Legislative Analysis

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TIFAs: AMEND DEFINITION OF "OTHER PROTECTED OBLIGATION"

House Bill 5038 (Substitute H-1)
Sponsor: Rep. Shelley Taub
First Committee: Commerce
Second Committee: Local Government and Urban Policy
First Analysis (5-4-04)

BRIEF SUMMARY: The bill would amend he Tax Increment Financing Authority Act to expand the definition of "other protected obligation" to include an obligation issued or incurred by an authority (or by a municipality on behalf of an authority) after August 1993, but before December 31, 1994, to finance "or pay for "a project described in a tax increment final approved by the municipality before December 31, 1993, for which a contract for final design is entered in before March 1, 1994. The bill adds the words "or pay for" and makes no other amendment to the act.

FISCAL IMPACT: The bill is currently being examined for any potential state or local fiscal impact.

THE APPARENT PROBLEM:

The Tax Increment Finance Authority legislation of 1980 allows cities to establish development and finance authorities, and to use tax increment financing to pay for improvements in their communities. Tax increment financing essentially allows a local unit to capture the growth in tax revenue in a specially designated development area for use in financing a wide range of public improvements. Originally, tax increment finance districts were an expansion of the Downtown Development Authority Act of 1975, and could be created to spur the development of virtually any kind, including commercial, residential, and industrial land uses. In 1986, the scope of tax increment finance authorities (sometimes called TIFAs) was reduced, when the more restrictive Local Development Finance Authorities were created by statute, targeting TIF dollars for manufacturing, agricultural, or high technology use. According to the Citizens Research Council, 87 municipalities had created tax increment finance authorities by June 2001. One of those municipalities is Keego Harbor, a town of 2,769 people in central Oakland County's lake district.

In March 1994, as part of new school financing arrangements under Proposal A, amendments to the various tax increment finance authority statutes took effect that prohibited a TIFA from capturing revenues derived from school property taxes, both state and local. Once the voters approved Proposal A, the revenue available to TIFAs statewide was reduced—some estimate by as much as one-half. The substantial reduction in revenues forced municipalities to stop projects, sometimes despite the fact that city officials had spent or obligated significant resources for their completion.

Recognizing the effects of the law on local redevelopment projects, the state legislature working together with the Department of Treasury "grandfathered in" so-called "pipeline" projects—or projects that had gotten underway before December 31, 1994, evidenced by the fact that an obligation had been issued or incurred to finance the project during the previous 18 months (between July 19, 1993 and December 31, 1994), and for which a "contract for final design" had been executed before March 1, 1994, a term defined and published as a rule by the Department of Treasury a year later, in August 1995. Other new and narrow provisions of the TIFA law that grandfathered pipeline projects were included within definitions of "obligations," or "other protected obligations."

A number of municipal projects entered into by public-private or public-public partnerships with the full expectation they would be partially financed by captured TIF revenues, came very close to meeting the new TIFA requirements, but fell short. The projects went forward, however, because the local partners were unaware of their shortcomings until state auditors issued their findings at the end of the decade. In 1999 and 2000, the Department of Treasury began announcing that their audits revealed many cities had captured school tax revenue inadvertently and owed hundreds of thousands of dollars to local school districts and the state School Aid Fund. Among the projects flagged were many in which the parties met the obligation deadlines to *pay for*, but not necessarily *to finance,* the development. A project to reconstruct Cass Lake Road in Keego Harbor (Oakland County) falls into this category. Others, such as the City of Belleville (Wayne County), were notified they fell short of the Department of Treasury's definition for "contract for final design," a shortfall already addressed by the legislature earlier in the session, and now enacted as Public Act 136 of 2003. See Background Information below.

Legislation has been introduced that would allow the tax increment finance authorities that entered into payment agreements (in contrast to financing obligations) in order to fund their projects before the statutory deadlines—such as the City of Keego Harbor/Oakland County Road Commission Cass Lake Road reconstruction project—to continue their capture of school taxes in their TIFA districts, and cancel their payments of back school taxes (which in the case of Keego Harbor amounts to $374,403).

THE CONTENT OF THE BILL:

House Bill 5038 would amend the Tax Increment Financing Authority Act (MCL 125.1801) to expand the definition of "other protected obligation" to include an obligation issued or incurred by an authority (or by a municipality on behalf of an authority) after August 19, 1993, but before December 31, 1994, to finance "or pay for" a project described in a tax increment finance plan approved by the municipality before December 31, 1993, for which a contract for final design is entered into before March 1, 1994.

Since the passage of Proposal A to fund public schools in 1994, development authorities have been generally prohibited from capturing taxes within tax increment finance districts when those taxes are used to fund school districts, except in cases specified in

the law where obligations had been entered into before or during the implementation of Proposal A. These are known as "eligible obligations" and "other protected obligations". The law sets forth several narrow definitions of "other protected obligation", including one that defines the term as 'an obligation issued or incurred by an authority (or by a municipality on behalf of an authority) after August 19, 1993, but before December 31, 1994, to finance a project described in a tax increment finance plan approved by the municipality in accord with the act before December 31, 1993, for which a contract for final design is entered into by or on behalf of the municipality or authority before March 1, 1994.' House Bill 5038 would retain this definition, and expand it to include an obligation either to finance *or pay for* a project described in a TIF plan, approved in accordance with the act before December 31, 1993.

BACKGROUND INFORMATION:

Cass Lake Road Construction in Keego Harbor. Keego Harbor and the Road Commission for Oakland County began a joint project to reconstruct Cass Lake Road in 1986, and entered into a "cost participation agreement" in February 27, 1991. The project was engineered during 1992 and 1993, and the city and the road commission signed a supplemental cost-sharing contract for construction, on August 19, 1993, a contract that was ratified by the county road commissioners a few weeks later, on September 22, 1993. According to city and TIF officials, the parties understood that Cass Road would be reconstructed using a combination of federal, state, county, city, and TIFA funds. Project construction, expected to begin in 1994, was then delayed, and the city's share of the cost consequently increased. The project was eventually completed in 2002.

Auditors for the State Tax Commission of the Michigan Department of Treasury have determined that the Keego Harbor Tax Increment Finance Authority was not entitled to capture tax increment revenues from state education, local school district, and intermediate school district millages for the audited tax years of 1994-1998, because the Cass Road Reconstruction Project did not quality as a "pipeline" project. On June 7, 2000, the auditors informed city officials that they would be required to pay back about $374,403 to the state school aid fund and local school districts, the total amount of money that had been "captured" for road construction during the four-year interval.

In response, city and TIFA officials claim that their project is a *bona fide* "pipeline" project because the project began with the cost participation agreement for preliminary engineering dated February 27, 1991, and was followed by a cost participation agreement dated August 19, 1993, approved by the county road commission in a construction contact dated September 22, 1993.

City of Belleville (Wayne County) preferred developer/final design contract agreement. Public Act 136 of 2003 (House Bill 4806) was enacted earlier in the session to clarify the definition of "other protected obligation" within the Downtown Development Authority Act with respect to the phrase "final design contract." Briefly, the City of Belleville in Wayne County created a downtown development authority—or DDA—that encompassed

wet, vacant land that was not suitable for a construction project without the creation of a drainage system. The DDA then entered into a "preferred developer agreement" with Crosswinds Development to build a 280-unit site condominium subdivision and a 23-acre public park on that land, and the DDA agreed to finance the infrastructure improvements as an incentive for the developer to improve the property. To fund the improvements, the city sold general obligation bonds for the DDA totaling $1,675,000, with the understanding that the bonds were to be repaid by using some of the tax revenue that was captured from the project (while other captured tax revenue was to support public improvements elsewhere within the DDA district). The land was then developed as a residential neighborhood within the VanBuren Public School district.

Beginning in 1999 and in subsequent years, the DDA was notified by the Department of Treasury that audits indicated the DDA had captured too much school tax revenue—in all, $390,334 between 1994 and 1999—and that the money would have to be repaid in order to reimburse the appropriate school agencies by August 31, 2003, or DDA officials would be subpoenaed to appear before the State Tax Commission (a subpoena that was never issued).

It seems that when the Belleville DDA officials originally proceeded with their project, they met all the requirements of the Downtown Development Authority Act. They signed the development agreement on July 6, 1993, adopted a DDA Development Plan on December 20, 1993, and sold bonds a year later, in December 1994. However, the rules of the DDA program changed in 1994 and 1995, after their project had gotten underway.

In March 1994, as part of new school financing arrangements under Proposal A, amendments to the DDA statute took effect that prohibited the capture of school taxes. The amendments included a requirement that in order to capture school taxes, a project had to have had a "contract for final design by March 1, 1994." The following year, in August 1995, the Department of Treasury published a rule defining the term "contract for final design." Four years later, and after the project to build the 280-unit condominium and public park were complete, the City of Belleville was notified that its "preferred developer agreement" did not constitute a "contract for final design," as defined by the department.

In response, DDA officials claim that their "preferred developer agreement" also embodies the final design contract since it was the only agreement entered into with the developer. They point out that no separate design agreement was necessary for this project, because the development company used the firm's own architectural and engineering resources, and did not rely upon the city's resources.

Public Act 136 of 2003 allows the DDA in the City of Belleville to continue its capture of school taxes in the DDA district, and canceled the $390,334 payment of back school taxes.

ARGUMENTS:

For:

In the case of Keego Harbor and the Road Commission for Oakland County which together reconstructed Cass Lake Road using tax increment financing (and other sources of funds), the State Tax Commission audit determination, while technically defensible, is grossly unfair. According to the auditors, signed contracts, entered into by the city and the road commission, were not a sufficient obligation *to finance* the project, despite the fact that those documents demonstrated a joint commitment to pay for the project. The city TIFA, while not in unilateral control of the project between its start in 1986 and its completion in 2002, made every reasonable effort to abide by the rules as they were known in 1993-1994 regarding the appropriate use of TIF revenue. Further, requiring such a substantial repayment—more than $374,000—so long after the fact will work a financial hardship on the citizens of Keego Harbor, whose total general fund budget in the most recent fiscal year was only $1.6 million. There are said to be a number of similar cases across the state.

Against:

The Department of Treasury has not yet tallied the "cost" to the School Aid Fund if this provision is adopted. In addition to the Keego Harbor TIFA, there likely are others whose repayments to the State School Aid Fund would be canceled, as a result of this legislation.

POSITIONS:

The City of Keego Harbor supports the bill. (4-27-04)

The Department of Treasury is neutral on the bill. (4-27-04)

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■ This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.