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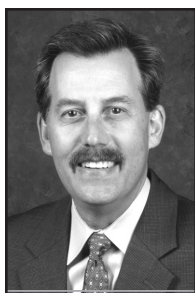
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Finding public finance in these challenging times: TIFs, credits

In these challenging economic times, developers need to look at a wider variety of options to satisfy their project financing needs. There are several types of public financing programs that can help to bridge the financing gap for certain types of projects. In the current economic environment, where traditional bank financing is more difficult to obtain, it is that much more important to explore options for other sources of financing. This article will address three programs for public financing that have been used in Colorado. Those include tax-increment financing, new market tax credit financing and historic rehabilitation income tax credits.

■ **Tax-increment financing.** Tax-increment financing is available in Colorado under the Colorado Urban Renewal statute. The general premise of tax-increment financing is that the sales tax and real property taxes that are generated by the project can be used to finance a variety of eligible expenses of the project. Those eligible expenses typically include all of the acquisition costs of the property, as well as the costs of any environmental remediation, the installation of any new utilities and other infrastructure in the project, and any other public improvements. As an example, a parking structure that is open to the public would qualify as a public improvement for purposes of the urban renewal law. The tax increment is defined as the increase in sales and property taxes generated by the project. In an environment where the sales taxes and/or the assessed value of the project have been declining, the developer is well advised to keep track of the levels of these tax amounts in deciding when to create an urban renewal area encompassing the project.

The anticipated incremental sales and property tax revenues are used as the revenue stream to borrow money to fund a portion of the project costs. Before the passage of the Taxpayer's Bill of Rights, it was more common for urban renewal authorities to issue bonds, the proceeds of which would be made available to the developer, and the urban renewal authority would use the tax increment to repay the bonds. However, it is uncommon today for urban renewal authorities to issue bonds. Most often, the developer



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has to borrow these monies from a conventional lender and pledge these tax increment revenues to the lender as a source of repayment. However, the existence of these tax revenues increases the amount that can be borrowed from lenders by providing an additional revenue stream to support repayment of the loan. Also, lenders typically see the tax revenues as a fairly reliable and consistent income stream.

One requirement to be able to utilize tax-increment financing is that the project has to be located in an urban renewal area. So the municipality that the project is located in has to have an urban renewal authority and it has to be willing to establish an urban renewal area that includes the project. Many municipalities in the metro area have urban renewal authorities today and those municipalities recognize the economic development benefits and tools that are provided by the urban renewal law in Colorado.

■ **New markets tax credits.** Another relatively recent public financing program is the Federal New Markets Tax Credit program. Essentially, this program provides a federal income tax credit for development undertaken in areas that qualify as low-income areas under the most recent census. While the transaction can be complex and document intensive, the program can be very beneficial. The credits for this program are allocated on an annual basis based on applications submitted to the U.S. Department of the Treasury.

These deals essentially work by selling the credits to an institution that can use them to offset their federal income tax liability (often a major national bank) and then a portion of the proceeds from the sale of the credits is made available to the project. As originally intended, the net proceeds from the sale of the credits (after payment of significant costs and fees to the allocatee of the credits) are funded to

the developer as equity. The actual structure of these transactions usually involves these monies being loaned to the developer as a subordinate loan that is later forgiven. However, the purposes of this program have been manipulated by some and instead of the net proceeds from the sale of the credits being paid to the developer as equity, the deals often are structured as a recourse loan of the proceeds being paid to the developer at a discounted interest rate.

One of the challenges of this loan structure is that because the transaction costs are significant, the overall economic benefit to the borrower/developer is reduced to some extent. Some allocatees use a hybrid structure where some of the net proceeds are given to the developer as equity (after the deduction of a significant amount of the proceeds in fees) and some are loaned to the developer at a discounted interest rate. A pure equity deal is very beneficial to the developer since other than the tax consequences of having the subordinate loan forgiven (this is how it is usually done in the equity scenario), these dollars are basically free to the developer.

One other restriction worth noting about New Markets Tax Credit deals is that the property can't be transferred for a period of seven years after the property has been put in service or the unamortized portion of the tax credits has to be recaptured. The complexity of the deals can be a discouragement to many developers and it also can shrink the pool of lenders willing to participate in the program. But if you can pull a New Markets Tax Credit deal together that is a true equity deal, you end up with free equity money. There have only been a few New Markets Tax Credit deals that have been done in Colorado, including one I did on the west side of town for a retail deal.

■ **Historical rehabilitation tax credit.** The third type of public financing involves Historic Rehabilitation tax credits. This program provides both federal and Colorado income tax credits for a portion of the monies spent in rehabilitating a building that qualifies as a historic structure. In order to qualify for this project, one has to first have a building that qualifies as a designated historic structure.

One of the benefits of this tax credit

program is that the net proceeds from the sale of credits that get paid to the developer is a much higher percentage than get paid to the developer in the New Markets program. The credits for a historic tax credit deal are based on the eligible amounts that are spent in rehabbing the building. There are limitations on what types of expenses qualify for the credit. But generally speaking, most hard costs and many soft costs do qualify as eligible expenses.

One of the challenges of the historic rehab tax credit program is the bureaucratic challenges one faces in getting the proposed improvements to the building approved by the U.S. Department of the Interior. This program is overseen by the National Park Service in the Department of the Interior. While the statute has timelines for the review of the proposed improvements, it is very common for the NPS to take significantly longer than the statute provides to respond with comments. It also is typical for the NPS to require changes to the planned improvements that are either very expensive or impractical. Since the passage of time is a risk to any real estate deal, the longer this process goes on the more problems it can create for a project. The result is often that the developer will start the rehab work before it has formal approval from the NPS of the plans and the developer often will find itself making changes to the improvements during the course of construction to deal with the comments and requirements of the NPS. Sometimes, these required changes are unacceptable to the tenant that will be occupying the building, which creates its own set of challenges and risks.

One other important restriction is that the property can't be conveyed for a period of five years after the improvements have been completed or some portion of the tax credits has to be paid back. But if one can cope with these various risks and challenges, there is real economic benefit to be enjoyed from utilizing this program.

■ **Conclusion.** Because of the complexity of these deals, it is important to use legal counsel and other advisers who are both knowledgeable and experienced in these types of transactions.▲