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) contract and note means a written note or contractual obligation under which all of the following apply:

1. the note or contractual obligation evidences an authority's commitment to reimburse a developer, property owner, or note holder for the payment of costs of activities, including any interest on unreimbursed costs;
2. the reimbursement is made from tax increment revenues identified in the note or contractual obligation as received by a municipality or authority as taxes are paid; and
3. the risk that available tax increments may be insufficient to fully reimburse the costs is borne by the developer, property owner, or note holder. [1]

While both a contract and an associated note are commonly used in forming a pay-as-you-go obligation, sometimes there may only be a contract or only a note that still meet the criteria listed above. Regardless of its form, a pay-as-you-go obligation (referred to here as "PAYG Note") is included in the TIF Act's definition of a "bond."[2]

The PAYG 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 TIF revenues.
- Payments by the municipality to the developer on the PAYG Note 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 PAYG Note payments.
- Failure by the municipality to make payments because of insufficient TIF revenues does not constitute a default.
- A PAYG Note does not constitute a general obligation of the municipality and is not included when calculating debt limits.

These differences are discussed again and in more detail in the *Characteristics* section below.

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[1] Minn. Stat. § 469.174, subd. 30.

[2] *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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How They Work

With a PAYG Note, 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 expenditures qualifying for payment with tax increment 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 Note 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 Note).

Over the term of the PAYG Note, the authority makes debt payments, generally twice a year.[3] If the property taxes on the parcel in the TIF district are not paid or if the legislature changes the property tax laws, the authority's payments will be affected 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 Notes instead. PAYG Notes are used more frequently than GO Bonds.

Characteristics

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

If the PAYG Note is in the form of a note held by the developer-noteholder, 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 Note to the bank as security for bank financing. If a bank is assigned a PAYG Note as security or if a consortium of banks buy and bundle PAYG Notes 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 Note is just a promise to

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

pay the developer to the extent funds are available from TIF revenues generated within the TIF district. In other words, it is unsecured debt.

Relationship to the Six-Year Rule

Legislation in 2023 clarified the relationship of PAYG Notes to the Six-Year Rule.[4] Generally, the Six-Year Rule requires decertification when there is sufficient increment to pay all in-district obligations. Prior to the clarifications, there were questions as to how increment from parcels not subject to the PAYG Note might affect the requirement for decertification. If unobligated increments were sufficient to pay a PAYG but were not obligated to be used for the payment of the PAYG Note, a forced decertification might result in the PAYG Note going unpaid in accordance with expectations. Conversely, allowing in-district increment to accumulate from parcels not subject to the PAYG Note, raised other concerns about allowing unusable increment to accumulate. With the clarifications and changes, the Six-Year Rule requirement to decertify is generally deferred until the PAYG Note reaches termination under its terms, but parcels are required to be removed from the district if they are not pledged to an outstanding in-district obligation.[5] See the Statement of Position on the TIF Five-Year Rule and Six-Year Rule for more information.

Potential Pitfalls

A TIF development authority should regularly review the terms of PAYG Notes. 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 Note. 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 Notes can also help identify any defaults on the part of the developer that might allow or require their termination.

[4] *See* 2023 Minn. Laws, ch. 64, art. 9, sec. 8.

[5] Minn. Stat. § 469.1763, subd. 4(b).

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