Article Title: Criteria | Governments | U.S. Public Finance: Special-Purpose Districts Data: (EDITOR'S NOTE: —On March 17, 2021, we republished this criteria article to make nonmaterial changes. See the "Revisions And Updates" section for details.) Tax Increment Bonds Tax increment financing, sometimes called tax allocation bonds, has been issued in a majority of states, although California redevelopment agencies continue to account for the bulk of national volume. Tax increment financing is secured by taxes generated from the increase in property value in a district after a redevelopment project has begun. As such, it does not raise the tax rate on district taxpayers, but merely reallocates tax revenues that would otherwise flow to pre-existing taxing entities in favor of a redevelopment agency that issues debt. Tax revenues produced from pre-existing property before the tax increment district was formed continue to flow through to the underlying taxing entities as before; only the taxes attributable to the increase in property values flow to the redevelopment agency and are pledged to bondholders. Tax increment bonds benefit from several favorable structural elements compared to other special district debt. Unlike special assessment and Mello-Roos bonds, no additional tax burden is created for taxpayers, and tax collection rates are generally less of a concern, unless project area tax payments are concentrated in a few taxpayers. In addition, while undeveloped land in a special assessment or Mello-Roos district can lead to high debt burdens, undeveloped land in a tax increment district is generally a favorable factor, since tax revenue will increase to the extent new development occurs and taxable property values grow. In contrast, revenues do not increase for special assessment or Mello-Roos debt when property values rise because those taxes are not based on land value, although development may lead to more favorable value to debt ratios. The main credit risk for tax increment districts is that tax rates and the pace of private development in a project area lie outside the control of the redevelopment agency issuing the debt. Actual tax rates generating the tax are set by the underlying taxing entities—cities, counties, school, park districts, and others--that set their tax rates without consideration of the needs of the redevelopment agency. Changes in state tax law, or assessment practices, can dramatically influence tax increment revenue. Tax increment district bond pitfalls A typical investment-grade tax increment district already generates sufficient revenues to cover future maximum annual debt service (MADS) at the time of the sale of bonds, a feature sometimes called "coverage in the ground". However, the experience of southern California during the 1990s shows that many different factors can subsequently reduce tax increment revenues. Some of the common pitfalls of these bonds include volatility in commercial real estate values during an economic downturn, particularly for warehouses and hotel properties, widespread tax appeals that can overwhelm county assessment offices, a residential real estate bust, construction risk on projected projects, state tax law changes, plant closures, concentration in a few taxpayers, purchase or foreclosure of land by tax exempt entities, and a high tax increment volatility ratio for recently formed project areas. Project area analysis S&P; Global Ratings' analysis focuses first on general economic factors that may affect the economic growth of the project area, such as a municipality's population, employment, and income level. Building permits may indicate overall city construction trends. Nonetheless, the general character of a city is not necessarily a barometer of the conditions within a localized project area. In this respect, a site visit may help give credence to rapidly improving economic conditions that are not reflected in assessed valuation numbers. One way to get a description of a new project area is to read the redevelopment agency's plan, which outlines prior economic conditions and project objectives. Taxpayer concentration One weakness of many project areas is their small size, leading to taxpayer concentration. S&P; Global Ratings has no size limit on investment-grade rated project areas. Generally, smaller districts will have weaker credit characteristics and, thus, lower ratings. A larger project area, generally one of over 150 acres, is usually more diverse and more creditworthy. S&P; Global Ratings analyzes taxpayer concentration by comparing assessed valuation of the top taxpayers to project area incremental value—not project area total value—because revenues rise or fall based on incremental valuation. It is not uncommon to see each of the top taxpayers representing more than 100% of incremental project area valuation in newly formed project areas, even though top taxpayers may appear deceptively diverse when compared to total project area assessed valuation. Generally, S&P; Global Ratings requests the assessed valuations of the top 10 taxpayers. It is typical for 40% or more of the incremental tax base to be held by the top five taxpayers, based on the relatively small size of most project areas. Taxpayers may also not appear overly concentrated when considered individually, yet they may still comprise just one shopping mall or condominium development. Market factors can swing the value of such shops and homes together as a result of their common location and function, apart from fire or natural hazard risks of adjacent buildings. Districts concentrated in a particular type of property, such as aircraft or computer equipment capable of being moved to other locations, may also have other vulnerabilities, even if they are diverse by taxpayer. If payment of debt service is essentially dependent on just a few taxpayers making their tax payments, it may be difficult to achieve an investment-grade rating unless those taxpayers demonstrate creditworthiness, and the property is essential to its operations. Even in the case of a rated taxpayer, however, the property should be highly essential to the taxpayer to get the benefit of the credit rating assigned to the taxpayer. An example would be an important generating plant of a rated investor owned utility. Assessment practices that may at first appear to "guarantee" tax collections have been shown through experience to not always be reliable. A financially strong company can still remit smaller-than-expected tax payments by appealing its assessment (which can take three years or longer to resolve), not rebuilding after a fire, or delaying initial construction. Taxpayer bankruptcy proceedings can also temporarily forestall legal foreclosure or tax assessment sales, since federal bankruptcy law supersedes local law. Historical assessed valuation growth S&P; Global Ratings prefers to examine at least four years of project area assessed values, when available. One of the virtues of tax allocation bonds is the typically high growth rate of assessed valuation within most new project areas. However, a recent base year may cause deceptive percentage rises in incremental assessed valuation because of the comparison to small early-year incremental values (see the tax volatility ratio chart). Total project area assessed valuation may be a more meaningful indicator of growth trends. In a few states, fire, demolition, or conversion to tax-exempt property may be used to decrease the frozen base assessment—increasing incremental assessed value—without new construction. Future assessment growth An important indicator of future assessment growth is the acreage available for new development. A fully developed area, with no redevelopment potential, effectively limits the possibility of assessed valuation growth. However, project areas with large undeveloped land areas are not assured of attaining growth. Construction strikes, changes in market conditions, or higher interest rates can suddenly cancel or delay even the most promising development. Construction risk, when present, is such a risk factor that most investment grade-rated tax allocation bonds already demonstrate coverage of maximum annual debt service by historical tax revenues (S&P; Global Ratings will consider next year's tax levy an "historical" revenue if it is based on the current assessor's assessment roll and the current tax levy), although exceptions have been made when debt service could be covered with only limited amount of future growth that seems especially likely. Historical coverage of debt service alone, however, does not necessarily guarantee an investment-grade rating. Management Policy control of a redevelopment agency usually lies in a city council, with an executive director responsible for implementation. The agency holds broad authority to acquire, develop, and administer property, as well as eminent domain powers. Often a major portion of tax allocation bond proceeds is used to acquire and consolidate parcels of land. Questions for management may encompass additional debt plans, unusual features of the redevelopment plan, and the land use breakdown when the plan is completed. Legal considerations S&P; Global Ratings' analysis of the legal structure of a tax allocation bond focuses on the security pledge, flow of funds, debt service reserve fund, and provisions governing the issuance of additional parity debt. The flow of funds is usually simple. Tax increment pays debt service, makes up debt service reserve deficiencies, and then revenues are released for any purpose. Lack of a fully funded reserve is viewed as a negative rating factor in view of the low debt service coverage of most tax increment bonds. Additional debt issuance is likely over the life of a bond issue. Tests for additional bonds requiring 1.25x coverage of maximum annual debt service by historical revenues, or revenues to be realized as a result of the most recent finalized assessment rolls, are considered a typical provision. However, stricter additional bonds tests may enhance credit quality. Provisions allowing adjustments to revenues based on construction in progress or a consultant's projection can severely weaken the additional bonds test. The coverage multiple required under the additional bonds test is examined in relation to the number of taxpayers excess cash flow could cover in the event of delinquencies among major taxpayers, assuming a redevelopment agency bonded out to the limit of its additional bonds test. Thus, no one additional bonds test or coverage level can guarantee a specific rating. More established diverse districts have issued debt with less than a 1.25x additional bonds test without a negative impact on their credit rating as their tax volatility ratio declined and their taxpayer concentration diminished. S&P; Global Ratings weighs a more permissive test against taxpayer diversity, historical and projected growth trends in assessed valuation, the nature of such growth, and the need and likelihood for additional debt issuance. On the other hand, higher debt service coverage and stronger additional bonds tests may offset weaknesses in district economic diversity. Aside from an issue's legal structure, S&P; Global Ratings evaluates tax increment authorization laws and litigation. S&P; Global Ratings examines all new state authorizing legislation for potential problems. Litigation frequently accompanies tax allocation issues, especially in states newly authorizing such financing, because public entities losing the tax revenues have an incentive to sue. Taxpayers and overlapping units often contest the constitutional validity of new tax allocation legislation; counties may wish to postpone the loss of revenues, and taxpayers may want to delay eminent domain proceedings. Some tax increment bonds also have a pledge of a city's GO. S&P; Global Ratings will rate such double-barreled securities based on the higher of the GO or tax increment rating, since both are pledged to debt repayment. Financial operations Primarily, financial factors include an analysis of fluctuating tax rates, delinquent collection rates (for the project area, not the city), and historical debt service coverage. No specified level of coverage leads to a particular rating, since taxpayer concentration or legal factors may be much more important. When a particular weakness is identified, it is useful to check coverage sensitivity to such vulnerabilities. For example, if an issuer experiences poor property tax collection, coverage levels and additional bonds tests can be raised to compensate. The lower of the additional bonds test coverage level, or current revenue coverage of maximum annual debt service, is used for analysis. Projected coverage based on construction growth is not always reliable, but worth considering. Various mathematical considerations concerning the ratio of base to total assessed valuation also may affect the volatility of the revenue stream in the event assessed valuation declines (see chart on the tax volatility ratio). In general, the smaller a district's base valuation is compared to its total valuation, the lower the revenue volatility. Cumulative tax limits Project areas in California are subject to a cumulative cap on tax increment that can be collected from a project area over the life of the project area. Sometimes, higher-than-projected tax increment can cause the cap to be reached before final bond maturity. If this appears to be a significant possibility, S&P; Global Ratings would prefer a covenant by the redevelopment agency to annually review the total amount of tax revenues remaining and to escrow revenues or not accept tax monies if it would cause the tax limit to expire before final bond maturity. Frequently Asked Questions The criteria focus on property tax increment financing bonds. Are there any methodological nuances if, in addition to the property tax incremental revenues, the bonds are also secured (albeit to a smaller degree) by sales tax incremental revenues? Incremental sales tax revenues have risks similar to those present with incremental property tax revenue, and therefore the analysis mostly covers the same areas: incremental tax revenue volatility, taxpayer concentration, and economic and project area- specific characteristics. We recognize that sales tax revenue is less stable than property tax revenue in general, due to the volatility of the underlying economic activity being taxed. Hence, some measures (such as volatility ratio and coverage) are very important and are used to analyze the impact of the potential loss of the top 10 sales tax generators. Similar to property TIFs, we analyze economic change within the project area (most notably commercial growth for sales TIFs), taxpayer concentration within the project area; "coverage in the ground", and legal protections. Despite many similarities, we won't apply sections which are specific to property tax increment revenues, such as historical assessed valuation growth, future assessment growth, and cumulative tax limits. Revisions And Updates This article was originally published on June 14, 2007. These criteria have been partially superseded by "Special Assessment Debt," published April 2, 2018. Specifically, sections pertaining to "Special Assessment Bonds," "California's Mellow-Roos Districts," "undeveloped Special Districts," and "District Size" have been superseded by the "Special Assessment Debt" criteria. Changes introduced after original publication: Following our periodic review completed on Feb. 7, 2017, we updated the author contact information and added the "Related Criteria And Research" section. On Aug. 1, 2017, we added the section "Frequently Asked Questions." Following our periodic review completed on Feb. 5, 2018, we updated the author contact information and added the "Revisions And Updates" section. On March 18, 2020, we republished this criteria article to make nonmaterial changes to the contact information. On March 17, 2021, we republished this criteria article to make nonmaterial changes to the contact information. Related Criteria And Research Related Criteria Principles Of Credit Ratings, Feb. 16, 2011