# OMAC MuniNews

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# Tax Increment Financing: Risk vs. Reward

***By: Bradford M. Sprague***

**Introduction:** Tax Increment Financing ("TIF") has become an increasingly popular economic development tool over the past decade in Ohio. Some of the most high profile projects in the State, including Polaris, Easton and Nationwide Arena in the Columbus area and the Rock and Roll Hall of Fame in Cleveland, have used TIF financing to facilitate the development process. Many smaller projects have also employed TIFs to leverage other infrastructure financing tools. It appears that TIF financing is here to stay, and its utilization is likely to continue to increase.

It is impossible to address, in this abbreviated space, all of the issues that must be faced when pursuing a TIF financing. It is my goal to address the risks associated with TIFs and who assumes those risks.

**Fundamentals:** A TIF can be designed to capture all or a portion of the increase in assessed valuation associated with a project. The base year assessed valuation for the property within a TIF District is established in the year that the TIF is created. Real property taxes attributable to this base valuation are not captured by the TIF, and they continue to be collected and distributed in the normal manner. *No governmental unit forfeits existing taxes as the result of creating a TIF.* When a TIF is created, a full or partial exemption is granted for the increase in property value above the base. The owner(s) of the property within the TIF District make Payments In Lieu of Taxes ("PILOTS") equal to the real property taxes that would have been paid if the TIF had not been created. These PILOT payments can be used to pay for infrastructure improvements or pay debt service on bonds issued to pay for such improvements within the TIF area. *The property owner(s) do not receive a "tax break". They continue to pay the full amount due, but the PILOT portion of the total payment is used to offset the cost of <u>public</u> infrastructure.*

**Inherent Risk:** While a TIF can be a powerful economic tool, its utilization does not come without risk. The risks can be grouped into two primary categories: development risk and credit risk.

Development risk is the more difficult of the two categories to quantify. It is usually necessary to have the capital improvements supporting the development in place prior to completion of the project. Development risk centers on the answers to the following questions.

Will the project be completed?

Will the project be completed in a timely manner?

Will the assessed valuation of the development meet or exceed expectations?

The least development risk is associated with projects that are proven and well defined, have a reasonably short development horizon and are controlled by an experienced developer. Conversely, development risk is high for unique projects, projects scheduled to be completed in multiple phases and those not fully controlled by a single developer. The local government constructing or financing the infrastructure improvements can insulate itself from a large portion of this development risk by incorporating the following features into the TIF documents.

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# TIF continued

Insist that the developer agree to a minimum assessed valuation or payment schedule. The developer is controlling the pace of development and possesses the expertise in this area. The developer is also making certain representations concerning the ultimate tax value of the project. Therefore, it is only appropriate to ask the developer to stand behind the financial projections that he is asking the local government to accept.

Require the developer to waive his right to appeal the assessed valuation of the project as determined by the County Auditor. This is especially important on unique projects such as arenas and museums.

TIF bonds should be structured with ample excess coverage. This will help insulate the issuer of the bonds from deviations in assessed valuation.

Structure the bonds to provide for a generous "ramp up" period for the revenues. This can be accomplished by providing for several years of capitalized interest and minimizing the amortization of debt in the early years. This insulates the issuer from unanticipated construction delays. This is especially important in multi-phase developments.

The above suggestions are designed to insulate the local government from development risk and shift that risk to where is appropriately belongs: to the developer.

Credit risk is better understood than development risk by local governments, but the issuer of TIF bonds should nevertheless try to insulate itself from such risk to the extent possible. Credit risk is a result of the following factors:

Fluctuation in tax rates: There is no guarantee that tax rates will remain constant over time. Only unvoted millage grows with inflation. Voted levies are "rolled back" on an annual basis, and many levies are in place for a limited period of time and are subject to renewal or replacement by the electorate.

Developer/Owners ability to pay: Even if the project is completed on time and the assessed valuation meets expectations, the financial strength of the developers and tenants will ultimately determine the ability to pay. This risk is highest when the property is controlled by a single taxpayer and minimized when the ownership structure is diverse.

Future declines in assessed valuation: There is an inherent predisposition to assume that assessed valuation will always increase. This is not always true for commercial properties which

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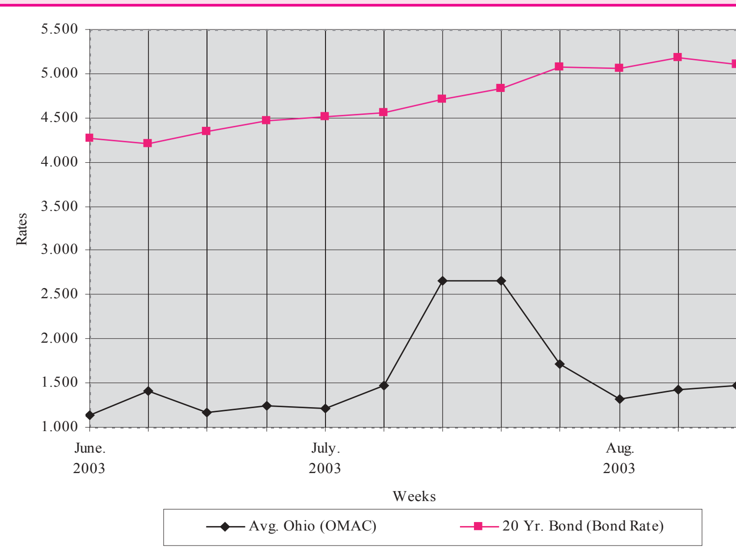
# MARKET UPDATE

## GENERAL OBLIGATION

Note and Bond Interest Rates for June thru August

The following graph compares Ohio short-term note rates with the Bond Buyer's 20 year bond index. The short-term rates represent actual rates reported to OMAC by Ohio purchasers and reported on OMAC's weekly calendar.



## TIF continued

can become dated over time.

Local governments can at least partially insulate themselves from these risks by employing the following techniques:

Structure debt to provide for ample coverage in the event that tax rates decline in the future. This can be accomplished by eliminating temporary levies and levies that have previously experienced difficulty in maintaining voter support from the analysis.

Insist that the developer secure PILOT payments with a letter of credit or some other form of financial guaranty.

Insist that the developer agree to a minimum payment schedule. This protects the issuer of TIF bonds from declines in assessed valuation as the project matures.

TIFs are a powerful economic development tool. Nevertheless, when a local government agrees to issue TIF bonds, it should do so with its eyes open. There is inherent risk in each transaction and, to the extent possible, the government should shift those risks to the developer and away from itself. Local governments are often so worried about losing an attractive economic development opportunity that they assume a disproportionate share of the risk. Risk should rightfully be shared by all parties who can be expected to receive financial gain from the project in question.

*Bradford M. Sprague is President and cofounder of PRISM Financial Solutions*

## Good Luck Wade

At the recent Ohio GFOA conference, it was announced that Wade Steen has resigned from the Board of Trustees of the Ohio GFOA. Wade has accepted a position as Chief Financial Officer with the Lutheran Social Services of Central Ohio. The Ohio GFOA thanked Wade for all his hard work and timeless efforts and dedication over the years to the organization. OMAC would like to join the GFOA in wishing Wade the very best in his new endeavors.

## Employee Profile

**Name: Jason Hart**

**Length of Service**
6+ years

**Main Duties with OMAC**
Maintenance and report writing of all Revenue and State of Ohio issues; maintenance of Hospital database and publishing yearly Hospital Book. Processing Material Events and Sid Requests and some maintenance of Public Utility information.

**Family**
Single

**Interests**
Sports, travel and reading.

## Please Contact Us

If you are in charge of planning your organization's meetings, we would like to hear from you. If you are planning a meeting or conference for your organization, we would be happy to include it in OMAC's Muninews newsletter. Our newsletter reaches over 1,000 readers involved with municipal finance including, County Auditors, City and Village Finance Officers, Municipal Treasurers, School District Officials and others. Please contact Chris Scott at 800-969-6622 or email Chris at chris@ohiomac.com.

**Ohio Municipal Advisory Council**
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Twinsburg, OH 44087-2445



## CALENDAR

*Calendar of Issuer Conferences & Outings for 2003*

| NAME | EVENT | DATE | LOCATION |
|---|---|---|---|
| GFOA | Annual Fall Conference | September 16 - 18 | Cincinnati Marriott North, Cincinnati, Ohio |
| MFOA (OML) | Annual Conference | October 1 – 3 | Hyatt Regency Hotel - Cincinnati, Ohio |
| CCAO | Winter Conference | Nov. 30 – Dec. 2 | Hyatt Regency – Columbus, Ohio |
| OSBA | Conference | November 9 - 12 | Hyatt Regency - Columbus Convention Center |
| OAPT | Annual Conference | October 8 – 10 | Hilton Cincinnati Netherland Plaza – Cincinnati Ohio |
| CAAO | Winter Conference | November 18 - 20 | Embassy Suites - Dublin, Ohio |
| OPEC | Annual Meeting | TBD | Columbus, Ohio |

CCAO – County Commissioners Association of Ohio – (614) 221-5627
GFOA – Government Finance Officers Association – (614) 221-1900
MFOA – Municipal Finance Officers Association of Ohio – (614) 221-4349
NACO – National Association of Counties – (614) 221-5627
OASBO – Ohio Association of School Business Officials – (614) 431-9116
OMCA – Ohio Municipal Clerks Association – (614) 221-4349
OSBA – Ohio School Boards Association – (614) 540-4000
OAPT – Ohio Association Public Treasurers– (440) 885-8812
CAAO – County Auditor's Association of Ohio – (614) 228-2226
OPFOTP – Ohio Public Finance Officers Training Program – (330) 672-7148
BMA – Bond Market Association – (212) 440- 9429
OPEC – Ohio Public Expenditure Council – (614) 221-7738

*If you would like your event highlighted, contact Chris Scott at 1-800-969-6622, or by email at Chris@ohiomac.com*