Use of Public Incentive Finance in Commercial Real Estate Developments: A Developer's Perspective

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The authors discuss how to conceive and structure public incentive financing for a commercial real estate development.

''Public incentive financing'' in the context of commercial real estate development provides a powerful stimulus for economic development. Traditionally, economic development has been focused on providing incentives to manufacturing and technology companies, with the main goal being job creation. Increasingly, however, economic development has begun to focus on sales tax generation and efforts by states, counties and municipalities to lure retailers capable of generating high sales tax revenue. One reason for this added focus is that, in many areas of the country, property taxes remain quite low, and sales taxes are the primary revenue drivers for communities. Further, while retail economic development has been used, historically, by larger metropolitan areas to facilitate large commercial developments, it is now being used to attract much smaller developments to less urban areas, providing counties and municipalities with much needed cash flow. In relative terms, the impact to a small municipality from the location of a Fred's or Dollar General store within its city limits can be equal to or greater than the benefits derived by a larger city from a Wal-Mart or Target development.

This article is intended as a primer for conceiving and structuring public incentive financing for a commercial real estate development. Public incentive financing transactions involve a varied cast of characters, including real estate developers, elected officials, economic developers, land planners, civil engineers, government employees, real estate lawyers, bond lawyers, investment bankers, and prospective tenants or purchasers in the finished project. Each of the participants is typically proficient in his area of expertise, but very few have a thorough working knowledge of the entire process. This article will attempt to broadly span the public incentive financing process and discuss several key concepts in structuring and negotiating a public incentive financing deal.

The context of public incentive financing, as used in this article, is the abatement of taxes or use of tax revenue to return the costs of public improvements back to a developer's proforma so that a project will become

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economically feasible. The reader should note that other types of public financing tools, such as tax credits and improvement districts, may also be statutorily created for specific types of projects. However, this article does not address project-specific legislation.

What is Public Incentive Financing and Why Would a Developer Want it?

A commercial real estate developer's goal in obtaining public incentives for a development is to reduce his total cost and thereby render the development more profitable. This cost reduction is typically effected through alternative funding sources for infrastructure associated with the development. In general, public incentive financing must be directed toward public improvements. This is due to widespread constitutional and statutory prohibitions against governmental assistance of private enterprise and is necessary to allow bonds associated with such improvements to receive tax exempt status, thus lowering the cost of lending.

Public incentives frequently revolve around the abatement or reduction of taxes otherwise payable in connection with a development, and a typical menu of abatements might consist of personal and real property ad valorem taxes; sales taxes; income or franchise taxes; and impact fees. However, public incentives can also involve low-interest loans, tax-exempt financing, and direct grants for infrastructure purposes. Often, various incentives are combined in order to structure an incentive package that best benefits the municipality or county and the developer.

In order of their practical significance to most real estate developers, the most important categories of public incentives are:

(1) abatements of taxes;

(2) improvement districts; and

(3) tax exempt financing.

Tax Abatements

Tax abatements are typically associated with tax increment financing (''TIF'') statutes. These statutes allow the re-direction of taxes generated with respect to a defined geographic area (such as the site of a retail development) toward the payment of public improvements located within that area. TIFs are available in most states. TIFs are most typically based upon ad valorem taxes but depending upon applicable law may be based upon sales taxes, or both sales and ad valorem taxes. In a typical TIF financing, a quasi-governmental body called a ''District'' is created to manage the TIF and to issue bonds to pay for public improvements. Those bonds are, in turn, repaid by an incremental increase in real property and/or ad valorem taxes generated by the development. The fact that the District is a quasi-governmental entity increases the likelihood of tax exempt financing and, thus, a lower borrowing cost. A common, but not ubiquitous requirement, of TIF statutes is that the defined geographic area of the TIF be ''blighted,'' a term that is often ambiguously defined.

The amount and nature of the taxes that may be abated through a TIF will vary from state to state and in some cases from municipality to municipality. In many states, cities, but not counties, collect sales taxes. Therefore, a TIF structured by a municipality will have the ability to forego ad valorem or sales taxes, or both, thereby creating more flexibility than offered by a TIF created by a county. Likewise, the TIF statutes in many states do not permit the abatement of the local school district's portion of ad valorem tax revenue. Obviously, the TIF component of any public incentive package will be dependent on the particular locality of the proposed development.

Developments best suited for a sales tax TIF structure are most often high-end retail developments, such as lifestyle centers or a mixed use developments, with a significant entertainment and/or retail component. Upscale developments in areas of increasing property values are particularly well-suited for ad valorem tax TIF projects.

Payment in lieu of tax (''PILOT'') programs work in much the same way as TIF's. In a typical PILOT financing, the developer shifts ownership of the real property to a tax-exempt entity, such as an industrial development board. The developer then agrees to make a payment to the tax-exempt entity in an amount that the developer would have been required to pay were the real property not tax-exempt. The tax-exempt entity then uses the PILOT payment to fund the construction of public improvements within the development. As with TIF's, PILOT programs can entail a bond issue.

It is important to keep in mind that, even though a state may not have a statutory tax abatement financing structure, it may be possible to achieve the same result through a negotiated agreement with a taxing jurisdiction. This option may provide increased flexibility to all parties. In other words, a financing structure that may not be expressly allowed may be viable as long as it is not disallowed.

Improvement Districts

The second broad category of public incentive financing structures generally available to commercial real estate developers are public improvement districts (''PIDs''), referred to in some states as community development districts. PIDs, like TIFs, allow developers to capture tax revenues generated from a defined geographic area, or district. The main difference between the two is that improvement districts are not focused on the relinquishment or redirection of taxes by a local jurisdiction, but rather on the creation by the developer of additional taxes and fees within the development to pay for public improvements. The

most common example of an improvement district financing allows a developer to assess owners within a district a ''tax'' equal to the difference between the fair market value of the property before development and the fair market value after it is developed and the public improvements installed; i.e. the incremental positive difference. This additional tax revenue is used by the PID district to fund improvements to the entire district and may be pledged towards repayment of a bond issue, as discussed above.

PIDs may be established to undertake residential, commercial or industrial developments, but are most commonly used in large residential or mixed-use developments. PID districts are typically empowered to finance the construction of streets, sidewalks, water and wastewater lines and facilities, bridges and drainage improvements. In a typical residential PID with a bond issue, the infrastructure costs are financed pro rata over the life of the PID bonds. Because each lot owner within the development is assessed with an annual incremental tax increase, the developer may pass through the infrastructure costs in the form of the assessment rather than adding those costs to the price of each lot.

Tax-exempt Financing

In lieu of or in addition to the foregoing incentives, tax-exempt bond financing can be a powerful tool to a real estate developer. Historically, tax-exempt bonds were only available to very limited categories of enterprises, such as large manufacturing and processing facilities. However, recent legislation has expanded the usefulness of tax-exempt financing for other types of developments, particularly in the states bordering the Gulf of Mexico. The federal Gulf Opportunity Zone Act of 2005 created a variety of tax incentives for developers building or rebuilding property in the wake of Hurricanes Katrina and Rita. Among these benefits is the creation of a new class of tax-exempt revenue bonds known as ''GOZone Bonds.'' These bonds not only receive tax-exempt status under state and federal law, but the interest derived from GOZone Bonds is not subject to the federal Alternative Minimum Tax, a very attractive feature for many investors.

First Steps in the Process

Since taxes are the central theme of most incentive structures, the first question a developer should ask is, ''who are the applicable taxing authorities?'' Taxing authorities will invariably be some combination of state, county and municipal governments that will tax a project's sales revenue and land and improvement value, and may also levy additional taxes such as business licenses and impact fees.

Aside from gaining an understanding of types of public incentive financing available in a particular locale, perhaps most critical step a developer will take on the road to a successful incentive package is the identification of one or more key local officials who will support and sponsor the development. The continuum from state to municipal governments will typically become more political and flexible as the political subdivision becomes more local. A developer will seldom be successful without a champion for his cause at the local level.

A public incentive financing proposal will usually give rise to several political truisms of which the developer must be aware. First, unless the proposed development is significant enough to generate competition between competing states, the state government is unlikely to be motivated to offer significant incentives. For example, once a decision has been made to locate a development within a state, the selection of a particular county or municipality as the development site within that state will largely be irrelevant to state officials. The situation changes somewhat if the cities in the running for a development are located within different states, so that each state stands to gain or lose depending upon the ultimate location of the development. The same analysis applies for county and city governments. Therefore, the most meaningful negotiations are likely to take place at the local level.

Second, states and counties are often hesitant to provide incentives that benefit a particular commercial development because they fear setting a precedent and creating an expectation of public incentives for all similar developments within their borders. Third, cities and counties often have more legal flexibility to structure creative public financing deals than do state governments. Finally, and most importantly, however, the relative political impact of a commercial development is greatest at the local level. A public official who invests politically in a successful project in his community will add enormous value and bring to the project resources that will otherwise be unavailable to the developer. The strength and success of the relationships created with local public officials will often determine the overall success of the development.

A Developer Should Know What He is Giving Before He Starts Negotiating

Fundamentally, a governmental entity's decision to support a commercial project is made (or, at least, should be made) through a cost-benefit analysis, and the developer must be prepared to successfully demonstrate that the benefits of constructing his project will outweigh the costs of the proposed public incentives. The critical question for a developer to answer when negotiating public incentives is: ''what is the *net gain* of *direct and indirect* (and induced), *temporary and permanent* benefits (i.e. tax revenue and jobs) created by the development?''

Net Gain

The net gain describes those benefits that would not

occur ''but for'' the project. This is in contrast to existing tax revenues and jobs that may be simply transferred from an existing project within the same taxing jurisdiction to the new project to be developed. As an example, a new big box center may cannibalize sales tax dollars and jobs from mom-and-pop stores located within the same taxing jurisdiction, resulting in a lower net gain to the taxing jurisdiction if the proposed, new project is constructed.

Direct and Indirect Benefits

A commercial development will create both direct and indirect benefits. Direct benefits are those directly resulting from the construction and operation of the development. Examples include new retail or entertainment jobs created at establishments within the development. Indirect benefits are those created by the infusion by the development of jobs and tax dollars into the local economy, such as increases in expenditures of discretionary income within the community or improved city or county services. Other examples of indirect benefits include service stations, convenience stores, or restaurants located in the vicinity of the development. More detail on the methodology for calculating benefits is provided below.

Temporary and Permanent Benefits

Temporary benefits are those that occur during the construction period, and permanent benefits are those occurring throughout the operational period of the development. Of course, most of the direct and indirect benefits described above could likewise be temporary or permanent in nature. The most commonly cited temporary benefits are construction jobs required to design and build a commercial project. However, other temporary benefits could include increased sales and use tax revenue during the construction period, as well as less quantifiable benefits such as a short-term increase in the visibility of the local area by reason of press releases, groundbreaking ceremonies, and similar publicity. Permanent benefits may be similarly difficult to measure. Certainly, increased tax revenue, job creation numbers, and salaries can be easily tracked. However, benefits such as improvements in the perceived quality of life and desirability of a community, resulting from a well-designed and constructed development, will in many cases be matters for subjective determinations.

Analysis of Benefits

The methodology used to track and estimate the economic impact of the construction and operation of a commercial center on the local economy is the input-output (''I/O'') model. The I/O model mathematically describes the transactions necessary among various industries as these industries produce goods and services for consumers, other businesses and industries, and government. It provides a systematic method to analyze inter-industry relationships.

The impacts captured by the I/O model fall into three categories: direct, indirect, and induced effects, as generally discussed, above. The direct effects are the most obvious, and they are simply the direct purchases of inputs for the construction and operation of the development. These expenditures include materials purchased within the given geographic area, plus the payroll of establishments at the project. The indirect and induced effects are also referred to as multiplier effects. The payroll and expenditures of the construction companies working on the project will have a significant ripple effect on related industries throughout local economy. Similarly, the payroll and expenditures of the retail establishments in the center may have a significant ripple effect on related industries throughout the local economy.

For example, the operation of retail establishments within a retail development will require the purchase of materials and supplies on a daily basis. These materials and supplies range from electricity to computer services to cleaning the buildings to other such services. The firms selling these materials to the retail establishments will then require additional orders from its suppliers, and those suppliers will expand their orders from their suppliers, and so on. Employees working for these retail establishments and employees working for companies that provide supplies to the retail stores within the project will spend and re-spend their dollars in the local and state economy. This spending and re-spending creates ripples throughout the economy.

The Regional Input-Output modeling System (''RIMS II''), as created by the United States Department of Commerce, Bureau of Economic Analysis (''BEA''), is often used for capturing indirect and induced economic impacts. BEA I/O tables are the most widely used and accepted tools for estimating the direct and indirect impact on:

(1) business sales to state and local firms,

(2) household earnings of households in the geographic area, and

(3) the number of jobs created by the construction of and the recurring operation for a proposed development.

These economic impacts will be distributed across the economic landscape according to sectors of the economy that will be most affected by having this project become an integral part of the local economy. In a retail development, for example, jobs in the wholesale and retail sector will be estimated, as well as jobs in construction, manufacturing, services, transportation and utilities, and financial services. This breakdown of where the indirect and induced jobs are located will assist in understanding the economic impact of a commercial development.

How Much Should a Developer Request?

Once a developer understands the quantitative impact

of his project economy, he is in a position to analyze and negotiate the amount of public incentives. Where statutory or state constitutional provisions are prohibitive, the total amount of public incentives may not exceed the cost of public improvements to be constructed for the project. Public improvements will typically be broadly defined and will not be limited to the construction costs of the infrastructure; they may also include the fair market value of publicly dedicated land, engineering costs, landscape, hardscape, and other related costs.

Ultimately, analyzing the amount of public incentives appropriate for a project is similar to underwriting a loan. For example, when considering the size of a bond issue, one would determine the total amount of debt that the tax revenue can service by estimating the annual tax revenue in light of the appropriate debt service coverage, interest rate (taxable or tax exempt), and term.

Quick Lesson in Bonds and Their Impact on the Deal

A public authority may issue a general obligation (''GO'') bond or a limited or special obligation or revenue bond. Repayment of a general obligation bond offering is backed by the full faith and credit of the issuing entity. A limited obligation bond offering is backed by a specific revenue stream, such as tax revenue generated from a commercial development or lease revenue, or PILOT payments, paid by the developer or operator of the project. Therefore, if a city with a good credit rating issues a general obligation bond to pay for public improvements, the developer will likely not be required to enhance the issue (typically with a letter of credit or guaranty) to make the bond saleable. Since limited obligation bond issues are not back by the full faith and credit of the issuing authority, they are viewed by bond buyers as a more risky investment, especially if repayment is dependent upon an unproven sales tax record of the financed project. Therefore, unless the developer is extremely well capitalized, investment bankers and bond buyers may require that the developer agree to guarantee sufficient tax revenues to cover debt or provide a letter of credit to cover those costs. Developers should also be aware of any constitutional debt limits that would prohibit a city from lending its full faith and credit towards a bond issue.

Tax exempt debt carries with it a lower interest rate and, therefore, enables fewer tax dollars to service an increased level of debt for public improvements. If tax exempt bond issues are available for a project, it is critical to engage competent public finance attorneys early in the planning process. A tax-exempt bond offering must be carefully planned from the project's inception, and care must be taken throughout the process not to jeopardize the tax exempt nature of the issue. A case in point is a large retail development for which the city in which it was located agreed to use funds towards the construction of certain public improvements within the development, including a parking lot. At the time of dedication of the parking lot to the city, it was discovered that the developer had already given his anchor tenant a long-term exclusive on the parking lot. This destroyed the tax-exempt nature of the debt and resulted in a much higher borrowing cost. It is critical to have a bond lawyer fully engaged and aware of all deals being structured within the development.

A bond issue will typically undergo a validation process before the debt becomes a governmental binding obligation and is, therefore, marketable. Technically, this is accomplished through a suit that is filed in court against the taxpayers within the taxing jurisdiction. The bond validation hearings are subject to certain notice, objection and appeals periods. The validation process is typically quick and streamlined, if there are no objections by taxpayers. In the rare case of an objection, a lengthy legal proceeding is possible.

Key Concepts in Development Agreements

Because a developer will spend significant sums on its due diligence with respect to a site, it is critical that he obtain committed public incentives as early in the process as possible. Public incentive financing commitments are almost always outlined in a development agreement between the developer and the applicable taxing authorities. This agreement will be the principal document defining the rights and obligations of the parties with respect to the dollars at stake. Development agreements, and developers' preferences with respect to them, will range from brief documents with very general terms, to long agreements in intricate detail. The particular features and content of the development agreement will depend on the specifics of the project. While a brief development agreement may be acceptable to an inexperienced governmental entity, the developer may nonetheless be better served by a detailed agreement, carefully outlining the specific rights, obligations and protections afforded to each party.

A development agreement will often contain very specific remedies in favor of the governmental entity in the event of a default by the developer. These remedies usually take the form of repayment obligations, or ''clawbacks,'' payable by the developer if he does not proceed with the development after incentives have been provided. Examples include repayment of state funds expended for infrastructure or other development costs and repayment of deferred taxes or tax credits afforded to the developer as part of the incentive package.

As with financing structures in the private sector, the developer of a public-private project may be required, as discussed above, to guarantee various monetary and non-monetary obligations until certain financial benchmarks have been achieved. In this instance, the development agreement will often require

the guaranty to remain in place until a designated debt service coverage ratio is met or until a desired lease and occupancy level has been achieved.

In the planning and drafting of a development agreement, developers should consider whether the state or local public bidding laws will apply to the project, and, if so, how compliance will affect timing, financing and control issues. States have enacted bid laws, applicable to all levels of government, to open the process by which contracts for public works are awarded and, ostensibly, to prevent favoritism, graft and corruption. How a project is structured may affect whether a developer must comply with these bid laws. A few questions to ask about expenditures for public improvements made in connection with a private development are:

(1) Will the improvements be initially made on public or private property?

(2) Who will be constructing the improvements, the developer or the city?

(3) If the developer is making the improvements, will he make the improvements on his own behalf and then convey them to the city, once completed, or will the developer act in the role of development manager on behalf of the city?

All of these questions can affect whether bid laws are applicable.

Timing of construction is another critical element that should be addressed in a development agreement. There are several structural solutions for timing problems that a developer should build into his planning process when negotiating the development agreement. The developer must carefully plan when and in what order public infrastructure work will be undertaken and completed. Once the developer commits to a timeline with his lender, contractor and tenants, a failure to complete public infrastructure work on schedule may result in tremendous problems for the developer. Therefore, prior to finalizing the development agreement, the developer must reach an intermediate stage of the planning process, so that his lender, major tenants, architect and engineers all agree on the overall construction process and schedule, with sufficient allowances for delays. The timing of each separate infrastructure component is critical to the overall success of the project. Likewise, the developer and the construction lender must both be comfortable with the timing of all private and public financing so that sufficient funds are available for infrastructure development prior to the data refunding by the governmental entity, or a planned bond issue.

The developer should attempt to maintain complete control over the construction of all improvements. A typical deal structure may involve a purchase by the developer of unimproved land as the proposed project site. Infrastructure located on the developer's property may be constructed privately and then dedicated or sold to the city in which the development is located. Other public improvements, such as widening existing public roads, or building new roads leading to the new project site, will be undertaken by the city or applicable governmental entity. If at all possible, the developer should secure the agreement of the city to appoint the developer as the ''construction manager'' of the off-site, public improvements, thus giving the developer more control of the construction process.

The timing of actions by public bodies may also impact the project. Absent a validated bond issue, certain agreements made by a city or county may not be enforceable. For instance, a city's agreement to reimburse a developer a certain percentage of sales tax revenues from a retail development located within the city may only be legally binding upon the city for a short period due to constitutional limitations. While backing out of such a deal would damage a city's reputation and reduce its prospects for future developments, a developer should consider requiring the city's legal counsel to deliver an opinion letter as the to enforceability of the agreement and secure in the development agreement the developer's right to require validation of the city's obligations even if bonds are not issued.

A final, important aspect of the deal structure is the relationship between the anchor leases and the bond financing. If the anchor tenant is not required to open and operate, for at least one day, much more risk is inserted into the deal from the bond purchaser perspective, and financing could be significantly hindered. For illustrative purposes, assume that a developer sells or leases a portion of its development to ''Anchor A'', who will be generating most of the expected sales tax revenues from the proposed development. Without an ''open and operate'' requirement, Anchor A could simply choose not to construct and operate its store from the site, which would, in turn, mean reduced sales tax dollars to fund public improvements.

Conclusion

In the planning and structuring of a public incentive project, in addition to technical due diligence, a developer should do his homework on the entity from whom he seeks assistance and always be mindful of the practical, political nature of the task. If a local government has declined to provide public incentive financing for a project in the past, it will be likely to continue on that course absent a change in government leadership or other change in circumstances. In negotiating public incentives, time is a developer's enemy. If the developer cannot negotiate the incentive agreement quickly and in writing, this may signal problems ahead. A savvy governmental entity will know that a developer spends a great deal of time and money on due diligence and marketing, and the more time and money a developer has invested, the more reluctant he will be to withdraw from a project. For this reason stalling by the city in entering into a development agreement may gradually turn the leverage of the situation against the

developer. Remember that many of the decision-makers with whom a developer must deal are elected officials who will be reluctant to be perceived as handing out public funds to a rich developer. That perceived risk is usually more pronounced in areas with healthy, competitive retail economies than in underserved markets.

Before entering into negotiations with a governmental entity, a developer should have a firm grasp of all issues associated with the request, including, just to name a few, the jurisdiction's debt capacity and whether the developer's request will count against the jurisdiction's statutory or constitutional limits; assigning the risks of funding and non-performance; the applicability of bid laws; whether leases in place or to be negotiated will violate federal tax exemption of a proposed bond issue; and required debt service coverage ratios and other covenants and conditions to be met by the developer. All of these issues, and many others, must be analyzed and addressed as part of a comprehensive development plan. If planned, negotiated and implemented properly, a commercial real estate development can be greatly enhanced by the appropriate use of public incentives. Such a public-private partnership, if properly structured, will provide benefits to the developer and to the county not otherwise available to either of the parties absent these joint efforts.