Virginia Resources Authority
2019 Governor's Infrastructure Financing Conference

<u>Tax Increment Financing: Some Basics and Some Battle Scars</u>

I. The Basics

A. Statutory Tax Increment Financing

1. Virginia Code Sections 58.1-3245 to 58.1-3245.5 authorize the governing body of any county, city or town to adopt tax increment financing.

2. The governing body shall hold a public hearing on the need for tax increment financing (58.1-3245.2B).

(a) Notice is required to be published for "three consecutive weeks immediately preceding the public hearing in **each** [emphasis added] newspaper of general circulation" in the locality.

(b) Notice is required to include the time, place, and purpose of the hearing; define tax increment financing; indicate proposed boundaries of the "development project area;" and propose obligations to be issued to finance "development project area costs."

3. After the public hearing, the governing body may adopt an ordinance designating a "development project area" and providing that real estate taxes in the development project area will be assessed, collected and allocated according to the TIF statute (58.1-3245.2A).

4. TIF statute provides a mechanism for calculating incremental real estate taxes (58.1-3245.2A).

(a) Local assessor records "base assessed value" and "current assessed value" of real estate in the development project area.

(b) Real estate taxes attributable to the increased value between current assessed value of any parcel and the base assessed value of such parcel shall be paid into a special fund entitled "Tax Increment Financing Fund" to pay debt service on "obligations" or "development project cost commitments."

5. TIF statute authorizes localities to issue "obligations" or to make "development project cost commitments" secured by the Tax Increment Financing Fund (58.1-3245.4).

(a) Obligations are subject to the requirements and limitations of Public Finance Act (Sections 2600 et seq.) and any charter provisions.

(b) Obligations must be subject to annual appropriation or they will be treated as general obligation debt for constitutional purposes and subject to referendum requirements applicable to counties or the general obligation debt limit applicable to cities and towns (unless and until there is a test case clarifying that a TIF pledge is not a general obligation).

(c) Obligations may pledge all or part of the revenues in the Tax Increment Financing Fund.

(d) Any revenues not pledged may be paid into general fund at the end of the tax year.

(e) The locality may also pledge (i) net revenues of any development project; (ii) all real estate and tangible personal property taxes; (iii) full faith and credit; and (iv) any other taxes or anticipated revenues that the locality may lawfully pledge.

6. Definitions

(a) "Base assessed value" means assessed value of real estate in a development project area on January 1 of the year preceding the effective date of the ordinance creating the development project area.

(b) "Current assessed value" means the annual assessed value of real estate in a development project area as recorded on land book records.

(c) "Development project area" means any area designated for development or redevelopment in an ordinance passed by the local governing body.

(d) "Development project cost" has the same meaning as "cost" in the Public Finance Act. Public Finance Act defines cost to include acquisition costs, professional services, engineering, construction, financing, etc. of a "project." Project is defined as "any public improvement, property or undertaking for which the locality is authorized by law to appropriate money, except for current expenses."

(e) "Development project cost commitment" means a determination by the local governing body of payment of an amount of development project costs from tax increment and other available funds [allows pay-as-you-go financing rather than issuance of "obligations"].

(f) "Obligations" means bonds, general obligation bonds and revenue bonds as defined in Section 15.2-2602 of Public Finance Act and any other form of indebtedness a locality may incur. Public Finance Act defines "bonds" as any obligations of a locality for the payment of money; "general obligation bonds" as bonds for which the locality is required to levy ad valorem taxes; and "revenue bonds" as bonds for which only specified revenues are pledged to which no ad valorem taxes are pledged.

B. "Informal" or "Synthetic" TIF

1. TIF accomplished by agreement relying on statutory authority available to the locality other than the TIF statute.

2. Typically involves an agreement between the locality and another party (usually the EDA/IDA or a community development authority) to pay certain tax revenues to the other party to be used for specified purposes.

(a) Localities have authority to make gifts, donations and appropriations to an EDA/IDA for economic development purposes (Sections 15.2-953 and 15.2-1205).

(b) EDA/IDA has authority to accept contributions and grants from governmental entities (Section 15.2-4905(12) and to make loans or grants for its purposes, including the purpose of promoting economic development (Section 15.2-4905(13)).

3. A locality could probably establish a tax increment fund through its normal budgeting process without undertaking an agreement with a conduit entity, but only if the TIF revenues will be spent on projects and infrastructure the locality is authorized to pay for directly.

4. Advantages of "synthetic" TIF:

(a) Locality may determine base year and method of calculation of TIF revenues.

(b) Locality may agree to use all or any portion of revenues from any source (real estate, personal property, sales tax revenues).

(c) Use of revenues is not limited to "development project costs." TIF revenues may be used for any purpose for which the locality is authorized to expend funds.

5. Disadvantages of "Synthetic" TIF

(a) Statutory authority is "cobbled together." Some investors may prefer that a financing follow the specific statutory framework of the TIF statute.

(b) The TIF statute may provide a clearer path to issuing obligations of the locality secured by TIF revenues (Section 58.1-3245.4) rather than using a "conduit" issuer.

II. Some "Battle Scars" and Other Considerations

A. Calculation of Incremental Tax Revenues

1. Why not just subtract $ amount of base year revenues from current year revenues?

(a) The TIF statute seems to limit calculation of tax increment revenues to the increase resulting from increases in assessed value from base year to current year, excluding increases resulting from an increase in tax rate.

(b) Under the informal TIF scenario an increase in tax base could motivate the governing body to lower the tax rate, effectively keeping incremental tax revenues flat.

2. A more complicated, but more creditworthy, calculation would require incremental tax revenues to be calculated using the greater of (i) same tax rate as

the base year, applied to current assessed value or (ii) current tax rate applied to current assessed value.

3. If the locality pledges 100% of TIF revenues, the governing body could suffer political consequences of diverting significant amounts of general tax revenues from other services.

4. In calculating the TIF revenue pledge, thought should be given to the duration of the pledge. Does the pledge extend for the life of the obligations secured by the pledge or is it a pledge of fixed duration, regardless of whether the obligations have been paid in full?

B. TIF obligations are difficult to market and carry a higher interest rate.

1. The source of repayment for TIF obligations is often speculative. The locality cannot be compelled to raise taxes or user fees. Most TIF obligations will be subject to annual appropriation.

2. There can be political, as well as financial, consequences to using TIF to pay for infrastructure that could be financed with a more secure financing, such as general obligation bonds or revenue bonds for which rates can be imposed and increased as needed to pay debt service. A locality may ultimately refinance TIF obligations on a general obligation or other more secure basis to lower debt service.

3. A locality may need to pledge additional revenue sources or provide some additional security in order to sell TIF bonds.

C. What happens if TIF revenues are not sufficient to pay debt service?

1. The locality is not obligated to make payments other than from TIF revenues.

2. TIF obligations are often secured by a back-up source of revenue, such as a special assessment. Numerous community development authority financings were structured with TIF revenues and a back-up special assessment.

3. If bonds secured by TIF revenues go into default, does that affect the locality's ability to issue general obligation bonds (or other types of financing)?

(a) TIF is not the same as general obligation financing and, in theory, a TIF default should not affect a locality's general obligation credit any more than a revenue bond default would affect the general obligation rating.

(b) Similarly, as long as the default was not the result of a failure to appropriate, a TIF default should not affect a locality's ability to borrow on a "subject to appropriation" basis, such as a lease financing.

(c) There has been discussion by the rating agencies questioning whether defaults on TIF or special assessment financings evidence fiscal distress that reflects negatively on a locality's credit.

D. Can economic development incentives or other private development be financed using incremental tax revenues or is TIF limited to public infrastructure?

1. Does the definition of "development project cost," by cross-referencing the definition of "cost" in the Public Finance Act, incorporate the Public Finance Act definition of "project"? If so, the TIF statute can be used only to finance capital items for which the locality is authorized to appropriate money. Traditional public improvements and infrastructure, such as roads, water and sewer, parks, would clearly be permitted to be financed using the TIF statute.

2. The Public Finance Act defines "project" as "any public improvement, property or undertaking for which the locality is authorized by law to appropriate money, except for current expenses. . ." Does the qualifier "public" apply to "property" and "undertaking" so that only public projects qualify to be financed? If the "public" limitation does not apply to property and undertaking, could the TIF statute be used to finance private development or redevelopment? If localities are authorized by law to make payments of money to their EDAs, is that a qualifying "project"?

3. Informal TIF arrangements may provide more flexibility to finance facilities that may be privately owned or to provide economic development incentives to private development.

E. How can a locality protect its interests when it uses TIF to incentivize private development? How does a locality insure that the private sector delivers?

1. If possible, the transaction should be structured so that the locality's contribution finances infrastructure that will benefit the locality, regardless of the private sector's performance (such as traditional water and sewer, roads and other public infrastructure).

2. If TIF revenues are used for economic development incentive payments, a development agreement that clearly outlines the obligations of the parties is necessary, including "clawback" provisions if the private sector does not perform.

3. If possible, the public and private financial contributions should be made on a pro rata basis.

F. Are TIF obligations tax-exempt?

The tax-exempt status of an obligation depends on several factors, not simply the public ownership and use of the financed facilities. Tax-exemption may also be affected by the source of funds to repay the obligation and whether the obligation is deemed a "private loan." These issues are beyond the scope of this outline, but need to be carefully considered in structuring a TIF transaction.

G. Does the TIF statute authorize a locality to pledge revenues other than incremental real estate taxes?

Section 58.1-3245.4 authorizes a locality to pledge "any other taxes or anticipated revenues that the county, city or town may lawfully pledge." The statute is not clear, but it seems likely that this is intended to allow a pledge of taxes other than real estate taxes.

H. What is the significance of references to blight in the TIF statute?

(a) As initially enacted in 1988, the TIF statute was limited to financing improvements to blighted areas. Subsequent amendments eliminated this requirement.

(b) Despite the findings in Section 58.1-3245.1 there is no requirement that the locality make a finding of "blight" (although such a finding does help establish a public purpose).