Tax Increment Financing - Update and Implementation

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What is a TIF?

- TIF is an acronym for tax increment financing. It is somewhat of a misnomer as no financing may be involved so tax increment incentive is a more accurate term. In Tennessee, the tax increment generally refers to property taxes.
- Incremental property tax growth from a specific area is allocated to an IDB or housing authority to provide an incentive.
- In the case of an IDB, incremental taxes allocated to the IDB can be used to make direct grants to a private party to reimburse eligible costs or to pay debt service on debt incurred by IDB to finance such costs. The proceeds of the debt are usually granted to a developer.
- In the case of a housing authority, tax increment must be used to pay debt service on tax increment financing issued by housing authority to finance eligible costs.

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How is a TIF different from Tax Abatement ("PILOT")?

- No acquisition of property with TIF.
- Value of TIF often leveraged through a borrowing by IDB (hard to borrow against a PILOT payment).
- TIF usually results in grant to developer.

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Bad for TIFs - The Tax Cuts and Jobs Act of 2017 ("TCJA")

- Remember TIF usually results in a grant to developer.
- Prior to TCJA, it was fairly easy to avoid taxation of grant as income. Government contributions were not generally considered taxable income as capital contributions.
- After TCJA, economic development grants generally result in taxable income to the developer, making TIFs less valuable to developer (unless grandfathered under older redevelopment or economic impact plan).
- Grants of TIF proceeds for public infrastructure are probably still not taxable.
- Value of tax abatement (i.e. PILOT) is still not taxable.

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Why would a developer request a TIF instead of a PILOT?

- Project may not be eligible for PILOT (such as residential condos).
- Developer needs additional funds beyond construction loan to pay project costs up front.
- Developer wants to get benefit of incremental property tax growth from adjoining properties.

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Protecting Public Funds – Determining Whether a TIF is needed

- Most TIFs are used to provide an incentive to a developer to undertake a specific project.
- Most developers will claim that they will not undertake the project without the incentive – this is the “but for” test.
- But how can a community know whether an incentive is really needed or is just extra profit to a developer?
- Some Tennessee communities are seeking an independent “but for” analysis.
- This analysis is different from determining whether the economic impact exceeds the incentive cost.

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Excerpt from Municap Report - A Typical TIF Project

The Applicant has presented a plan to build a new building at 316 Gay Street that will include 88 residential condominiums, 88 structure parking spaces (under the building) and 13,513 square feet of commercial space. The Applicant's estimates indicate that the 88 condos will range in size from approximately 750 to 1,750 square feet of finished space, totaling approximately 103,587 square feet.

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Excerpt from Municap Report – The Bottom-Line Conclusion

EXECUTIVE SUMMARY

Utilizing assumptions provided by Bass Berry and Sims, PLC (the "Client"), as counsel to Knoxville's Community Development Corporation ("KCDC"), which assumptions were based on information provided by Hatcher Hill Properties (the "Applicant"), MuniCap, Inc. ("MuniCap") has calculated the estimated financial returns for the proposed construction of 88 residential condominiums at 316 Gay Street (the "Project"). Utilizing the given assumptions, the estimated financial returns indicate that 1) the Applicant would likely **not** proceed with the Project without public assistance and 2) the requested level of public assistance (through a proposed tax increment finance borrowing) does **not** provide a projected financial return that is outside of typical parameters.

Please see MuniCap's full report for an explanation of the indications stated in the paragraph above, other relevant information and the limitations of MuniCap's analysis.

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Excerpt from Municap Report – What is being calculated?

Internal Rate of Return Explanation

The **Internal Rate of Return** (often referred to as the "IRR") is a metric used to measure the attractiveness of potential investments and the performance of actual investments. The internal rate of return metric is used regularly by real estate developers. The internal rate of return can be defined as the discount rate at which the net present value of a set of cash flows (i.e., the initial investment, expressed negatively, and the returns, expressed positively) equals zero.

In more simple terms, it is the annual rate at which a real estate investment grows.

Among many other sources, additional information on the internal rate of return can be found at the link below:

https://www.realtymogul.com/resource-center/articles/what-irr-can-tell-investors-about-real-estate-investments

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Excerpt from Municap Report – The Assumptions

Assumptions Affecting Return Calculations - Provided to MuniCap

Capital Sources and Construction Expenditures		
Value of real property contributed	$1,725,000	
Cash equity provided by Applicant	$4,099,051	
Debt funding provided by commercial bank	$24,089,889	Provided after TIF bond and cash equity from Applicant
Capital provided by proposed TIF bond	$4,500,000	
Capital provided to fund a "Developer Fee"	$0	
Total capital available for construction costs	$32,688,940	
Construction costs, including contingencies	$32,688,940	Includes all soft and hard costs
Developer Fee	$0	
Sale Proceeds		
Gross sales proceeds from condo sales	$35,218,000	
Average sales price per foot used for standard units	$340	
Annual inflation on condo sale prices	None	
Timing of condo sales	50% (approx. 26 units) pre sold before construction loan closings and construction commencement; none sold during construction phase loan closing construction. 21 units sold per year beginning after construction is completed.	
Commissions and closing costs on residential units	5.0%	
Gross sales proceeds from sale of commercial property	$2,430,000	
Timing of commercial property sale	At the end of the 3rd year (approximately one year after construction completed)	
Operating income and expenditures during sales period		
Operating income from commercial space in 3rd year	$212,223	
Interest rate on bank loan	5.5%	
Payoff terms of bank loan	100% of net sales proceeds through 3rd year; 90% of net sales proceeds thereafter	
Real property taxes on unsold inventory		
Starts	Year after construction completion	
Assessed value for real property tax	100% of estimated sale value	
Other operating costs during sales phase		
1st year after construction completion	$98,458	
2nd year after construction completion	$61,536	
3rd year after construction completion	$24,615	
4th year after construction completion	$0	
Use of proceeds from property sales	Repay bank debt; operating expenses (interest, taxes, other operating costs); equity distributions	

MuniCap has not attempted to determine the reasonableness of these assumptions; MuniCap is not expressing an opinion on the reasonableness of these assumptions.

Additional Assumptions

Applicant has the responsibility to provide the lender for the proposed TIF borrowing;

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Excerpt from Municap Report – Return without Incentive

Table 1
Summary of Estimated Financial Returns Assuming No Public Assistance

Investment	
Cash investment	$8,599,051
Land investment (assumed value)	$1,725,000
Total investment	**$10,324,051**
Estimated capital returned	$10,357,790
Return period	3rd to 5th year
Estimated internal rate of return (levered)	**0.10%**

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Excerpt from Municap Report- Return with Incentive

Table 2
Estimated Financial Returns Assuming Requested Public Assistance

Investment	
Cash investment	$4,099,051
Land investment (assumed value)	$1,725,000
Total investment	**$5,824,051**
Estimated capital returned	$10,357,790
Return period	3rd to 5th year
Estimated internal rate of return (levered)	**18.10%**

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