STATE OF MINNESOTA

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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 (often referred to as a note) 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.

How They Work

With a PAYG Bond, the developer and the municipality or development authority first determine the costs that qualify for public reimbursement and enter into a redevelopment agreement. The developer then spends its own money or borrows money from a bank to finance the qualifying upfront costs.

The developer 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 redevelopment agreement. The municipality or development authority issues a PAYG Bond to reimburse the developer for these costs. The documented costs generally establish the reimbursable principal amount (up to the principal amount stated in the PAYG Bond).

[1] *See* Minn. Stat. § 469.174, subd. 3 (defining "bond"). The TIF Act is found at Minn. Stat. §§ 469.174 to 469.1794, as amended.

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Over the term of the PAYG Bond, the authority that issued the bond pays debt service, generally twice a year, to the bondholder.[2] 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.

Background

Historically, municipalities incurred debt by issuing tax-exempt general obligation (GO) bonds to raise the capital needed to pay for qualifying tax increment expenditures. 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. 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. 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 are used more frequently than GO Bonds.

Characteristics

PAYG Bonds differ from GO bonds. Generally, with a PAYG Bond, if sufficient tax increment revenues pledged to pay the debt service are not generated from parcels within a TIF district, the bondholder does not get paid or does not get paid in full.

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.

It may be 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, which happened when the 2001 Minnesota Tax Reform Act was enacted, financial institutions may not receive anticipated payments. 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.

Potential Pitfalls

A TIF development authority should regularly review the terms of PAYG Bonds. Some violations of the TIF Act have occurred when authorities fall into a routine of making payments and continue to make payments beyond the termination or final maturity of the PAYG Bond. A development authority should take care to collect and maintain documentation of the developer's costs and avoid payments for undocumented amounts. Regular reviews of development agreements and PAYG Bonds can also help identify any defaults on the part of the developer that might allow or require their termination.

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[2] The payment of debt service on the PAYG Bond generally follows the settlement dates for the distribution of property taxes and tax increment. August 1st and February 1st are common examples.

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