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TO: Economic Development Committee's Subcommittee on TIF
FR: Aaron Olver
RE: TIF Policy Items for December 3, 2012
DT: November 30, 2012

Overview
This memo lays out some background and considerations for the three topics the subcommittee has selected to address on December 3, 2012:

- The 50% rule
- Equity Participation
- Sustainability

Acronyms Used in this Memo
TIF – Tax Increment Financing
TID – Tax Increment District

Background on the 50% Rule
Current policy provides the following language:

> **50% Rule.** No more than 50% of the net present value of the tax increment generated by a private development project shall be made available to that project as gap financing. The City may make exceptions to TIF Policy.

This rule serves two primary purposes:

1. **Public Infrastructure -** The rule ensures that a portion of the increment will be available for public purposes such as infrastructure, bike paths, pedestrian improvements, etc.
2. **Risk Management -** The rule provides a margin of error for the City. Because Madison currently provides TIF assistance by incurring the debt, the 50% limitation on awards (along with the personal guarantee required of developers) provides a cushion in case the actual increment generated by a project falls below projections.

In considering the 50% rule, the subcommittee should address both the reservation of increment for public use and the management of risk to Madison.

The primary weaknesses of the 50% rule are:

1. The current policy provides no guidance on extraordinary projects or situations. While staff routinely recommend minor exceptions to the rule (e.g. projects using 53% or 59% of increment), the current rule provides no guidance to staff or developers considering projects requiring major exceptions to the rule.
2. The rule is somewhat blunt or arbitrary. The percentage of increment a project consumes is sensitive to current market conditions, the age of the Tax Increment District, and the City's assumptions.

3. TIDs vary in their need to use increment for public infrastructure expenditures versus private development assistance. Few, if any, TID project plans call for exactly a 50-50 split between these categories.
4. In addition to the 50% rule, there are several other mechanisms that reduce risk. Together, these make the City's approach quite conservative. While this is generally good, the policy does not anticipate occasions where a more aggressive approach may be warranted.

Public Infrastructure

The issue of reserving increment for public uses should be addressed in context of each individual TID project plan. Staff should review project plans on a case-by-case basis and make recommendations on the use of increment that consider the health of the TID and the public infrastructure needs. Staff recommendations should anticipate planned public expenditures.

Risk Management

The city uses a variety of mechanisms to reduce risk to the City of a TIF loan going bad. These mechanisms include:

- A model with slightly conservative assumptions about appreciation and mill rates
- The use of a discount rate (7%) that exceeds the City's current and recent borrowing rates
- The requirement of for personal guarantees
- The 50% rule

In addition, there are other mechanisms the City does not typically use that are available to reduce risk or manage distressed TIDs if necessary. These include:

- Use of developer-financed TIF or Pay-as-you-go
- Use of donor TIDs
- Use of statutory provisions for distressed or severely distressed TIDs

In considering the 50% rule, the subcommittee should consider how to accomplish the goal of managing risk while providing for flexibility where flexibility is warranted.

In the PowerPoint briefing I raised several possible alternatives including:

1. Replacing the 50% rule with an analysis of "margin for error"
2. Replacing the 50% rule with an analysis of "years of payback"
3. Building a cash flow model for each TID and TIF award
4. Modifying the 50% rule to allow for variations

In thinking about these options, I have personally come to believe that option #4 (modifying the 50%) rule may be the most fruitful. Options #1 and #2 are likely, over time, to develop the same failing of the 50% rule and result in an arbitrary and standard rule of thumb (formulated as X% margin of error or Y years of payback). Option #3 is a powerful and very accurate way to analyze TIF. However, it is quite labor intensive to develop these models. Option #4 can accommodate additional sophistication while preserving a language (expressed as a percentage of increment) that has become familiar to staff, the public, and policymakers.

Potential Framework

I would suggest the subcommittee consider creating bands of increment and outlining criteria that developers or companies would have to meet to fall in each band. The idea is to create some clarity (as well as some flexibility) to guide staff and the public on situations where the Mayor and Common Council will consider projects that consume more than 50% of the increment.

What follows is an example of how such bands might be constructed solely for the purpose of illustration and to stimulate subcommittee debate and discussion. It is not an attempt to outline all of the criteria (or even the specific bands) the subcommittee might wish to consider or specify.

Example of Framework

Increment Band	Criteria for increment level to be supported
Up to 50%	- General projects demonstrating - Affordable housing projects requiring City match[1]
50% to 75%	- Complicated infill projects/adaptive reuse of historic structures - Unusual environmental remediation - Extraordinary sustainability features - Project includes civic component - Project likely to catalyze additional development - Project with a substantial job creation/retention element
75% to 100%	- Pioneering project area untested for commercial or residential - Project likely to catalyze substantial additional development - Project with unusual civic/public benefits - Complicated or multi-phase commercial/mixed-use project where developer has agreed to pay-as-you TIF - Project with a substantial and strategic job creation/retention Element
Over 100%	- Project has extraordinary and strategic civic purpose - TID sufficiently healthy to support extraordinary investment

Such a framework could be presented in this relatively simple form or it could take another form (such as a point system). Possible elements the subcommittee could consider might include:

- Type of development either generally (commercial, residential, manufacturing, etc.) or specifically (office, hotel, retail, industrial, warehouse, apartment, etc.)
- Location within city (e.g., downtown vs. non-downtown, infill vs. greenfield, targeted neighborhoods or corridors)
- Economic impact (jobs, wages, etc.)
- Property tax base created (dollars)
- Sustainability features (building systems, certifications such as LEED, reuse of materials, etc.)
- Environmental remediation of brownfields (or other contributions, such as to the health of the lakes)
- Complexity of development (scope, acres, phasing, mix of uses, partners)
- Advancement of other policy goals (e.g., affordable housing)
- Degree to which development is transit-oriented

[1] At some future point the subcommittee will have to grapple with the way a policy of supporting affordable housing, attracting WHEDA tax credit projects, and using gap analysis interact

- Use of best-value contracting or provision of other community benefits during construction
- Industry cluster
- Catalytic potential on nearby property
- Civic or strategic importance
- Creation of public space or open space
- Creation of community gardens or other impacts on food system
- Density benefits
- Extraordinary design

There are, no doubt, many other criteria that could potentially be incorporated into such a system by policymakers.

Background on Equity Participation
Current policy requires an equity participation payment and reads as follows:

> **Equity Participation Payment.** An equity participation payment shall be required for both commercial and/or residential rental and/or owner-occupied projects.
>
> > (a) The rental equity participation formula, whether commercial or residential, shall be the percentage of TIF in the total project financing multiplied by the gross sale proceeds or the assessed value of the project on a date certain, capped at the total amount of TIF invested in the project.
> >
> > (b) The owner-occupied formula, whether commercial or residential, shall be payable by Developer from any excess sales proceeds, defined as the net sales proceeds less actual TIF-eligible costs, less City fees identified in 5.4(4) and less a 12% return on investment (ROI) over a period not to exceed two (2) years from the date a construction permit is issued. Fifty percent (50%) of said excess sales proceeds shall be paid to the City, and fifty percent (50%) retained by the Developer. Actual TIF-eligible costs, City fees and ROI are subject to verification by an independent financial audit conducted by the City of Madison.

For purposes of this discussion, I will focus on sub (a) which is more typical now that few condos are built (though note that sub (b) applies to commercial and would impact companies). Also note that the equity participation payment is paid when the property is sold or at a date certain (typically at the maximum hypothetical life of the TID).

The primary rationale for the payment is to allow the City – and therefore the public – to share in the upside of TIF investments. The City regularly receives equity participation payments and plans on this revenue. From the City's point-of-view, equity participation is a helpful source of revenue.

From the developer's point-of-view, the equity participation payment is a complicating factor. It has two impacts:

1. Equity participation effectively converts the City's TIF assistance from an award that behaves like a forgivable loan to one that behaves like a 0% loan with a balloon payment. While a 0% loan is valuable, it's not nearly as valuable as a forgivable loan.
2. Equity participation adds an element of complexity for developer that they must sell to their equity investors and plan for.

Developers protest the equity participation payment more than any other feature of Madison's TIF Policy. They object to the financial complexity it introduces and they object to it on philosophical grounds. Though equity participation is often described as a vehicle for the City to share in the upside of successful projects, the truth is that developers typically owe the equity participation payment regardless of how long they hold the building and how much they make on the project. A developer could lose money on a project and still owe an equity participation payment.

To assist the deliberations, here are a few concepts the subcommittee might consider (in addition, of course to maintaining the status quo):

1. **Eliminate Equity Participation** – The equity participation payment, often paid decades in the future, is of relatively little fiscal significance compared to the increment and tax base generated by projects. The City can enjoy the upside of successful projects by closing TIDs faster and benefiting from the positive fiscal impact. To the extent that eliminating this provision makes Madison a more attractive place to pursue development, the impact would be compounded. Several staff members prefer this option.
2. **Maintain Equity Participation for Life of City Debt –** The City typically pays off the debt it incurs to provide TIF loans over ten years. The City could keep equity participation in place for properties sold during this period and eliminate it (or phase it out) after this period ended. This would encourage developers to build projects they were committed to holding. A variation of this approach might be to phase out equity participation after the City recovered sufficient increment to pay off the debt it has incurred for the project. This time period could be shorter or longer than ten years, but will generally be specified in the personal guarantee schedule for City-financed TIF awards.
3. **Maintain Equity Participation for Owner-Occupied Residential Projects** – When a developer knows they are going flip a property (e.g. with condos), there is an incentive to be conservative in estimating projected sales price (since optimistic projections will reduce the amount of TIF the City provides). The owner-occupied provision helps align the City and developer's incentives and provides a vehicle for true sharing in upsides that exceed a twelve percent hurdle rate.
4. **Peg Equity Participation to Actual Returns** – the City could devise a system of accounting for a developer's actual return (expressed, say, as a percent return-on-investment or ROI) at the time a property is sold or at some time-certain future date. If the project failed to return a threshold ROI, the City would collect no equity participation. If the ROI exceeded the threshold rate, the City would be entitled to some share of the excess. This approach, while having its attractions, would introduce accounting and legal complexity and could be labor-intensive to administer.

Background on Sustainability

Current policy is silent on the issue of sustainability and environmentally friendly building systems. According to Chapter 66.1105 which governs the use of TIF, project costs include:

> Capital costs including, but not limited to, the actual costs of the construction of public works or improvements, new buildings, structures, and fixtures; the demolition, alteration, remodeling, repair or reconstruction of existing buildings, structures and fixtures other than the demolition of listed properties as defined in s. 44.31 (4); the acquisition of equipment to service the district; the removal or containment of, or the restoration of soil or groundwater affected by, environmental pollution; and the clearing and grading of land.

Sustainability features or systems are clearly eligible to be funded with TIF.

In terms of developing a policy with regard to sustainability, the area is something more of a blank canvas for the subcommittee. Should the subcommittee wish to encourage greater sustainability by providing incentives, the subcommittee could consider allowing projects that meet certain sustainability standards to qualify for a greater percentage of TIF increment (e.g., achieving LEED Platinum might qualify a project to up to 75% of the increment provided it demonstrated a sufficient gap). The challenge for the subcommittee will be how to establish (and keep up-to-date) criteria that distinguish typical or standard sustainability features from extraordinary ones.

It's also possible that a policy encouraging greater expenditures on sustainability features will drive up gaps and therefore TIF requests. It's critical to provide mechanisms to ensure that sufficient increment is generated to cover both these larger gaps as well as the other expenditures of the district.