Increment Options

With tax increment financing, sometimes a developer note makes more sense than a bond.

Tax increment financing (TIF) is one of the important governmental initiatives encouraging redevelopment in urban areas and on sites that have particular developmental or environmental problems. Most states have adopted TIF legislation that gives municipalities the power to capture real estate taxes, and sometimes other taxes as well, generated from development in qualifying areas, and apply those new tax revenues to pay for eligible costs of development.

In the absence of TIF, tax revenues are paid directly to the various taxing districts encompassing the new development. The theory behind TIF is that if it were not for this financing tool, the proposed development would not occur; therefore, there would be no new taxes. The new development provides incremental new tax revenue to be used for development, but the existing taxes, or "base," will be retained to be paid to the taxing districts. The municipality gets a new project, the existing taxes continue to be paid, and the new real estate taxes are used to help finance the project, thus ensuring its development. At the end of the TIF term, all the taxes, incremental and existing, are again paid to the taxing districts.

Municipalities across the country are using TIF extensively to jump-start commercial and industrial developments. The source for incentive payments under TIF generally is real estate taxes, while some states also allow new sales taxes to be used for retail projects.

Often, developers are unclear as to what form of TIF assistance they can receive and how TIF dollars reach them. The structure of a TIF deal will determine how a developer gets the benefit of the economic incentive. Getting the benefit of TIF dollars does not necessarily mean getting them immediately. There are essentially two forms of TIF assistance: a TIF bond and a developer note, sometimes referred to as a "pay-as-you-go" deal.

In most large urban redevelopment projects that utilize TIF, TIF funds will derive from a bond issued by a governmental authority, resulting in immediate proceeds to pay for eligible costs. The TIF bond will be secured by the flow of future incremental TIF revenues. This makes sense because the typically significant costs of urban redevelopment, which include infrastructure costs, need to be paid immediately.

Another common TIF structure does not use bonds but instead relies on the issuance of a developer note; this is an obligation to the developer that will be repaid over a negotiated term and that does not produce immediate bond proceeds for the development. A developer note can sometimes be used as a source of private financing to secure TIF when the developer can otherwise front-fund the development costs and wait for the TIF dollars to be generated over the life of the project. The developer—or sometimes its national tenants or users—becomes the bond buyer.

There may be several reasons why using a developer note can, at times, make more sense. Although TIF bonds yield

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immediate proceeds for a development, the issuance of bonds may not be possible because of the difficulty in marketing bonds for a project that involves construction risk, and the inherent inefficiencies and costs of issuing bonds too early in the development process.

In order to sell a TIF bond, the underwriter generally wants one of several assurances: a general obligation pledge from the municipality; a completed project generating the new taxes that are the source of bond repayment; or national credit tenants or users that can ensure performance and completion of the project.

Except for major redevelopment initiatives that have broad political support, general obligation bonds usually are not issued due to the financial and rating risk to the issuing authority. With the exception of a few highly creditworthy national users, an underwriter may find it difficult to sell bonds until a project is built and there is assurance of the new tax stream. If the bonds are salable, the underwriter may require a significant debt coverage factor.

In addition, issuing a TIF bond before the project is completed and generating taxes is generally not an efficient way to utilize the new increment. For example, say that a redeveloper's total budget is $50 million, with $10 million being reimbursed from TIF for eligible costs. In order for a municipality to issue a TIF bond to yield $10 million to the developer, it will need to sell a bond of about $13 million. This is because approximately $3 million of the bond proceeds will be used for non-project-related costs such as capitalized interest, interest reserves, and bond issuance costs.

Since there usually is a two-year gap between project commencement and collection of incremental taxes after reassessment, a bondholder will want proceeds from the bond put aside to pay interest on it (rather than merely

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accrue) until the new taxes are paid and there are funds available to pay debt service. Similarly, bondholders may require an interest reserve of one year's debt service put aside in case there is an interruption in receiving tax payments, whether as a result of delays in the tax collection process, legislative changes, casualty, or otherwise. In addition, issuing bonds also involves paying underwriters, bond counsel, printers, and other costs of issuance. All these reserves and costs can add up to 20 to 30 percent of the par amount of the bonds. This is why a $13 million bond may have to be sold to net $10 million toward development costs.

What about the debt coverage factor? In order to sell a bond of $13 million, it may be necessary to have new tax increment available to pay not only debt service on $13 million, but also a cushion of 115 to 120 percent coverage on the debt service. Bondholders are risk averse and want a safety factor on the annual revenue

projections. If the debt service is $780,000, on average, for an unrated $13 million bond, one will need almost $900,000 in increment annually to satisfy the bondholders (1.15 x $780,000).

Because of these reasons, a municipality may issue a developer note instead of going through the difficulty and inefficiencies of issuing a TIF bond. A developer note is no more than an obligation to pay the developer a stated principal amount bearing interest at a negotiated rate.

Using the example above, the developer would receive a developer note for $10 million. After the project is built and generating new taxes, the municipality begins paying interest and principal on the note, including interest that accrued during the period prior to the new tax assessment and payment. Except for incidental costs, no major issuance costs are incurred and no reserves are needed, so there is no need to finance an amount much greater than $10 million. It also is not necessary to meet underwriter debt coverage ratios that can further erode the amount of funds available to be used for the project. Using the aforementioned example, only about $600,000 of annual increment (0.06 x $10 million) will be needed to fund the annual obligation under this scenario, as opposed to almost $900,000 under the bond structure. (For the purposes of simplification, this example ignores the effect of the interest rate differential for bonds versus notes.)

If a developer needs the $10 million at the time of construction, he or she may have no choice but to use the bond structure if it is available. If the developer can otherwise finance the development for the short term, and perhaps use the developer note as collateral for additional financing, the note option can be more efficient. Once the project is completed and generating increment, the municipality can redeem the note by issuing a TIF bond. At that point, the developer receives the full amount of the incentive and the municipality usually does not have to worry about capitalized interest or other significant reserves being added to the amount of financing. In addition, the interest rate on the bond at that point will be less than under the note and it is an incentive for the municipality to redeem the note, if possible.

Negotiating a TIF incentive package involves analyzing the form of the obligation to be issued. Although the developer may prefer to receive bond proceeds, that structure may be unavailable or not efficient. Understanding the ramifications of a developer note will allow a developer to employ a more efficient manner of capturing TIF revenue to enhance his or her project. It also will permit the developer to determine whether the funds represented by the note can be financed for the short term, without the necessity of issuing bonds. ■

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