and revitalization to an area that might not see this but for the tools of TIF. Both communities and developers can benefit when TIF bridges the gap and makes redevelopment work in an area of need.

NOTES

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