Tax Increment Financing and Affordable Housing in Minnesota:

The *very* BASICS

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Tax Increment Financing - Basics

- ***What is TIF?***
  - Tax increment financing (TIF) is a public financing method that uses the increased property taxes that a <u>new real estate development</u> will generate to finance costs of the development.
  - TIF allows local governmental units to provide financial assistance to developers by using additional property taxes, or "tax increment," paid as a result of the development.
  - The Program is authorized and controlled by the State of Minnesota.

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- ***For what purposes may TIF be used?***

In Minnesota TIF is used for two basic purposes:

- To induce or cause a development or redevelopment that <u>otherwise would not occur</u> – TIF funds are used by developers to pay for a variety of costs such as land acquisition, site improvements, environmental remediation, and demolition that the developer would normally pay.

- To finance public infrastructure (streets, utilities, sewer, water, or parking facilities) that are <u>related to the development</u>. TIF may pay all or a portion of these costs.

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- ***How does TIF work?***

  - Creation of a TIF district by a local government (called an Authority for TIF purposes).
  - When a new TIF district is created, the county auditor certifies the current property tax base of the TIF district and the local property tax rates.
  - As the tax capacity of the district increases, the property taxes (i.e., the "tax increment") paid by this increase in value is dedicated and paid to the development authority.
  - Increases in value that generate more taxes may be caused by construction of the development or by general inflation in property values. The authority uses the increment to pay qualifying costs that are incurred for the TIF project.

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- ***How is TIF used to pay development costs?***

  - Mismatch between when most TIF costs are paid—at the beginning of a development—and increased taxes due to development) are received—after the development is built.

Three basic financing techniques are used to finance these development costs:

◦ **Bonds -** *Traditionally*, the authority may issue bonds to pay the developers for eligible costs ("upfront costs") and use increased taxes due to development to pay the bonds back.

However, there other strategies

◦ **Local government funds -** The authority may advance money from its own funds (e.g., a development fund or sewer and water fund) and use the increments to reimburse the fund.

◦ **Pay-as-you-go financing (notes).** The developer may pay the costs with its own funds, with the promise of being reimbursed. The tax increments, then, are used to pay the developer for development costs.

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- ***There is also a "but-for" test governing TIF***

Before an authority may create a TIF district, it and the local government must make "but-for" findings that:

  - the development would not occur without TIF assistance and

  - that the market value of the TIF development will be higher than what would occur on the site, if TIF were not used.

The "but-for test" has two purposes:

  - to prevent excessive or unnecessary use of TIF –
    if a development would have been done anyway, why should TIF be used to assist it?
  - to protect the interests of other, overlapping governmental units (like the county or school district), which would lose tax revenue unnecessarily if TIF funds supported developments that would be built anyway.

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- ***Different Types of TIF Districts***

To qualify for tax increment financing, a project must be located within a TIF district.

TIF District Types

The types of TIF districts include the following:

- Redevelopment Districts. For areas where most the land has been developed but usually where most of the buildings are substandard.

- Renewal and Renovation Districts. For areas where most of the land has been developed and where a portion are substandard or in need of rehabilitation.

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- Other Types of TIF Districts
  - Economic Development Districts. to discourage commercial or industrial relocation; to increase employment or to preserve or and enhance the tax base.
  - Hazardous Substance Subdistricts and Soil Conditions Districts. TIF used for removal or remediation of hazardous substances, pollution or contaminants.

AND

Housing Districts

Housing Districts consist of projects intended for occupancy, in part, by persons or families of low and moderate income – by definition for Affordable Housing.

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- ***What TIF Can Be Used for in Affordable Housing***
  - Pay for a portion of the Projects itself, mainly hard cost such as construction.
  - Pay for a portion of development-related infrastructure cost, like roads, sidewalks, sewer and water lines.

- ***How TIF payments enable Affordable Housing***
  - One time, lump sum payment – Can be used <u>directly</u> as one of the sources of funds to construct housing (Due to the taxable value of land and improvements for smaller projects in small towns and rural areas , may not have a large impact. Bigger impact on bigger projects.)
  - Payments made over a period of time (years) – Can have larger impact on smaller projects than a lump sum payment.

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- ***Possible Scenario of TIF use for Affordable Housing in Region Five (based on CMHP project experience)***

  - Smaller (24 units) affordable rental project, appropriate for the market in small towns and rural areas of Minnesota

  - Total Development Cost (TDC)
    $2,400,000
    $100,000 per unit

  - Sources of Financing include:
    Low-Income Housing Tax Credits (federal);
    First Mortgage from Local Lender
    as well as
    Tax Increment Financing (TIF)

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- Choices:

  - One-time, lump sum payment of $100,000 <u>or</u>

  - $10,000 per year for 10 years (proposed life of the TIF) = $100,000

Effect of $100,000 lump sum – lower principal of amount borrowed for First Mortgage.

However, it may require the authority to use bonds to provide the funds, which can have high bond transaction costs and interest costs.

An amount of $100,000 is a fairly small amount for bonding.

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- Effect of $10,000 per year for 10 years on a 30 year mortgage at 6%

  $10,000 per year ÷ 1.2 Debt Coverage Ratio
  $8,333 more for Debt Service to Pay First Mortgage

  May be able to borrow more than $100,00, possibly $115,000 more or less.

- However it may be most advantageous to the authority .

  Easier for authority than interest and high transaction costs on bonds for $100,000 lump sum.

  Authority can avoid borrowing (bonding) for TIF or taking a large amount out of funds at one time.

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- ***TIF in Smaller Towns and Cities of Greater Minnesota***
  - To summarize, Tax Increment Financing (TIF) is a complex but effective tool for assisting the development of Affordable Housing. It needs to be used in conjunction with other financing; it doesn't work by itself.
  - Models that may work in larger urban areas, may not be the best for smaller towns and cities.
  - However, models that are more appropriate for Greater Minnesota can be developed and used to allow the TIF program to work effectively in smaller towns and cities.

Thank you.

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