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# TIF 101:

## ADVICE FOR MUNICIPALITIES CONSIDERING THE FIRST USE OF TAX INCREMENT FINANCING

### Part 1 in a 3-part series: What is TIF and how is a TIF plan prepared?

by David Bushek and Rich Wood

*This is the first article in a three-part series. This Part 1 will address questions regarding the preparation of a TIF plan and the appropriate use of TIF. Part 2 will discuss in detail the process for approval of a TIF plan. Part 3 will provide an overview of the effective use of a TIF contract and financing alternatives to implement a TIF plan.*

Cities or counties that are considering the use of tax increment financing (TIF) for the first time, or that possibly approved a TIF plan in the past under different leadership, may have many questions about the potential use of TIF for a proposed project. These questions can involve numerous issues such as: what should be included in a TIF plan, the process of considering and approving a TIF plan, the best method to finance a project, the performance standards that a developer must satisfy to receive TIF assistance, and the best method of protecting the municipality when public financing occurs. Addressing these questions is a critical part of providing full and fair consideration of a proposed project.

This article is designed to address several fundamental questions that a city or county (collectively referenced as “municipalities”) may raise when considering the use of the Real Property Tax Increment Redevelopment Act, Sections 99.800 to 99.865 RSMo (TIF Act), for the first time. It is not intended to be a comprehensive list of all the various issues that may arise in the review of a TIF plan. Addressing these questions on a case-by-case basis allows a municipality to formulate public policy over time, which then guides the municipality for its consideration of future TIF plans.

#### What is tax increment financing?

Tax increment financing is a method of redirecting tax revenues to enable the redevelopment of property that is (1) blighted, (2) a conservation area, or (3) an economic development

area. The TIF Act authorizes the capture of 100% of the incremental increase in property taxes above the property taxes generated by the property prior to redevelopment, called “payments in lieu of taxes” (“PILOTs”) and 50% of the new economic activity taxes (“EATs”) generated from the redevelopment project through sales taxes, earnings taxes, and utility taxes.

PILOTs are calculated by first establishing the amount of real property taxes paid in the base year, which is the most recently ascertained assessed value of property in the redevelopment project area before the TIF project is approved. For each year during the term of TIF, up to 23 years, as property is developed and reassessed at a higher value, higher property taxes are paid. The increase in taxes over the base year is captured as PILOTs and deposited in the special allocation fund created by the municipality for the TIF plan to pay approved reimbursable project costs.

EATs are calculated by determining the sales taxes, earnings taxes, and utility taxes generated in the redevelopment project area in the calendar year prior to the year that the TIF project is approved. For each year during the term of the TIF project, as sales taxes, earnings taxes, and utility taxes are generated within the redevelopment area, 50% of the increase in such taxes over the base year is captured and deposited into the special allocation fund for the TIF plan to pay reimbursable project costs.

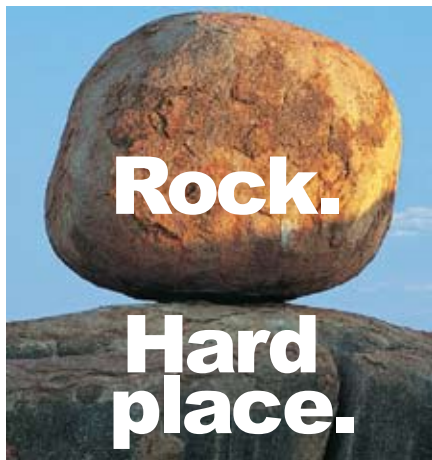
Captured PILOTs and EATs are used to reimburse the developer or the municipality for certain costs of redevelopment authorized by the TIF Act

and approved in the TIF plan. A common misconception is that TIF provides tax abatement. The property owners continue to pay the same amount that would have been imposed as property taxes, except that TIF allows 100% of the increased payments to be diverted to pay for approved project costs. TIF allows for the diversion or redirection of property taxes, but not the abatement of taxes.

#### Does a municipality have to capture the maximum PILOTs and EATs allowed by the TIF Act?

The technical answer is “yes,” but the practical answer is “no.” When a municipality approves a TIF redevelopment project, the ordinance which authorizes the collection of PILOTs and EATs cannot specify the initial capture of any amount other than 100% of the PILOTs and 50% of the EATs. However, the municipality can achieve the desired result – lower effective PILOTs or EATs – through other means. The most common method is for the TIF plan to require a declaration of surplus TIF revenues during each year of TIF collection that results in the desired effective TIF collection rate. Surplus TIF revenues are distributed on a pro rata basis to the applicable taxing districts, in proportion to their respective levy rates.

For example, if the goal is to achieve an 60% effective rate for the capture of PILOTs, the TIF plan could require that 40% of the PILOTs be returned as “Surplus PILOTs” to the taxing districts. The property owners would pay 100% of the incremental increase in property taxes as PILOTs



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during each year of TIF collection, and 40% would be distributed as surplus PILOTs to the taxing districts which impose real property taxes in the project area, on a proportional basis according to the levy rates of the affected taxing districts. This then annually leaves 60% of the PILOTs in the special allocation fund for use in accordance with the TIF plan.

#### **What costs are eligible for reimbursement?**

Costs which are reasonable and necessary, or incidental to, the implementation of a TIF plan are eligible for reimbursement from captured PILOTs and EATs. Within a blighted area, common reimbursable project costs include (1) public infrastructure, such as streets, water, sewer, and storm drainage, (2) private improvements within the redevelopment area, such as buildings, parking lots, and landscaping, (3) capital contributions to taxing districts, including the costs of taxing districts for capital improvements that are found to be necessary and to directly result from the redevelopment project (e.g., new school facilities), (4) property assembly and land purchase costs, (5) certain off-site improvements to public infrastructure outside the redevelopment area if they are essential to the preparation of the redevelopment area for use in accordance with a redevelopment plan, (6) professional fees associated with the preparation and implementation of the plan, such as attorneys' fees, engineering fees, and architect fees, and (7) costs of issuing notes or bonds. Municipalities have flexibility in deciding what costs may be eligible for reimbursement under a TIF plan.

#### **Does the TIF Act require that a TIF Plan contain certain information?**

The TIF Act sets out minimum requirements for what every TIF plan must contain. The municipal governing body is also required to make certain findings with respect to the TIF plan during the approval process, and information sufficient to support those findings should be set forth in the plan. The municipality's legal advisors should be consulted regarding the required contents of a TIF plan. A few of the more significant requirements are discussed more fully in this article.

Information which a municipality should require to be included in or accompany a TIF plan includes: (1) a general description of proposed development, (2) a blight study, (3) objectives of the plan (e.g., cure blighted conditions, provide needed services to municipal residents or provide additional employment), (4) a division of the redevelopment area into project areas and proposed land uses, including a schedule for development of each phase of development and public infrastructure to be constructed, if applicable, (5) sources of funds and commitments for financing project costs, including plans for any bonds to be issued, (6) a project budget showing project expenses to be funded privately by a developer and publicly by TIF revenues, (7) a market analysis showing the feasibility of the proposed development, (8) a cost-benefit analysis showing the impact of the TIF plan on taxing jurisdictions if the project is built and not built, (9) a statement regarding whether condemnation

is expected to be necessary, and (10) a relocation plan.

#### **What conditions must exist to declare that property is "blighted"?**

There are three basic types of TIF plans in Missouri, each of which focus on the conditions of the property. To approve a TIF plan, a municipality must find that the property is: (1) blighted, (2) a conservation area, or (3) an economic development area. The most common form of TIF plan is a "blighted area" TIF plan.

The definition of blight in the TIF Act has multiple parts that require a municipality to undertake a cause-and-effect analysis. A property may be declared blighted in an area which, by reason of -

- (1) the predominance of defective or inadequate street layout,
- (2) unsanitary or unsafe conditions,
- (3) deterioration of site improvements,
- (4) improper subdivision or obsolete platting, or
- (5) the existence of conditions which endanger life or property by fire and other causes,

or any combination of such factors, results in one of the following -

- (1) retards the provision of housing accommodations or
- (2) constitutes an economic or social liability or a menace to the public health, safety, morals, or welfare in its present condition and use.

Although the Missouri TIF Act provides this elaborate definition of blight, local officials often apply a common-sense test to determine whether

property is blighted – “I know it when I see it.” The statutory definition should be applied in each instance, however, rather than the common view. In some circumstances, the presence of blight is obvious. In many cases, however, a blight declaration is at least fairly debatable, and reasonable minds could reach different conclusions on whether property is blighted. The Missouri courts typically defer to the local legislative decisions and will uphold a blight finding if there is evidence to support a blight finding. The recent judicial trend, however, is to more closely scrutinize municipal blight findings when challenged in a lawsuit, with particular attention to each component in the definition of blight. For this reason, municipalities should closely analyze the evidence of blight in light of the statutory definition.

#### **Are there negative consequences to declaring property “blighted”?**

A blight designation is a finding of fact that is made by a municipal governing body. This finding does not change the characteristics of the property, but rather is an official designation regarding the current state of the property. Declaring that property is blighted allows redevelopment of the property to become eligible for TIF reimbursement.

If blight is promptly cured through implementation of a TIF plan, the blight designation should have no lasting negative effects. The blight that exists in an area is usually what depresses property values, and not the declaration of blight. If property that has been declared blighted is not promptly redeveloped, some negative effect on the property values could result from the designation. For this reason, the municipality should ensure by contract that the property is promptly redeveloped according to an agreed schedule.

#### **What is the “but for” test?**

The “but for” test is an inquiry into whether the property would be redeveloped without TIF assistance – *but for the approval of TIF, the redevelopment would not occur*. More formally, the TIF Act requires a finding by the municipal governing body that the redevelopment area “has not been subject to growth and development through investment by private enterprise and would not reasonably be anticipated to be developed without the adoption of tax increment financing.” In most instances, this is demonstrated by a developer providing sufficient evidence that the developer is unable to make a reasonable rate of return on investment if required to bear all costs associated with redeveloping the property. A developer is required to sign an affidavit to this effect.

#### **Does the municipality write its own TIF plan or does the developer write the TIF plan?**

Either method can be used. A TIF plan is approved by legislative action of the municipality and serves as a municipal declaration regarding how a blighted or conservation area will be cleared of the blight or blighting influences and how the property will be redeveloped. In the strict sense, the municipality is approving its own plan for redevelopment. This does not mean, however, that the municipality must actually prepare the plan. Municipal staff or officials can prepare a TIF plan, or a TIF plan can be prepared by a developer or property owner and submitted to the municipality for consideration. A developer that prepares the plan is typically the advocate for its approval in order to achieve a mix of public and private financing for a redevelopment project, and in this sense the developer commonly takes ownership of the plan. However, even when proposed by a developer, a TIF plan is ultimately the

municipality’s plan for redevelopment of property.

#### **What resources does a municipality need to properly consider a TIF plan?**

Larger municipalities may have in-house staff that can assist with the preparation or analysis of a TIF plan. However, many municipalities may find it beneficial to hire outside consultants to assist with these functions. A market study may be beneficial for the governing body in its determination that there is a market to support proposed retail development. A financial feasibility analysis may be prepared to insure that the estimated redevelopment costs and revenue projections set forth in the TIF plan are accurate and that the redevelopment would not occur “but for” TIF assistance. A blight study is required to be prepared and included in the TIF plan. A municipality also needs legal assistance to ensure compliance with all procedural and substantive requirements of the TIF Act and to negotiate a TIF contract.

#### **What if the municipality does not have the resources to hire outside consultants?**

It has become common practice for municipalities to require that a proposed developer of a TIF project enter into a funding agreement with the municipality which requires the developer to pay for the costs of consultants incurred by a municipality which are necessary to properly prepare or analyze the TIF plan and negotiate a TIF contract. In most cases, the funding agreement requires the developer to post a cash deposit with the municipality which may be used to pay consultant bills as they become due. The developer is required to maintain the deposit at a certain level during the time the TIF plan is considered and a TIF contract is negotiated.

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A municipality should not rely exclusively on the consultants engaged by the developer for a TIF plan. While many of the studies and reports presented by a developer's consultants can be safely relied upon by a municipality (such as the blight study), many consultants are engaged for the purpose of persuading the municipality, on behalf of the developer, to approve a TIF plan. It is common for a municipality to engage its own financial advisor and legal counsel to review a TIF plan, both of whom have a fiduciary duty to the municipality and work exclusively for the municipality. In particular, an attorney engaged by a developer has an attorney-client relationship with the developer and represents only the developer throughout the TIF process, whose job is to persuade the municipality to adopt the TIF plan in a form that is most financially advantageous to the developer. The municipal attorney or special legal counsel should represent the municipality during the TIF process.

### Is a municipality required to seek proposals from other developers?

The TIF Act requires that each municipality which is considering a TIF plan establish written procedures relating to bids and proposals for implementation of redevelopment projects and that all interested persons be given a reasonable opportunity to submit alternative proposals or bids. In order to comply with this requirement, municipalities must adopt written procedures for obtaining alternative proposals and invite the submittal of alternative proposals through the notice process for implementation of a TIF project.

### How long should TIF be provided and when should the TIF plan terminate?

The TIF Act allows TIF revenues to be collected on any property for a maximum of 23 years. A municipality may establish a policy which provides more favorable consideration for a TIF plan that will terminate earlier than 23 years, but the municipality must consider each TIF plan on its own merits and make an independent decision regarding the duration of each TIF plan. The municipality may base its decision regarding the duration of a TIF plan on a number of factors about the project, including, for example, the type and

quality of the development, the total project costs, the amount of equity provided by the developer to build the project, and the financial benefits on the local economy.

### What evidence must be presented for a developer to demonstrate that a project can be privately financed?

The TIF Act provides that each TIF plan must include evidence of commitments to finance the project. Financing may be from public and private sources, and private financing can be from equity contributed by the developer or a private loan. If the developer proposes private financing, it is common to require a commitment letter from a financial institution which demonstrates that the bank is familiar with the project and will provide financing if the TIF plan is approved. This letter may be conditioned upon final loan approval and subject to typical loan documentation.

### Is a developer required for a TIF plan?

The TIF Act requires that a TIF plan contain an affidavit signed by a developer or developers attesting that the redevelopment area is blighted, a conservation area, or an economic development area; has not been subject to growth and development through investment by private enterprise; and

would not reasonably be anticipated to be developed without the adoption of TIF. Although a municipality may prepare its own TIF plan, a developer affidavit is required to be included in the plan.

### Under what conditions should bonds be issued by the municipality to finance the TIF project costs?

The most common minimum requirements for bond issuance is proof that the developer has secured signed leases or commitments for tenants; closing on any private financing with proof of available proceeds, final plans and specifications for the project; a signed construction contract; and the commencement of construction. Other performance standards may be required from the developer for bonds to be issued, such as that a specific portion of the stores are actually open for business. Market conditions may increase the requirements for a bond issuance. For example, the underwriter for the bonds may require that the project has some history of revenue production before bonds can be issued, or an annual appropriation pledge of the municipality might be required. The underwriter for the bonds will specify the conditions that must be met in order to sell bonds for the project, accounting for prevailing market conditions.

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### What is a “pay as you go” TIF?

As an alternative to the issuance of bonds to fund redevelopment project costs, a developer may be required to fund all project costs up front from private equity or a private loan and then receive reimbursement only as moneys become available in the special allocation fund established for the TIF plan. “Pay as you go” then means that the developer is paid (reimbursed from TIF revenues) as the project generates PILOTs and EATs over time. It is common in this situation for the developer to receive an agreed-upon amount of interest for accrued reimbursable project costs. These arrangements are set forth in a TIF contract between the municipality and developer.

### Should other forms of public funding be provided in combination with TIF?

It is common for special funding districts, such as a transportation development district (TDD) or community improvement district (CID), to be proposed in connection with a

TIF plan. Typically, the TDD or CID will impose a sales tax to generate additional revenue to pay for a portion of reimbursable project costs. When a TDD or CID operates within a TIF area, one-half of the funding district sales tax revenues are captured as economic activity taxes (EATs) through operation of the TIF plan. The revenues which are captured as EATs are expended as directed in the TIF plan. This eases the impact of the TIF plan on the jurisdictions which impose property taxes in the TIF redevelopment area because it helps to retire the TIF plan at an earlier date, allowing all property taxes to flow normally at an earlier date.

Imposing a special sales tax within the boundaries of the TIF area can have some negative market affect on the project because it makes the total sales tax rate in the TIF area incrementally higher than in the surrounding community. A significant number of extra sales taxes in a municipality may also have a negative affect on the municipality’s ability to increase municipal sales tax rates. A municipality will need to weigh the

benefit of a special sales tax within a TIF area against any impact it may have on the community.

### Does approval of one TIF plan increase the likelihood that TIF assistance will be provided for other projects?

Approving a TIF plan may create the perception that public assistance will or should be provided to similar redevelopment projects. The approval of each TIF plan, however, is a purely legislative decision, and approving a TIF plan in a community does not bind the municipality to approve a future proposed TIF plan for another proposed development. Adoption of a TIF policy, which sets forth the key performance standards that the municipality would like to see in any proposed TIF plan, will help establish conditions under which a municipality will most favorably approve a TIF plan in the future. □

**David Bushek** and **Rich Wood** are attorneys who practice with the Economic Development Group in the Kansas City office of Gilmore & Bell, P.C.

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