REBECCA OTTO
STATE AUDITOR

STATE OF MINNESOTA
OFFICE OF THE STATE AUDITOR

SUITE 500
525 PARK STREET
SAINT PAUL, MN 55103-2139

(651) 296-2551 (Voice)
(651) 296-4755 (Fax)
state.auditor@osa.state.mn.us (E-mail)
1-800-627-3529 (Relay Service)

Statement of Position
TIF Pay-As-You-Go Obligations

A tax increment financing (TIF) pay-as-you-go (PAYG) obligation may be a contractual commitment in a development agreement, a separate contract-to-pay or a separately issued PAYG note. Regardless of its form, it is defined as a "bond" in the TIF Act.[1]

The PAYG Bond differs from a traditional municipal bond in several important ways:

- Initially, it is the developer, not the municipality, who finances the costs of making improvements.
- The municipality later reimburses the developer for qualified expenditures with a bond to be paid with TIF revenues.
- Payments by the municipality to the developer on the bond are contingent on the availability of TIF revenues.
- The developer, not the municipality, carries the risk that TIF revenues will not be sufficient to cover the bond payments.
- Failure by the municipality to make bond payments because of insufficient TIF revenues does not constitute a default.
- A PAYG Bond does not constitute a general obligation of the municipality and is not included when calculating debt limits.

With a PAYG Bond, the developer finances the upfront costs of redevelopment. After negotiating and entering into a redevelopment agreement with the municipality or development authority in which the parties determine the costs that qualify for public reimbursement, a developer spends its own money or borrows money from a bank to finance the upfront costs of clearing and remediating the site and installing the necessary infrastructure. Conventional bank financing is generally issued at a prime interest rate, a rate higher than the interest rate on a taxable PAYG Bond (often referred to as a note).

The developer clears and prepares the site, and then submits invoices to the development authority to show that qualifying tax increment expenditures have been made. The municipality or development authority approves those invoices that qualify as costs reimbursable with tax increment revenues and that meet the requirements of the

[1] *See* Minn. Stat. § 469.174, subd. 3 (defining "bond"). The TIF Act is found at Minn. Stat. §§ 469.174 to 469.1799, as amended.

Reviewed: August 2013 2009-3005
Revised: April 2012

redevelopment agreement. The municipality or development authority then issues a PAYG Bond to reimburse the developer for these costs. The principal amount of the bond should be less than or equal to both the amount of the qualifying expenditures and the present value of the cash flow stream created by the annual tax increment revenues.[2] The interest rate on the bond will generally be no more than one and a half to two percent higher than the interest rate on tax-exempt general obligation bonds of the municipality. This interest rate is generally still lower than the interest rate the developer paid for financing at the bank.

If the PAYG Bond is in the form of a PAYG note held by the developer-bondholder, it is considered a form of legal tender. It can, for example, be presented to a bank or lender as collateral for a loan to raise capital for project improvements.

Historically, municipalities incurred debt by issuing tax-exempt general obligation (GO) bonds to raise the capital needed to pay for qualifying tax increment expenditures. Traditionally, GO bonds were issued prior to beginning construction of public improvements related to development activity. These bonds were secured with the full faith and credit of the municipality. The risk of failure of the development rested entirely with the municipality. A levy was imposed on the property taxpayers of the municipality to cover the debt service on the bonds. If the development failed or the tax increments are insufficient to pay the bond, the debt became a burden to the taxpayers.

In 1986, Congress enacted the Federal Tax Reform Act which declared the interest on GO bonds to be taxable when the bonds are used to finance tax increment qualifying expenditures. Previously, such GO bonds had been tax-exempt. The Tax Reform Act had a substantial impact on the cost of development by public entities, as the interest rate on taxable municipal bonds is generally one and a half to two percent higher than the interest rate of tax-exempt bonds. Such an increase in the interest rate on a municipal bond was often too steep a price for a municipality to pay. Since there was no longer any interest rate savings to be had by issuing tax-exempt municipal bonds, municipalities and development authorities began using PAYG Bonds instead.

PAYG Bonds differ substantially from GO bonds. PAYG Bonds are revenue bonds.[3] With a PAYG Bond, the bondholder (the developer) carries all the risk. In the event that sufficient tax increment revenues pledged to pay the debt service on a PAYG Bond are not generated from parcels within a TIF district, the bondholder does not get paid or does not get paid in full. PAYG Bonds are used more frequently than GO Bonds are used. GO bonds made up approximately 25 percent of the TIF debt obligations in 2010, while PAYG bonds constituted approximately 45 percent of the TIF debt obligations.[4]

---

[2] A PAYG Bond can be used alone or in combination with other more traditional funding mechanisms.
[3] The 2009 Legislature clarified that PAYG Bonds are revenue bonds. The debt service on revenue bonds is paid only to the extent that pledged revenues are available.
[4] Tax Increment Financing Legislative Report for years ending December 31, 2010 (chart on page 21 shows approximate percentages).

A PAYG Bond allows a developer to begin construction and enables tax increment revenues to be used to reimburse the developer for qualifying expenditures. Once the project is completed, the increase in tax revenues in the TIF district generates a stream of revenue that can be pledged in whole or in part to make payments on a bond issued by the municipality or the development authority to the developer-bondholder. The developer-bondholder is reimbursed for qualifying expenditures through debt service payments from the tax increment revenues generated by the redevelopment.

A two-year lag is common between the time the TIF district is established, the site is cleared and prepared for development, and the time the new development generates tax increment revenues. Depending on the condition of the site, the term of years between the establishment of the TIF district and the receipt of tax increment may be substantially more than two years. For this reason, the term of a TIF district is calculated from the year in which the development authority receives its first tax increment.[5] An amendment to the TIF Act in 2008 permits an authority to specify in the TIF plan the first year in which it elects to receive tax increment, up to four years following the year of approval of the district.[6]

Over the term of the PAYG Bond, the authority that issued the bond pays debt service, generally twice a year, to the bondholder.[7] If the property taxes on the parcel in the TIF district are not paid or if the legislature changes the property tax laws, the bondholder will be paid accordingly or may not be paid at all.

It is common for the developer to assign the PAYG Bond to the bank as security for bank financing. If a bank is assigned a PAYG Bond as security or if a consortium of banks buy and bundle PAYG Bonds to trade in the secondary market, these financial institutions assume the same risks as the developer. If sufficient property taxes are not paid on a new development or if the legislature changes the property tax laws in a way to affect tax increment payments, as occurred when the 2001 Minnesota Tax Reform Act was enacted, financial institutions may be holding bonds that are worth less or worthless. Even though a stream of tax increment payments has been pledged for payment, the PAYG Bond is just a promise to pay the developer to the extent funds are available from TIF revenues generated within the TIF district. In other words, it is unsecured debt.

[5] Minn. Stat. §469.176, subd. 1b.
[6] Minn. Stat. §469.175, subd. 1 (b). The election does not apply to economic development districts.
[7] The payment of debt service on the PAYG Bond generally follows the May 15th and October 15th dates for payment of property taxes.