September 24, 2003

Dear ITIA member:

Local taxing bodies and ITIA members have frequently raised questions about how overlapping local taxing bodies can legally be assisted using tax increment funds. In addition many questions have been raised about the legality of municipalities entering into "make whole" agreements that provide financial assistance to one overlapping taxing body without providing comparable assistance to the other overlapping local governments.

The persistence of these unanswered questions prompted ITIA's Board of Directors to ask the law firm of Bell Boyd & Lloyd to research Illinois' tax increment statutes in order to provide our members with a definitive legal analysis of these issues. A copy of Bell Boyd's research report "Illinois Authority on Tax Increment Financing ("TIF") Make-Whole Agreements" is enclosed.

We hope you find the report useful. If you have any questions about its contents or its application to your situation, please call Greg Hummel of Bell Boyd & Lloyd at (312) 807-4253.

Sincerely,

Greg Sparrow
President

MEMORANDUM

TO: Illinois Tax Increment Association

FROM: Bell, Boyd & Lloyd LLC

DATE: September 17, 2003

SUBJECT: Illinois Authority on Tax Increment Financing ("TIF") Make-Whole Agreements

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Executive Summary

The "make-whole" agreement is a tool utilized by some municipalities in order to address challenges to the establishment of a TIF district brought by other local taxing districts. Such agreements provide that one, but not all, overlapping taxing bodies will receive annual payments of its proportionate share of the tax increment when the increment is received by the municipality. Unfortunately, under both the language of the TIF Act, as well as recent case law, the direct redistribution of TIF monies to a specific local taxing district, attempted by make-whole agreements, is forbidden. Instead, the Act requires that any reimbursement of property taxes within a TIF be redistributed to all local taxing districts on a pro rata basis. While this type of "make-whole" approach is not legally allowed, the TIF Act does provide a number of alternative methods by which a municipality may provide direct benefits to a specific local taxing district.

Introduction

TIF districts have traditionally proven remarkably successful in encouraging growth in previously blighted areas. TIF establishment is sometimes contested by various local taxing districts due to the fact that, in the local taxing district's view, the TIF prevents them from realizing increased revenue caused by increases in property valuation within the TIF. In order to address such challenges, some municipalities have entered into so called "make-whole" agreements with specific local taxing districts. Part One of this memorandum addresses "make-whole" agreements between municipalities and local taxing districts under the Tax Increment Allocation Redevelopment Act (the "Act"), 65 ILCS 5/11-74.4-1 *et seq.*[1], their inherent problems, and how the Act implicitly forbids disproportionate payments to specific local taxing districts. Part Two discusses possible alternative methods of accomplishing the goals of make-whole agreements without the inherent legal difficulties described below.

PART ONE: "Make-whole" agreements

To reiterate, make-whole agreements are tangential arrangements to a TIF plan whereby a municipality agrees to pay a specific local taxing district[2] for the difference between the fixed property taxes actually received by the taxing district and the increased property taxes the district would have received had the TIF not been enacted. Thus, in effect, the local taxing district at issue is "made whole" and receives property tax revenues equivalent to what they would have been if the TIF had never been created. The inherent problem with make-whole agreements is that the Act does not allow a municipality to make compensatory payments to one local taxing district while neglecting to make similar payments to the other local taxing districts affected by the TIF, except where a district incurs TIF eligible costs that the municipality is willing to reimburse. To best illustrate this difficulty this memo discusses two proposed methods of distributing TIF monies to a specific local taxing district, 1) payments in lieu of taxes and 2) distributions of surplus TIF revenues.

1. Payments in Lieu of Taxes

The Act specifically permits municipalities to "make payments in lieu of taxes or a portion thereof to local taxing districts." TIF Act § 11-74.4-4(l). "Payments in lieu of taxes" are defined as

> [T]hose estimated tax revenues from real property in a redevelopment project area derived from real property that has been acquired by a municipality which according to the redevelopment project or plan is to be used for a private use which taxing districts would have received had a municipality not acquired the real property and adopted tax increment allocation financing and which would result from levies made after the time of the adoption of tax increment allocation financing to the time the current equalized value of real property in the redevelopment project area exceeds the total initial equalized value of real property in said area.
>
> TIF Act § 11-74.4-3(m).

This definition of "payment in lieu of taxes" allows payments by the municipalities to local taxing districts for the difference between the fixed tax assessment (the "initial EAV") and the tax assessment the districts would have received once the value of property increased due to redevelopment. Thus, many make-whole agreements have attempted to use this provision of the Act to allow for a disproportionate payment TIF revenues to a specific local taxing district. However, this interpretation of the Act is incorrect for two reasons. First, as suggested by the legislative history of the Act, payments in lieu of taxes can only be made for the difference in assessment on property that is to be used for a "private use" and that has been "acquired by a municipality". Therefore, in order to make a payment in lieu of taxes, the municipality must have actually assumed ownership of the property and intend to allow private development on it. Second, the language of the Act provides and at least one Illinois court has further ruled that the payment in lieu of taxes provision as requiring the municipality to make a payment to <u>all</u> affected local taxing districts according to their pro rata share rather than allowing a municipality to selectively choose what districts will receive payment.

A) Requirement of Actual Municipal Ownership

The Illinois House and Senate legislative history concerning the "payment in lieu of taxes" provision indicates that the subsection was only meant to provide payments for the period from when the municipality acquired ownership of property to the time a private developer acquired possession of that property. Senator Carroll, sponsor of the bill and author of the amendment that created the provision, explained that the amendment provided that a municipality would "add on to the cost of the project, the taxes that would have been paid . . . a payment in lieu of taxes on real estate."[3] 79th General Assembly, Senate Day 149 at 153 (1976) (ellipsis in original). In the House, Representative Tuerk clarified that the amendment was only meant to provide "payments in lieu of taxes" for a relatively brief period:

> [The amendment] said that even that period when the city, the municipality owned that property, those taxing units could get the same amount of money even during that one interim period of maybe six months to a year.

79th General Assembly, House Day 172 at 90 (1976).

Furthermore, Representative Tuerk stated that the Act:

> speaks precisely to the point that a municipality may pay the taxes to the other governmental bodies <u>during that time that the municipality owns the property</u> at the rate comensurate [sic] to that they would have received if a tax increment project had not been adopted.

79th General Assembly, House Day 172 at 86 (1976)(underline emphasis added).

Therefore, according to both the Act's plain language and legislative history, "payments in lieu of taxes" to taxing districts should only be made during the period when a municipality owns land that will be used for private development.

B) Requirement of Pro Rata Distribution

Under the Act, if a municipality makes payments in lieu of taxes, such payments "shall be made to all districts within a project redevelopment area on a basis which is proportional to the current collections of revenue which each taxing district receives from real property in the redevelopment project area." TIF Act § 11-74.4-4(l). Under this definition, when a municipality chooses to make payments to any single local taxing district, the plain language of the Act appears to require pro rata distribution of funds to <u>all</u> overlapping local taxing districts.

The legislative history of the provision supports the idea that all payments in lieu of taxes must be made on a pro rata basis. In the House, Representative Tuerk stated that the Act:

> speaks precisely to the point that a municipality may pay the taxes to the other governmental <u>bodies</u> during that time that the municipality owns the property at the rate comensurate [sic] to that they would have received if a tax increment project had not been adopted.

79th General Assembly, House Day 172 at 86 (1976)(underline emphasis added). Here the use of the plural "bodies" indicates that the drafters intended the payments to go to all local taxing bodies, not selectively favored local taxing districts.

One Illinois state court has interpreted these provisions and concluded that the Act prohibits selective payments in lieu of taxes and requires pro rata distribution of funds to all local taxing districts. Henry County Board v. Village of Orion, 278 Ill.App.3d 1058, 663 N.E.2d 1076 (Ill. 3d Dist., 1996). In Henry, the Village of Orion (the "Village") had inserted a provision in the ordinance creating the TIF district that required the Village to make payments to the local school district for the duration of the TIF district. Id. at 1079. The Village intended to reimburse the school district for property taxes it would have received had the TIF plan not been adopted. Id. at 1084. The Henry County Board and various other local taxing districts sought to enjoin the TIF project, alleging that the agreement between the Village and the school district violated the Act's pro rata distribution requirement. Id. at 1079.

The Village asserted that the school district payment agreement was valid because the "capital costs" provision allowed for payments to only one local taxing district.[4] Id. at 1084. Therefore, the Village argued, the payment in lieu of taxes provision must likewise allow payments to only one local taxing district. Id. The court flatly rejected this argument, stating that the Act's "mandate to provide payments in lieu of taxes to all affected taxing districts" could not be "circumvented by the legislature's grammar in a separate statutory section." Id. Continuing, the court reasoned that the capital cost provision was intended to repay capital expenditures made by a local taxing district, while the payment in lieu of taxes provision was intended to repay all affected local taxing districts for lost property tax revenue. Id. at 1084-85. The court concluded that there was "no basis in the Act or in the arguments presented to hold that a municipality may make payments to a single taxing district in lieu of taxes cloaked as an intergovernmental agreement." Id. at 1085. Thus, the court held that every payment in lieu of taxes made by a municipality must be made on a pro rata basis to all affected local taxing districts.

2. Distribution of Surplus TIF Revenues

In addition to requiring pro rata distributions of "payments in lieu of taxes" to all local taxing districts, the Act also requires that "surplus" funds arising from a TIF project be distributed to all local taxing districts on a pro rata basis.[5] TIF Act § 11-74.4-7. The legislative history and plain language of the surplus distribution provision illustrates the legislature's intent to ensure equal distribution of surplus to all local taxing districts, which bolsters the idea that the legislature intended to provide no one taxing district with a larger share of the incremental funds than those received by any other taxing district relative to their respective tax rates.

The Act permits municipalities to issue obligations in order to pay for redevelopment project costs, such as the capital costs of local taxing districts. Id. The obligations issued by the municipality are secured by a special tax allocation fund, which is funded by taxes and revenues specified by the municipality in the ordinance authorizing the obligations, including property taxes and sales taxes. Id. The money in the special tax allocation fund may be pledged to pay off the municipal obligations or to directly pay TIF eligible costs. In the event any excess money remains in the fund annually, it is deemed "surplus." Id.

When originally passed in 1977, the Act provided that surplus funds were to be distributed annually by the County Collector to taxing districts in the redevelopment project area, and such distributions were to be made on a pro rata basis based on the most recent distribution of property tax revenues. On the floor of the Illinois Senate, Senator Carroll, sponsor of the legislation, stated that this provision meant that "[a]ny amount . . . that is not used to pay off the bond in a given year is to be turn [sic] over that year to all of the taxing bodies." 79th General Assembly, Senate Day 133 at 51 (1976). In fact, the Legislative Finding and Declaration accompanying the Act expressly provides that "all surplus tax revenues are turned over to the taxing districts in redevelopment project areas." TIF Act § 11-74.4-2(c). Based on this language, the original intent behind the provision seems to be to ensure that each local taxing district receives a pro rata share of surplus.[6]

The current system by which surplus funds are distributed to local taxing districts requires that all overlapping local taxing districts receive pro rata distributions of surplus. TIF Act § 11-74.4-7. The surplus must be calculated annually, and must be distributed within 180 days of the end of the municipality's fiscal year. Id. Such distribution is made to the County Collector, the Illinois Department of Revenue, and the municipality, with each governmental unit receiving no more than whatever tax incremental revenue they had contributed to the special tax allocation fund. Id. The County Collector then "shall thereafter make distribution to the respective taxing districts in the same manner and proportion as the most recent distribution by the county collector to the affected districts of real property taxes from real property in the redevelopment project area." Id. Therefore, surplus stemming from a TIF plan is, as the Act originally provided, distributed on a pro rata basis to all local taxing districts.

PART TWO: Alternatives to "Make-Whole" Agreements

While the Act does preclude the type of wholesale subsidizing of a local taxing district's property tax revenue that make-whole agreements attempt, there are still a number of ways that a municipality may be able to use the powers given to it under the Act to make payments to a local taxing district for reimbursement of certain redevelopment project costs as defined in the TIF Act.

Municipal Powers under the Act

The Act provides a list of powers to a municipality. TIF Act § 11-74.4-4. Two of these powers are noteworthy. Specifically, the Act allows a municipality to "make and enter into all contracts with…overlapping taxing bodies…necessary or incidental to the implementation and furtherance of its redevelopment plan and project." TIF Act § 11-74.4-4(b). The Act also gives a municipality the power to "[within a redevelopment project area] renovate or rehabilitate or construct any structure or building, as permitted under this Act." TIF Act § 11-74.4-3(e).

1. The Power to Enter into Contracts

The municipality's power to enter contracts is limited by the fact that all contracts must be necessary or incidental to the implementation and furtherance of a redevelopment plan. This means that whatever contracts are entered into will be limited by the definition of "redevelopment plan" found in the Act, namely, "the comprehensive program of the municipality for the development or redevelopment intended by the payment of *redevelopment project costs*…". TIF Act § 11-74.4-3(n)(emphasis added). Therefore a municipality is limited to paying out TIF monies only for "redevelopment project costs." Unfortunately, this severely limits the municipality's ability to make payments to specific local taxing districts.

The Act provides four categories of redevelopment project costs that may be paid directly to local taxing districts. TIF Act § 11-74.4-3(q). Two of these categories have previously been discussed in this memorandum, namely payment in lieu of taxes and payment for public works (infrastructure and facilities), and are so limited to specific costs that they will not be useful to a municipality attempting to distribute TIF monies to a specific local taxing district.

Of the two remaining categories, one provides for the reimbursement to school districts for increased costs attributable to assisted housing units within the TIF. If the TIF actually contains assisted housing units, this category applies. TIF Act § 11-74.4-3(q)(7.5). The municipality may then directly reimburse the school district for the increased costs caused by the existence of assisted housing units within the TIF in accordance with a formula laid out in the Act.

The other redevelopment cost category allows a municipality to pay for the costs of training, retraining, or advanced vocational or career education incurred by a taxing district, provided that these costs are related to the training of persons who are or will be employed within the TIF and provided that the costs are set forth in a written agreement between the municipality and the local taxing district. TIF Act § 11-74.4-3(q)(10). While this category does not provide for the type of payments to a local taxing district that a make-whole agreement attempts, many TIFs will cause local taxing districts to incur additional costs for vocational and career training of this variety. Therefore this category of direct reimbursement may be useful for compensating the affected local taxing district for such costs.

2. The Power to Renovate or Construct any Structure or Building

The Act gives a municipality the power to "[within a redevelopment project area] renovate or rehabilitate or construct any structure or building, as permitted under this Act." TIF Act § 11-74.4-3(e). Further, the list of eligible redevelopment project costs includes: 1) the costs of rehabilitation, reconstruction or repair or remodeling of existing public or private buildings, fixtures and leasehold improvements, TIF Act § 11-74.4-3(q)(3), and 2) the costs of the construction of public works or improvements. TIF Act § 11-74.4-3(q)(4). The only seeming limitation on this power is that municipalities are not allowed to construct a new "city hall" type building unless the original building is to be demolished pursuant to a redevelopment project. Therefore, the power of a municipality to renovate or construct public buildings (other than "city hall"-type buildings) is quite broad. Thus, under the Act, a municipality is allowed to renovate or construct buildings for a specific local taxing district within a TIF. While this avenue does not provide the kind of exact repayment contemplated by make-whole agreements, it does provide a means by which a municipality may provide a significant benefit to a specific local taxing district. This method has been utilized by the City of Chicago, the City of Edwardsville, and many other municipalities.

Conclusion

Payments to a taxing district as contemplated by make-whole agreements are not allowed under the Act. The Act permits payments in lieu of taxes, but only during the period that a municipality owns property that will later be used for private development, and such payments must be made to all taxing districts. The Act permits reimbursement to schools districts for increased costs attributable to assisted housing units within the TIF, and permits payments to a taxing district for training costs for employees within a TIF. Finally, the Act permits a municipality to provide significant benefits to a specific taxing district via its powers to renovate and construct new buildings within a TIF.

Please feel free to contact us with any questions and comments on make-whole agreements and their alternatives.

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[1] All citations herein are to the Act unless otherwise noted.

[2] Under the Act, "local taxing districts" are defined as "counties, townships, cities and incorporated towns and villages, school, road, park, sanitary, mosquito abatement, forest preserve, public health, fire protection, river conservancy, tuberculosis sanitarium, and any other municipal corporations or districts with the power to levy taxes." TIF Act § 11-74.4-3(u).

[3] Other language in Senator Carroll's remarks concerning the amendment was apparently inaccurately transcribed in the legislative history: "The . . . Amendment No. 4 deals with the repayment of what would have been taxes during the period of the developments of the detaxing bodies within the district lose no income whatsoever." (ellipsis in original).

[4] The Act permits municipalities, by written agreement only, to reimburse "all or a portion of a taxing district's capital costs resulting from the redevelopment project necessarily incurred or to be incurred within a taxing district in furtherance of the objectives of the redevelopment plan and project." TIF Act § 11-74.4-3(q)(7). Taxing district capital costs are defined as "costs of taxing districts for capital improvements that are found by the municipal corporate authorities to be necessary and directly result from the redevelopment project." TIF Act § 11-74.4-3(u). Thus, in addition to payments in lieu of taxes, a municipality may reimburse a specific local taxing district for the cost of any capital improvements arising out of the needs of the TIF district.

[5] For the purposes of this memo references to TIF surpluses refer only to surpluses derived from property taxes. The Act also contains provisions for the distribution of surplus TIF revenues derived from sales and utility taxes. *See* TIF Act § 11-74.4-7 (providing such surpluses be redistributed to the municipality and the Department of Revenue in direct proportion to the tax incremental revenue received from the state and municipality).

[6] Later amendments further ensured pro rata surplus distribution. In 1986, the legislature amended the Act to provide a municipality that created a TIF district during a one-year period with a rebate of sales taxes collected within that TIF district. The rebate was pooled with the money in the special tax allocation fund, which included money from property taxes. The total sum of the fund could be used by the municipality to pay off bonds it had issued based on TIF revenues. P.A. 84-1090 (1986). The municipality would access the funds first to make bond payments, and then the various other local taxing districts collected a pro rata share from the remaining funds. Legislators recognized that this arrangement meant that schools and other local taxing districts would not have an equal opportunity to receive a pro rata share of funds. Representative Vinson, author of the amendment that corrected this flaw in the distribution process by creating the current surplus distribution system, stated during floor debate that his amendment would "place school districts on an even basis so that they would get a prorata share of the surplus funds," and that it ensured that "surplus funds will go on a prorata basis to school districts during the life of the TIF district." 84th General Assembly, P.A. 84-1417, House Day 132 at 182 (1986). However, Representative Vinson also stated that his amendment, which passed and was signed into law, would send surplus back to "the other local taxing districts rather than to the municipality and the state." Id.