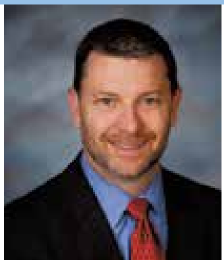

Managing the Risks of Tax Increment Financing

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Tax increment financing ("TIF") is a local economic development tool that can be an essential ingredient in making a development project happen. However, financing a development project can expose a municipality and its taxpayers to significant financial risk. This article describes common risks and risk management strategies associated with TIF projects.

All TIF projects have one important feature in common: they depend on private development to increase the assessed value of taxable property. In a TIF district, the tax revenue generated by that increase in value is the economic engine that pays the bills. Most of the risks involved in TIF projects stem from the risk that anticipated private development will fall short of expectations. If anticipated tax revenue fails to materialize, then, without adequate safeguards, taxpayers will be left paying the bill.

The degree of risk a TIF project exposes the municipality to will vary widely depending on the circumstances. For example, some communities have independently purchased land and constructed infrastructure to develop a business or industrial park, hoping to attract new development and promote economic development. One might call this the "if you build it, they will come" model. With this approach, the municipality is bearing all the risk that private development will not come, or will come more slowly or at lesser values than needed.

A municipality is in a stronger position to manage financial risk when partnering with a developer, particularly one who is ready to proceed with a private development project. When partnering with a private developer, the municipality has the opportunity to shift financial risk from the taxpayer to the developer.

One way a municipality can protect itself when partnering with a developer is to use the so-called "pay-as-you-go" approach. With this approach, the municipality's financial contribution to the project is strictly limited to tax increment actually generated by the private development project after the project is completed. The municipality does not finance up-front development costs and does not borrow money. If the private development does not generate enough value to pay the municipality's financial contribution, it is the developer, and not the municipality, who doesn't get paid.

Sometimes a developer needs TIF funding at the front end of a project, making the pay-as-you-go approach unworkable. Typically in those cases, the municipality borrows money for the project, exposing itself and taxpayers to debt service obligations before the private development has occurred. Without proper safeguards, the municipality faces risks that the private development will not be completed, will not be completed on schedule, or will be assessed as planned at a lower value than anticipated.

When a municipality provides up-front financing for a development project, it should manage its financial risk by requiring two things from the developer. First, the developer should be required to promise (i.e., "guarantee") that its project will generate enough new taxable value to fully fund the municipality's debt service payments. Second, the developer's guarantee should be adequately secured.

When seeking to secure a developer's guarantee, a municipality's position is analogous to that of a bank making a loan. The bank will require security in the form of

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collateral, such as a mortgage. A developer's guarantee to the municipality can be secured in various ways, including, but not limited to, a letter of credit from a bank, a special assessment lien, a mortgage, and personal and corporate guaranties.

Obtaining adequate security tends to be one of the more challenging and complex elements of any TIF-related development agreement. In many cases, developers will lean hard on a municipality to accept something less than full security. In those cases, municipalities need to recognize the extent to which they are putting their taxpayers at financial risk. If a bank wouldn't take such a risk, why should a municipality and its taxpayers?

In conclusion, TIF is a powerful economic development tool, but one that can pose substantial financial risks. With proper safeguards, these risks can be managed. Municipalities should work with qualified legal and financial advisors whenever funding development projects.

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A TIF Agreement should contain guarantee and security provisions. The language set forth below is for *illustrative purposes* only. Your municipal attorney should draft language that is specific to your municipality's circumstances.

Sample "guarantee" language: *Guarantee of Sufficient Actual Tax Increment to Pay Annual Debt Service*. Developer guarantees that, beginning in the calendar year ________, the Actual Tax Increment will be sufficient to fully pay the Annual Debt Service on City Borrowing. If, in any calendar year beginning with calendar year ________, the Actual Tax Increment received by the City is insufficient to pay the Annual Debt Service due that year, then Developer shall be required to pay to the City, and the City shall be entitled to draw on the Letter of Credit, the amount by which the Actual Tax Increment is insufficient to pay the Annual Debt Service due that year.

Sample "letter of credit" language: Developer shall provide an irrevocable letter of credit issued pursuant to Chapter 405 of the Wisconsin Statutes to the City to secure Developer's tax increment guarantee obligations under Section _____ of this Agreement. The letter of credit shall be in a form acceptable to the City, and shall be issued by an entity that is acceptable to the City, or that has a rating of its long-term unsecured debt not lower than A1 by Moody's Investors Service or A+ by Standard and Poor's. It shall be payable at sight to the City, and shall bear an expiration date not earlier than ____ years after its initial issuance. The letter of credit shall be payable to the City at any time upon presentation of the following: (1) a sight draft drawn on the issuing bank in an amount to which the City is entitled under this Agreement; (2) an affidavit executed by a person authorized by the City stating that monies are due from Developer pursuant to the guarantee obligations in Section ________; and (3) the letter of credit. After the initial term, Developer shall timely renew the letter of credit for additional terms of not less than one year, so that the amount of the letter of credit is at all times not less than the amount required by this Agreement. The initial and each renewed or replacement letter of credit shall by express language be automatically extended without amendment for a period of one year from its expiration date, unless at least 45 days before such expiration date the issuer of the letter of credit notifies the City in writing that the letter of credit will not be extended for an additional one-year period, or notifies the City in writing that the letter of credit will be renewed or replaced by a letter of credit in an amount that is less than the amount required by this Agreement, which amount shall be specified in such written notice. Upon receipt of notice that the letter of credit will not be extended for an additional one-year period, or will be extended, renewed or replaced in an amount that is less than the amount required by this Agreement, the City may draw upon the letter of credit an amount sufficient to secure performance of Developer's remaining guarantee obligations. The amount of the initial and each renewed or replacement letter of credit shall be equal to the total principal and interest payments that remain unpaid on all remaining Annual Debt Service Payments on City Borrowing. The Annual Debt Service payments that will be paid by Actual Tax Increment that has been created within the District shall be calculated by the City, using the actual Value Increment that has been created within the District at the time the required amount of the Letter of Credit is calculated, using the mil rate effective at that time.