

Tax Increment Financing Districts and Special Taxing Districts: Tools for Infrastructure Finance

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Tax increment financing districts and special taxing districts are a means whereby developers may utilize the public finance markets to finance off-balance sheet the costs of public infrastructure for various types of real estate development projects. The local jurisdictions creating the districts stand to benefit as well through the encouragement of targeted growth. This article summarizes the basic mechanics behind the formation and operation of these vehicles for real estate development.

In many jurisdictions around the country, the demands for development of both commercial and residential real estate projects have overwhelmed the ability of the local jurisdictions to provide the necessary roads, water and sewer, schools and other public infrastructure to satisfy the users of the new projects. Raising taxes across the board to finance the necessary infrastructure is oftentimes politically unfeasible, and requiring the private developer to finance such costs out of the project may be commercially impracticable.

A solution to the above conundrum has emerged in the form of specially created taxing districts which rely upon the dedication of a stream of tax revenues derived from the benefited properties to finance the necessary public infrastructure costs. These districts represent a “public-private partnership,” which can provide benefits to the developer seeing to obtain development approvals and the funds to complete its project, to the

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local jurisdiction seeking to accommodate growth while maintaining a constant tax base, and to the property owners who ultimately use the completed development.

The two types of taxing districts described in this article are Tax Increment Financing (“TIF”) districts and special taxing districts. While structured in a similar manner, they are often used in different ways and can, under certain circumstances, be used in combination to accommodate development projects.

Tax Increment Financing Districts

A TIF district involves the creation by a municipality, county or other local governmental body of a district comprising a defined geographic area wherein the real property taxes, sales taxes, or other general taxes are used to finance the desired improvements. The structure involves the establishment of a base year for the taxes in question, generally the year the district is established, with the increment of such taxes over and above that existing tax base diverted from the general governmental accounts into a special account where it

may be used directly to pay for the necessary infrastructure, or used to retire bonds issued by the local governmental authority, the proceeds of which bonds are used to finance the infrastructure.

Since the local jurisdiction is surrendering, at least temporarily during the life of the bonds, the additional tax revenues generated by the new development in the district, TIF districts are generally only utilized where the properties are subject to economic depression or the development represents a significantly higher potential for growth, and where concomitant economic benefits to the local jurisdiction are likely to accrue through higher property taxes on surrounding properties, or increased sales taxes, income taxes and other tax receipts projected to be realized from the benefited properties. The common test referred to in the context of TIF districts is the "but for" test whereby the increased tax base would not occur but for the real estate development, and accordingly, the local governmental jurisdiction is not giving up tax revenues that it would otherwise have.

Enabling statutes which permit the formation of TIF districts exist in almost every state.¹ The statutes differ with respect to the types of taxes which can be utilized in TIF financing districts, varying among real property, personal property, or sales taxes. The state statutes generally authorize a local governmental instrumentality to create the TIF district through the adoption of a resolution or ordinance which designates the defined area as a TIF district, sets the base tax year, and authorizes the capturing of the portion of the general tax revenues above the base tax year to be applied toward the designated infrastructure construction or debt retirement purpose.

Where a project is located in two or more overlapping jurisdictions, such as a municipality within a county, the incremental revenues from each of the governmental entities may be diverted towards financing the improvements.

Since the owners of the properties located within a TIF district will pay the same rate of property or sales tax as would any other property owner of the same class of property within the jurisdiction, there is no need for property owner approval of a TIF district, and typically state enabling statutes allow for the jurisdiction to unilaterally create the TIF district without the requirement for property owner consent. Nonetheless, the creation of a TIF district is often a bargained for element when the developer approaches the governmental authority and can be a useful tool in the arsenal of the local governmental authority in attracting new projects.

Special Taxing Districts

Special taxing districts (originally referred to as "Mello-Roos" districts in California, and also referred to in various state enabling statutes as community development authority districts, community facilities

districts, local improvement districts, municipal utility districts, or development districts) differ from TIF districts by virtue of the fact that an additional layer of special taxes or special assessments is imposed on the benefited properties over and above the general real property taxes, which revenues are in turn used to pay for the required infrastructure improvements. In virtually all state enabling statutes, special taxing districts may only be created after a specified percentage (ranging from 51 percent to 80 percent, by value and by number) of the owners of the benefited properties petition for, or ultimately consent to, the creation of the district.

As is the case with TIF districts, the local governmental authority is generally required to establish by resolution or ordinance the boundaries of the special taxing district. In addition, the authority must develop a methodology for the assessment of the special taxes and/or assessments which are imposed through the filing of a declaration recorded in the land records of the jurisdiction.

The state enabling statutes for special taxing districts generally provide that the special taxes and or assessments bear the same priority as general real property taxes and may be enforced, in terms of foreclosure procedures, in the same manner as the collection of delinquent real property taxes. Generally, in the event of a property owner default in the payment of special taxes or assessments, the property owner will be assessed a delinquency charge, and failing the payment of this tax by a date certain, the property will be subject to the local jurisdiction's tax sale procedures. Since real property taxes are senior to private liens, the local government is assured that it will have the ability to ultimately collect the delinquent special taxes and assessments through the local jurisdiction's tax sale of the property or a private property owner's redemption of the right to enforce a tax sale.

Some jurisdictions require advance disclosure in the real estate sales contracts to purchasers of properties located in special taxing districts as a precautionary method, although such taxes will generally appear on the real property tax bills sent to property owners.

Over 30 states currently have enacted enabling statutes to authorize the creation of special taxing districts, and depending upon state law, special taxing districts may be approved by municipalities and/or county governments.² In some jurisdictions, a quasi-governmental authority is authorized to be created by the enabling statute to administer the special taxing district and to issue bonds on behalf of the taxing district, while in others, the governmental authority itself maintains this authority.

It is possible to utilize TIF districts and special taxing districts in combination whereby the tax increment revenues are used as the primary source of repayment of the municipal bond obligations with the authority to impose special taxes and assessments as a "back-up" source of revenues. In such circumstances, the local

governmental jurisdiction creates separate TIF financing and special taxing districts with the same boundaries.

Municipal Finance Considerations For TIF Districts And Special Taxing Districts

The state enabling laws for TIF districts and special taxing districts generally authorize local governmental authorities (or quasi-governmental authorities) to issue bonds, which are supported by the tax revenues derived from TIF districts and special taxing districts to finance public infrastructure. The infrastructure eligible for such financing is specified in the enabling legislation and often includes roads, sidewalks, bridges, tunnels, culverts, intersection improvements, streetscape improvements, street lighting, transit facilities or systems, water and sewer pumping stations and force mains, stormwater management facilities, schools, police stations, fire stations, libraries, civic or governmental centers, parks, recreational facilities and other public facilities. Oftentimes, the cost of acquisition of the land on which such facilities are to be sited, and in the case of TIF districts, the cost of demolition and removal of existing vacant or underutilized buildings on such properties, is also authorized to be financed.

Depending upon the state enabling statute, the issuance of bonds on behalf of a TIF district or special taxing district will require the adoption of a separate resolution or ordinance by the local governmental authority which will specify the terms and conditions under which the governmental authority will issue the debt. Generally the bonds have maturities of upwards to thirty or forty years. Bonds issued on behalf of such districts may be given an investment grade rating by commercial credit rating authorities if there is a sufficient amount of development completed and a sufficient diversity of ownership of the underlying properties; however, in many cases, the debt is unrated.

Bonds issued on behalf of these forms of taxing districts are subject to a host of federal tax requirements, as well as municipal underwriting criteria, which may increase the cost of using this type of financing to the project. The primary benefit to the developer, however, which cannot be overlooked, is that bonds issued by local governmental authorities are off-balance sheet obligations for the developer, with recourse only to the benefited property owner. Further, most state enabling statutes provide that the failure of a single property owner to pay its dedicated taxes will not permit acceleration of the taxes owed by any other property owner, and accordingly, will not jeopardize an entire project if an individual property owner has difficulty paying its taxes. It is often possible to build in a period of "capitalized interest" whereby the interest on the bonds is paid out of bond proceeds pending the completion of a larger portion of the development and the increase in the tax base resulting therefrom dur-

ing which time the obligation of the property owners to pay special taxes or assessments is deferred.

Federal Income Tax Considerations

Municipal bonds issued by local governmental authorities may be issued on both a taxable and a tax-exempt basis from the standpoint of federal income taxes (likewise, interest on bonds can receive exemptions from state and local income taxes). While there is a limited market for taxable municipal debt, in most cases, the offering will be structured to insure that the interest on the bonds will qualify as tax exempt under Section 103 of the Internal Revenue Code of 1986, as amended (the "Code"). In order to achieve tax exemption, the bonds must not be deemed to be "private activity bonds" under Section 141 of the Code. In general, to avoid having a bond be treated as a private activity bond, no more than 10 percent of the proceeds of the bonds may be used for any private business use. A related test is that no more than 10 percent of the proceeds of the bonds may be secured by an interest in property to be used for a private business use or derived from payments in respect of property or borrowed money used or to be used for a private business use. For purposes of these tests, the term "private business use" means used in a trade or business carried on by any person other than a governmental unit.³

Accordingly, in order for the interest on bonds issued on behalf of TIF districts or special taxing districts to maintain their tax-exempt status, the proceeds of the bonds must be utilized to finance infrastructure which is owned and maintained, in substantial part, by a governmental entity. IRS Regulations issued under Section 141 state that the use during an initial development period by a developer of an improvement that carries out an "essential governmental function," such as a road, water system or recreational facility, is not considered private business use if the issuer and the developer reasonably expect on the issue date for the bonds to proceed with all reasonable speed to develop the improvement and the property benefited by that improvement, and to transfer the improvement to a governmental person, and the improvement is ultimately transferred to a governmental person promptly after the property benefited by the improvement is developed.⁴ The bonds cannot be used to finance privately owned facilities, such as recreational facilities owned by a home owners association, or private streets and alleyways, however, and certain jurisdictions as a matter of public policy look to see that the infrastructure is serving a wider population than the owners of the benefited development.

Certain other federal income tax requirements applicable to municipal debt may impact the structuring of bonds issued on behalf of TIF districts and special taxing districts. For example, the Internal Revenue Service regulations generally require that the proceeds of municipal bonds be disbursed by the issuer within a

defined period of time, generally ranging from three to five years from the date of issuance. These restrictions will limit the ability to finance projects with long construction periods through a single bond issuance, and may mandate the use of two or more series of bonds to complete the financing of a given infrastructure project. Further, restrictions on arbitrage, or the reinvestment of bond proceeds, will require that bond proceeds be held in yield-restricted accounts pending disposition through construction draws or the purchase of completed infrastructure.⁵ This in turn may also limit the ability of a developer to finance infrastructure for a development which will not be constructed or completed in close proximity to the date of issuance of the bonds.

Municipal Bond Underwriting Criteria

The municipal debt markets have developed a set of underwriting criteria which are applied to most TIF districts and special taxing districts, whether rated or unrated.⁶ For example, in most cases, bond underwriters will require that a debt service reserve fund of up to 10 percent of the principal amount of the bonds be established at the inception of the financing, which will be available to pay debt service on the bonds during a period of default or delinquency in the payment of the underlying tax revenues. The funds in the debt service reserve may be used to pay debt service during the life of the financing, or may be applied at the end of the financing to reduce the property owner's/taxing jurisdiction's funding requirements.

Depending on whether or not an investment grade bond rating is desired, the value of the underlying property in relation to the annual debt service will need to satisfy a minimum debt-to-value ratio. For unrated debt, the minimum value of the land must generally be at least two or three times the amount of the principal amount of the bonds at the time the bonds are issued. If this ratio cannot be supported, which may be the case in the early years of a project, a portion of the bond proceeds may be escrowed and not made immediately available to the project. Rated debt will require a much higher debt-to-value ratio.

Another criteria to be examined is the debt service coverage based upon the expected tax revenues. Oftentimes, the methodology for imposition of the taxes will permit the increase in special taxes and/or assessments up to a certain limit, but generally, there will be restrictions on the ability to increase taxes if property values are not sufficient to supply the necessary debt coverage. Accordingly, underwriters will need to evaluate the underlying economics of the benefited development, as well as the economic health of the area in question to assess the financial viability of the taxing district.

A competing concern for special taxing districts is often the desire of the local governmental authority to cap the amount of special taxes and assessments which may be assessed in any given year to property owners

from an affordability standpoint. Since a local jurisdiction will have the responsibility for collecting the taxes, and enforcing the tax sale procedures upon a delinquency of the property owner, from a political standpoint, it will generally seek to keep the special taxes at a reasonable rate.

The ownership of the properties in the district will be evaluated to see what entities will ultimately be responsible for paying the taxes on the properties. Generally, the greater the number of property owners, particularly in a residential development, the safer the district is considered. The closer the properties are to completion and ultimate sale to third party purchasers, the greater the assurance will be that a single developer's deteriorating economic condition will not result in a default in the payment of the taxes and assessments.

In order to assess these criteria, underwriters will often require appraisals of the underlying property, as well as engineering studies to assess the cost and feasibility of construction of the public infrastructure and market studies on the development potential of the project, to be conducted prior to the sale of the bonds.

Limitations on State and Local Debt Issuance

In addition to the enabling laws which authorize the issuance of municipal debt for TIF districts and special taxing districts, there may be constitutional or other local law restrictions on the issuance of municipal debt which must be considered. Bonds issued on behalf of TIF districts and special taxing districts are special revenue bonds and are not considered general obligation debt supported by the full faith and credit of the issuing authority. However, there may be limitations upon the ability of the jurisdiction to issue so-called "overlapping debt" or debt which is considered to be the debt of another governmental entity payable in whole or in part by the taxpayers of the jurisdiction. Due to the concern that taxpayers may have problems paying the general real property taxes which support the jurisdiction when they are also subject to special taxes or assessments, many jurisdictions have adopted fiscal policies which limit the total amount of overlapping debt, or at least overlapping debt which is not considered "self-supporting." In any event, the credit rating agencies which evaluate the general obligation debt of a jurisdiction will evaluate the total amount of other forms of municipal bonds when assigning credit ratings to the jurisdiction's general obligation debt, and the desire of many jurisdictions to maintain as high a general obligation bond rating as possible will influence the appetite of the jurisdiction for the issuance of revenue bonds to support TIF districts and special taxing districts.

Political Considerations

It goes without saying that given the public nature of the financing process of special taxing districts and TIF

districts, the creation of such districts is an inherently political process. The determination of whether a project is truly in the public interest when competing for scarce public resources involves a delicate political balancing act by the community, and developers seeking to establish these districts need to carefully cultivate the political leaders in the local jurisdiction and be prepared for the ancillary political fallout if their projects involve particular community concerns. Under the provisions of many state enabling statutes, the adoption of the resolution or ordinance necessary to establish the taxing district and/or to issue the bonds requires that the local jurisdiction conduct a public hearing, which must be generally advertised in the local media. Further, as noted, the establishment of a special taxing district will require the consent of a specified percentage of property owners. It is not always possible to anticipate concerns that may be expressed by persons attending such public hearings or otherwise being alerted to the development by the publication of the notice of the public hearing that a taxing district is being contemplated.

In some jurisdictions, the approval of special taxing districts may carry additional benefits, including the vesting of development rights, which are tied to the approval of these districts. Further, the approval of a district may work in a positive fashion from a governmental standpoint, serving as a galvanizing force behind obtaining the approval of other governmental agencies for development approvals and entitlements.

Time Considerations

The creation of TIF financing districts and/or special taxing districts and the issuance of municipal bonds to finance such districts will generally take more time than conventional financing due to the requirements for the political process, as well as the need to prepare the financing documents and to market the bonds to investors. With respect to the latter, the following financing documents are generally required in order to issue municipal bonds:

- A trust indenture between the issuing governmental authority and a banking institution to provide for the payment of monies owed to the bond holders (which includes the form of bonds);
- A bond purchase agreement between the governmental issuer and the ultimate purchaser or purchasers of the bonds;
- A disclosure document (Official Statement or Limited Offering Memorandum) and continuing disclosure agreement wherein the developer and local governmental issuer provide disclosures to the bond purchasers concerning the bond structure and the project, and agree to provide ongoing disclosure reports concerning same during the life of the bonds;
- A development agreement or other financing doc-

ument between the developer and the local governmental issuer which provides for the disbursement of bond proceeds to finance the construction of the public infrastructure.

The complexity of the financing documentation involved and the extended time period needed to create a TIF district and/or special taxing district and to market the bonds generally mandates building in lead times of at least six months before bond proceeds can be disbursed, and makes this process generally impracticable for developments with public infrastructure requirements of less than \$5 to \$10 million. The actual time and cost to create such districts will vary extensively from jurisdiction to jurisdiction.

Conclusion

TIF districts and special taxing districts can be a win/win situation for the local jurisdiction, the developer, and the ultimate owners of the benefited development.

The local jurisdiction is able to ensure that infrastructure necessary to sustain growth in the community will be built when it is needed, and not tied to the development schedule or financial condition of the developer. The infrastructure delivery can be accelerated from the timetable seen under the typical proffer arrangement whereby the developer is required to build certain public infrastructure only based upon the progress of the development. Further, these financial tools can be used as a carrot that can be used to attract development to a desired area. In the case of a special taxing district, the government is not giving up any tax revenues it would otherwise get, and in fact will benefit from increased general real estate tax receipts and other local taxes that are generated through the increased valuation of the properties. In the case of a tax increment financing district, the local jurisdiction is still gaining properties with increased value, which will ultimately result in an increased tax revenue, and which in the meantime may generate additional sources of other tax revenues, whether they be personal property, income, sales or other local tax revenues.

For the developer of properties located within such districts, a huge advantage is that the cost of constructing the public infrastructure is removed from the developer's balance sheet, which in turn reduces development cost and frees up capital resources. The developer is able to pass along the debt service obligation on such infrastructure to the ultimate property owners as the property is improved. Further, the interest coupon on the tax-exempt bonds is often lower than the cost of capital provided through private institutional lenders and private equity, although given the requirements for debt service reserve funds and the other municipal debt underwriting criteria discussed, the overall cost of the financing may or may not be less expensive.

The ultimate property owners will be benefited from the assurance that the public infrastructure will be

provided on a more certain basis without regard to the financial condition of the developer. Further, since the developer will not be financing the cost of the infrastructure through its own capital resources, the ultimate cost of the project will be reduced, and the developer may be able to pass along the cost savings to the property owners. In the case of tax increment financed districts, the owners will pay no additional property taxes to the local jurisdiction. While they will incur some additional taxes in the case of special taxing districts, such taxes are paid on an annual (or semi-annual) basis, are often escrowed along with other real estate property taxes and are only incurred during the period of time that the property is owned by each purchaser. Finally, depending upon the type of special tax or assessment, the property owners may also obtain federal and state income tax deductions for such taxes.

¹ *A Summary of State Legislation to Encourage Innovative Infrastructure Finance Options*, prepared for National Association of Homebuilders by National Conference of State Legislatures, August 2005.

² *Building for Tomorrow: Innovative Infrastructure Solutions*, National Association of Homebuilders, 2003.

³ I.R.C. § 141(b)(6).

⁴ Treasury Regulation § 1.141-3(d)(4).

⁵ I.R.C. § 148.

⁶ Many credit rating agencies, such as Standard and Poor's, Moody's and Fitch, as well as many municipal bond underwriters, publish internal guidelines for this type of municipal debt, and the specific circumstances of each district must be evaluated by the agencies and underwriters. The author is providing a summary of the factors most commonly considered by such agencies and underwriters in evaluating this type of financing.