

# **ABATING PROPERTY TAXES IN TENNESSEE: AN ESSENTIAL TOOL IN THE ECONOMIC DEVELOPMENT TOOLBOX**

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## **I. INTRODUCTION**

Put yourself in the shoes of the president of the chamber of commerce for a small Tennessee county. A Fortune 500 company identifies the county as a finalist for a large manufacturing plant. The lure of good jobs and a large capital investment motivates the county to make every effort to land the plant. The county promises to make improvements to the roads leading to the plant site, to provide utility connections at the plant site, and to provide employee training. The site location firm representing the company applauds the county's efforts but informs the county that every location that the company is considering offers the same incentives. The site location firm indicates that the county will need to abate the company's property taxes for at least ten years to remain in contention for the plant.<sup>2</sup>

Alternatively, put yourself in the shoes of a new Tennessee mayor who has made a campaign promise to revitalize the city's decaying downtown. The mayor promises property tax abatement to property owners who redevelop their properties in the downtown area as a development incentive. The mayor instructs his law director to draft an ordinance for the city council's consideration that would implement a property tax abatement program for the downtown area.

In both of these cases, property tax abatement serves a laudable goal, but many local governments in Tennessee do not know how to legally implement a tax abatement program. This implementation, however, can be critical to a community's success because the more tools that a local government has in its economic

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<sup>2</sup> In this Article, the term "tax abatement" refers to any agreement that results in a reduction in the amount of property taxes that would otherwise be payable by a private entity. Because the concept of tax abatement often carries negative connotations, tax abatement agreements are often referred to as "agreements to make payments in lieu of taxes."

development toolbox, the more likely that the government will succeed in its development programs. This Article examines how Tennessee local governments can legally use tax abatement as a tool to promote economic development initiatives.

## II. CONSTITUTIONAL LIMITATIONS: WHY LOCAL GOVERNMENTS CANNOT SIMPLY GRANT PROPERTY TAX ABATEMENT

Local government officials often assume that local governments can simply agree to reduce a taxpayer's property taxes. There have been a number of cases in which a city council or county commission, in an effort to attract a new business, has adopted a resolution agreeing to reduce the business's property taxes. The city council or county commission then forwards the resolution to the local tax assessor with instructions not to bill the business for the full amount of its property taxes. This approach often seems intuitively correct to local officials who assume that because the local government, and not the state, is the beneficiary of the property taxes, the local government has the authority to waive or reduce those taxes.<sup>3</sup> Unfortunately, this approach, while simple, is clearly unconstitutional.

Like many state constitutions, the Tennessee Constitution generally prevents local governments from directly abating property taxes.<sup>4</sup> Specifically, Article II, Section 28 of the Tennessee Constitution provides that “*all* property, real, personal or mixed shall be subject to taxation.”<sup>5</sup> This constitutional provision essentially requires uniform taxation of similarly situated properties and prevents local governments from picking and choosing which properties to tax.

Article II, Section 28 recognizes, however, that the legislature may exempt four types of property from property taxation.<sup>6</sup> The first exemption, which is most relevant for purposes of this article, is the exemption for property “held by the [s]tate, [and] by [c]ounties, [c]ities or [t]owns, and used exclusively for public or corporation purposes.”<sup>7</sup> The other exemptions are for property “held and used for

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<sup>3</sup> Attempts by local governments to directly waive or reduce property taxes are becoming less frequent. The State Board of Equalization has made significant progress in educating local government officials on the constitutional limits on granting property tax exemptions.

<sup>4</sup> See TENN. CONST. art. II, § 28.

<sup>5</sup> *Id.* (emphasis added).

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

purposes purely religious, charitable, scientific, literary or educational,” the “direct product of the soil in the hands of the producer,” and “the entire amount of money deposited in an individual’s personal or family checking or savings accounts.”<sup>8</sup>

Tennessee case law has long recognized that the legislature cannot broaden the exemptions provided in Article II, Section 28. As early as 1925, the Tennessee Supreme Court stated that “[t]he [l]egislature is without power to grant tax exemptions to individuals or institutions contrary to the express mandate of the Constitution” and that “[t]he requirement of the Constitution is imperative that all property except that mentioned shall be taxed.”<sup>9</sup>

The Tennessee Attorney General has opined that Article II, Section 28 prevents local governments from broadening the exemptions provided in the Constitution. For example, in a 1998 opinion, the Attorney General considered whether the City of Jackson, by private or public act, could provide tax abatement within a redevelopment area to stimulate economic development.<sup>10</sup> Because the abatement would not be limited to property exempted under Article II, Section 28, the Attorney General opined that such abatement would be unconstitutional.<sup>11</sup>

Not all is lost, however, for the local government that wants to provide property tax incentives to attract a business or to revitalize its downtown. As mentioned above, the Tennessee Constitution specifically recognizes that property owned by a local government can be exempt from taxation.<sup>12</sup> Relying on this exemption, a tax incentive program can generally be achieved by titling property in the name of a local government and then by leasing the property to the ultimate user. With this approach, the local government owns the property, which should therefore be exempt from taxation. However, these types of transactions present a number of

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<sup>8</sup> *Id.* The exemption that covers the “product of the soil in the hands of the producer” also extends to “his immediate vendee.” *Id.*

<sup>9</sup> *Cumberland University v. Golladay*, 274 S.W. 536, 537 (1925). *See also* Op. Att’y. Gen. 82-142, 1982 WL 177655 (Tenn. A.G. March 18, 1982) (opining that a state statute that purported to exempt historic properties from property taxation was unconstitutional); Op. Att’y. Gen. 79-179, 1979 WL 33789 (Tenn. A.G. April 10, 1979); Op. Att’y. Gen. 77-368, 1977 WL 28492 (Tenn. A.G. Oct. 26, 1977).

<sup>10</sup> *See* Op. Att’y. Gen. 98-031, 1998 WL 129900 (Tenn. A.G. Feb. 9, 1998).

<sup>11</sup> *Id.*

<sup>12</sup> *See supra* note 7 and accompanying text.

intriguing legal issues, and the remainder of this article discusses some of the more challenging issues that arise in implementing these types of transactions.

### III. CHOOSING THE TAX ABATEMENT VEHICLE

The first decision that must be made in connection with implementing a tax abatement transaction is identification of a governmental entity that can take ownership of the property that is to be the subject of the tax abatement agreement. Although cities and counties can own and lease industrial properties under somewhat antiquated statutes,<sup>13</sup> onerous requirements in these statutes discourage the use of cities and counties as vehicles to implement tax abatement agreements.<sup>14</sup> Therefore, almost all tax abatement agreements in Tennessee are implemented through two types of governmental entities: industrial development boards (“IDB”s) and health, educational, and housing facility boards (“HEHB”s). Of these two types of entities, more tax abatement transactions involve IDBs.

#### A. Industrial Development Boards

IDBs are public nonprofit corporations created by cities and counties in Tennessee.<sup>15</sup> Most counties and a large number of cities have created IDBs. If a county or city that wants to offer tax abatement has not created an IDB, one can usually be created within a few weeks. IDBs are governed by a board of directors consisting of not fewer than seven persons who are electors and taxpayers of the city or county creating the board.<sup>16</sup> Officers and employees of the city or county that created the IDB generally are ineligible to serve on the board of directors.<sup>17</sup> Most IDBs do not employ any staff and often are administered by the local chamber of commerce.

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<sup>13</sup> See generally TENN. CODE ANN. §§ 7-55-101 to -116 (2003) (entitled the “Industrial Building Bond Act of 1955”).

<sup>14</sup> For example, under these statutes, the city or county must obtain a certificate of public purpose and necessity from the state's building finance committee before undertaking a project. See *id.* § 7-55-105.

<sup>15</sup> Tennessee Code Annotated Sections 7-53-201 to -204 set forth the steps that must be taken for a county or city to form an IDB.

<sup>16</sup> TENN. CODE ANN. § 7-53-301.

<sup>17</sup> *Id.*

IDBs may own, lease, and finance<sup>18</sup> a wide array of projects.<sup>19</sup> For example, IDBs can own any facility used in industry<sup>20</sup> or in essentially any type of commercial enterprise,<sup>21</sup> office buildings,<sup>22</sup> amusement parks,<sup>23</sup> and multifamily housing facilities to be occupied by persons of low or moderate income.<sup>24</sup> Because of the broad scope of the types of projects that are eligible to be owned by IDBs, many types of projects can qualify for tax abatement.

Only one section of the statutes that govern IDBs even addresses tax abatement. Tennessee Code Annotated Section 7-53-305 states that IDBs serve a public function and that all properties of an IDB are exempt from taxation.<sup>25</sup> Therefore, the ownership interest in any property conveyed to an IDB and leased to a private entity should be exempt from property taxation.

Section 7-53-305 provides that the city or county that creates an IDB has the power to delegate to that board the authority to negotiate and accept payments in lieu of taxes from the board's lessees.<sup>26</sup> This is the most significant language in the IDB statutes to recognize that such boards have the authority to enter into tax abatement agreements, but the chosen wording of this language is odd. As mentioned above, any property conveyed to an IDB should be exempt from property taxation.<sup>27</sup> Therefore, if the project is conveyed to an IDB and leased to a

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<sup>18</sup> See generally *id.* § 7-53-302.

<sup>19</sup> See *id.* § 7-53-101(11).

<sup>20</sup> *Id.* § 7-53-101(11)(A)(i).

<sup>21</sup> *Id.* § 7-53-101(11)(A)(ii).

<sup>22</sup> *Id.* § 7-53-101(11)(A)(v).

<sup>23</sup> *Id.* § 7-53-101(11)(A)(ix).

<sup>24</sup> *Id.* § 7-53-101(11)(A)(x).

<sup>25</sup> *Id.* § 7-53-305(a). This exemption has been upheld as constitutional. See *West v. Indus. Dev. Bd.*, 332 S.W.2d 201 (Tenn. 1960). Although Article II, Section 28 of the Tennessee Constitution only exempts counties, cities, and towns from property taxes, the *West* court found that an IDB was merely an agent and instrumentality for a city or county. *Id.* at 202. See also Op. Att'y. Gen. 98-110, 1998 WL 423975 (Tenn. A.G. June 11, 1998) [hereinafter Op. Att'y Gen. 98-110].

<sup>26</sup> TENN. CODE ANN. § 7-53-305(b).

<sup>27</sup> See *supra* note 25 and following text.

private entity, the project should be totally exempt from taxation provided the transaction was properly structured. If the municipality that created the IDB does not delegate to that board the authority to negotiate and accept payments in lieu of taxes, the lease by the board to the private entity simply could be silent on that point, and the net result would be that the private entity would pay no property taxes or payments in lieu of taxes whatsoever.

To avoid this incongruous reading of the statutes, however, section 7-53-305's language could be construed to apply only when the IDB intends to "accept" payments in lieu of taxes for its own use and not to deliver them to the city or county.<sup>28</sup> This reading would permit an IDB to have a free hand, without any municipal oversight, in negotiating a tax abatement agreement, and this result appears to be inconsistent with the purpose of the statute. An alternative construction assumes that the legislature intended for the statute to prevent an IDB from negotiating a tax abatement agreement that results in payments in lieu of taxes that are less than the property taxes otherwise payable with respect to a project that lacks the city's or county's delegated authority to negotiate such an agreement. Although section 7-53-305 does not clearly make this point, the Tennessee Attorney General opinions that construe this statute seem to assume that this is the purpose of this language,<sup>29</sup> and when the statute is read as a whole, this reading best reflects the gist of the statute. For this reason, the safe approach in a tax abatement transaction is for the IDB to receive a delegation of authority from the city or county that created the board before entering into any lease that results in a reduction in taxes payable with respect to the project.<sup>30</sup>

Section 7-53-305 provides few limits on an IDB in negotiating a tax abatement agreement. A recently enacted amendment to that statute prohibits an IDB from permitting payment in lieu of taxes to be waived or otherwise assessed for a period greater than 20 years without the approval of the state commissioner of

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<sup>28</sup> Opinions of the Tennessee Attorney General have recognized that an IDB may retain payments in lieu of taxes or may provide that these payments are payable to the local governments that otherwise would have received the taxes with respect to the project that is the subject of the agreement. *See, e.g.*, Op. Att'y. Gen. 96-083, 1996 WL 324413 (Tenn. A.G. June 5, 1996) [hereinafter Op. Att'y Gen. 96-083].

<sup>29</sup> *See* Op. Att'y. Gen. 98-110; Op. Att'y. Gen. 96-083.

<sup>30</sup> Some cities and counties prefer to adopt a resolution for each project delegating the authority to negotiate a tax abatement agreement for that particular project. Other cities and counties have adopted resolutions generally delegating the authority to negotiate tax abatement agreements to their local industrial development boards, sometimes establishing parameters for such agreements.

economic and community development and the state comptroller.<sup>31</sup> Also, if a project is in an area designated as the center-city area by a municipality that has a central business improvement district,<sup>32</sup> the amount of the payments in lieu of taxes for that project cannot be fixed below the lesser of the taxes that would (1) otherwise be due and payable with respect to the project or (2) have been due and payable on the project for the period immediately preceding the date of acquisition by the IDB.<sup>33</sup> Except for these two limitations, there are no statutory limits on the length of the term of the agreement or the amount of taxes that can be abated. The IDB granting the tax abatement is required to attach to each tax abatement agreement an analysis of the costs and benefits of the agreement, but there is no requirement that this analysis justify the amount of tax abatement granted.<sup>34</sup> The city or county that delegates the authority to the IDB to negotiate the tax abatement agreement may also require the board to submit any tax abatement agreement to its legislative body for approval,<sup>35</sup> but this power is rarely exercised. Therefore, there are few checks on an IDB's ability to significantly abate property taxes.

Section 7-53-305 provides that payments in lieu of taxes are secured by first lien upon the fee interest in the property that is the subject of the tax abatement agreement.<sup>36</sup> The industrial development board entering into the tax abatement agreement may enforce the lien and also obtain interest on the amounts owed.<sup>37</sup> Because of this lien, payments in lieu of taxes, like property taxes, have a high likelihood of being collected.

When a project that is the proposed subject of tax abatement is located within the corporate limits of a city, one of the most difficult, and often contentious, issues that arises is how to divide the payments in lieu of taxes for the project between the city and the county in which the project is located. Section 7-53-305 does not provide a mechanism for dividing payments in lieu of taxes between taxing

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<sup>31</sup> TENN. CODE ANN. § 7-53-305(b).

<sup>32</sup> Under the Central Business Improvement District Act of 1971, a municipality can create a central business improvement district. *Id.* § 7-84-201.

<sup>33</sup> *Id.* § 7-53-305(b).

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

<sup>36</sup> *Id.* § 7-53-305(d).

<sup>37</sup> *Id.*

jurisdictions, nor does Section 7-53-305 give a county or a city the right to approve tax abatement agreements entered into with respect to projects in its jurisdiction that are negotiated by an IDB that the county or the city did not create.<sup>38</sup> Therefore, an IDB created by a city could theoretically enter into an agreement that did not provide for any payments in lieu of taxes payable to the county in which the project is located, and an IDB created by the county could do the same with respect to a city within which a project is located. In most cases, the city and county in which a project is located work together to determine the appropriate level of tax abatement, but on occasion, cities and counties cannot agree on or do not consult with each other about a tax abatement agreement, which usually results in conflict between the two governments and an economic development prospect caught in the middle of a dispute.

### B. Health, Educational, and Housing Facility Boards

The statutes authorizing the creation of HEHBs<sup>39</sup> provide a similar mechanism for providing tax abatement as the statutes governing IDBs. HEHBs, like IDBs, can be created by cities and counties to own, finance, and lease certain types of project.<sup>40</sup> An HEHB is governed by a board of directors consisting of not less than seven persons who are electors and taxpayers of the county or city that created the board.<sup>41</sup> Officers and employees of the city or county creating the HEHB are ineligible to serve on the board of directors.<sup>42</sup>

Like IDBs, HEHBs are authorized to own and lease only certain specified types of projects. In this case, HEHBs generally are permitted to own, lease, and finance facilities used by educational institutions, hospital facilities, and housing

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<sup>38</sup> Section 7-53-305 was amended in 2002 to prevent an IDB from negotiating any payment in lieu of taxes for less than the applicable county's ad valorem taxes unless the industrial development board (i) is jointly created by a county and a city; (ii) the IDB enters "into an inter-local agreement with the county" regarding the payments in lieu of taxes; or (iii) the county approves the payments in lieu of taxes. *Id.* § 7-53-305(g). Primarily because of certain population restrictions, however, this amendment effectively only applies to Shelby County, and the Tennessee Attorney General has questioned the constitutionality of the amendment. *See* Op. Att'y. Gen. 02-044, 2002 WL 649040 (Tenn. A.G. Apr. 9, 2002).

<sup>39</sup> *See* TENN. CODE ANN. §§ 48-101-301 to -318.

<sup>40</sup> *See id.* § 48-101-308.

<sup>41</sup> TENN. CODE ANN. § 48-101-307(a).

<sup>42</sup> *Id.* § 48-101-307(c).

facilities to be occupied by persons of low or moderate income.<sup>43</sup> Therefore, the universe of projects that may be owned and leased by HEHBs is much smaller than the types of projects that may be owned and leased by IDBs. Because most of the types of projects that can be financed by an HEHB, such as non-profit schools and hospitals, already are exempt from property taxation, the question of tax abatement arises less frequently in the context of HEHB projects. However, because many housing projects are owned by private parties, HEHBs frequently are asked to provide tax abatement for that type of project.<sup>44</sup>

For HEHBs, section 48-101-312 is the most relevant tax abatement agreement statute. That statute specifically recognizes that an HEHB's properties are exempt from taxation.<sup>45</sup> The city or county that creates an HEHB can delegate to the board the authority to negotiate and to enter into agreements with respect to the payment in lieu of taxes.<sup>46</sup> The city or county may require the HEHB to submit the tax abatement agreement to the legislative body of the city or county for approval.<sup>47</sup>

Unlike section 7-53-305, section 48-101-312 does not contain a limit on the term of the tax abatement agreement. Also, section 48-101-312 specifically provides that payments in lieu of taxes with respect to a project located within the corporate limits of a city are to be apportioned between the county and the city in the same manner as ad valorem taxes are apportioned as of the date the tax abatement agreement is consummated.<sup>48</sup> As a result, in the case of tax abatement agreements implemented through HEHBs, the potential conflict between the city and county in

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<sup>43</sup> *Id.* § 48-101-301(14).

<sup>44</sup> The legislature also recently authorized housing authorities to enter into tax abatement agreements with respect to low-income housing projects that involve the use of federal low-income housing tax credits. *See id.* § 13-20-104(f). The authorizing statute for housing authorities to enter into such agreements is similar to the comparable HEHB statute.

<sup>45</sup> *Id.* § 48-101-312(a).

<sup>46</sup> *Id.* § 48-101-312(b)(1). Notably, the wording of this provision of section 48-101-312 is different from the comparable provision in section 7-53-305 in that an HEHB may “negotiate and *enter into*” agreements for payments in lieu of taxes while an IDB may “negotiate and *accept*” payments in lieu of taxes. *Compare id.* §48-101-312(b)(1) (emphasis added), *with id.* § 7-53-305(b) (emphasis added). Whether the legislature intended a substantive difference between these two statutes is uncertain.

<sup>47</sup> *Id.* § 48-101-312(b)(1).

<sup>48</sup> *Id.* § 48-101-312(b)(2).

which a project is located usually does not arise, although the city and county could still dispute whether the project should be eligible for tax abatement in the first place.

In summary, IDBs and HEHBs can serve as the vehicles for providing tax abatement for a wide range of projects. Because these boards are exempt from property taxation as governmental entities, projects conveyed to these boards and leased to private entities should be exempt from property taxation. The documents implementing a tax abatement transaction must be carefully drafted, however, to obtain the full benefit of this exemption.

#### IV. AVOIDING TAXATION OF LEASEHOLD INTERESTS

When property is conveyed to an IDB or to an HEHB, the ownership interest in the property clearly is exempt from taxation. The user of the property holds a leasehold interest in the property, however, and in structuring a tax abatement transaction, the potential taxation of this leasehold interest must be considered. In the case of real property, Tennessee case law clearly indicates that a leasehold interest may be taxed separately from the fee interest in the real property if the leasehold interest has any value.<sup>49</sup> Therefore, if the leasehold interest of a lessee from an IDB or HEHB is determined to have value, the lessee may not receive the expected benefit of a tax abatement agreement. In the case of leased personal property, the applicable statute provides that leased personal property is assessed to the lessee unless that property is the subject of a lawful tax abatement agreement with a local government.<sup>50</sup> Therefore, in the case of personal property, as long as a legal tax abatement agreement is in effect, the leasehold interest of the lessee should not be taxable.<sup>51</sup> Consequently, when structuring a tax abatement agreement that involves real property, careful attention should be paid to minimizing the value of the leasehold estate.

The method for determining the value of a leasehold interest is established by statute. Tennessee Code Annotated section 67-5-605 provides that a leasehold

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<sup>49</sup> *See, e.g.*, Metro. Gov't of Nashville and Davidson County v. Schatten Cypress Co., 530 S.W.2d 277, 281 (Tenn. 1975); State v. Grosvenor, 258 S.W. 140, 142 (Tenn. 1923). *See also* TENN. CODE ANN. § 67-5-502(d).

<sup>50</sup> TENN. CODE ANN. § 67-5-502(c).

<sup>51</sup> At least one bill introduced during the current legislative session would shift the assessment of leased personal property from the lessee to the lessor. *See* S. 1859, Reg. Sess. (Tenn. 2003). This change should not affect tax abatement transactions because the lessor, being a government entity, is already exempt from taxation.

interest is “valued by discounting to present value the excess, if any, of fair market rent over actual and imputed rent for the leased premises, for the projected term of the lease including renewal options.”<sup>52</sup> Importantly, any purchase option that the lessee holds is deemed to have no value for purposes of making this calculation due to the speculative nature of valuing purchase options.<sup>53</sup>

In a simple tax abatement transaction, the property that is the subject of the agreement is conveyed to an IDB or to an HEHB and leased to a private user.<sup>54</sup> The lease payments that are to be made under the agreement typically consist of the payments in lieu of taxes that are usually payable under the lease, together with any payments that the lessee is required to make for items such as maintenance, insurance, and similar costs. Other than these amounts, the rent payments payable under these types of leases usually are nominal. As a result, the actual monetary payments to be made by a lessee as rent in these cases usually are significantly less than the fair market rent for the facility.

In most leases between an IDB or HEHB and a project’s lessee, the lessee also usually commits to acquire, construct, rehabilitate and/or equip a project. This obligation should also be treated as additional rent, and the costs of acquiring, constructing, rehabilitating and/or equipping a project should be amortized over the term of the lease as additional rent. Because these costs usually are quite substantial, the inclusion of these costs in the calculation of the rent payable under the lease should result in the lessee’s leasehold interest having little or no market value.<sup>55</sup>

Although the inclusion of the amortized cost of required improvements as rent should, in most cases, prevent the leasehold interest of the lessee from having any significant value, many lessees in tax abatement transactions are uncomfortable

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<sup>52</sup> TENN. CODE ANN. § 67-5-605.

<sup>53</sup> *Id.*

<sup>54</sup> The transfer of the property to the IDB or the HEHB should not effect the ownership of the property and the related right to depreciate the property for purposes of generally accepted accounting principals or for federal tax purposes.

<sup>55</sup> Lessees of IDBs and HEHBs often are asked by the local tax assessor to complete a leasehold valuation form to determine whether the lessee’s leasehold interest has any value. When completing these forms, lessees should include the amortized costs of required property improvements as part of the rent calculation in order to minimize the risk that their leasehold interests will be taxed. If a leasehold interest is taxed notwithstanding these precautions, most tax abatement leases provide that the lessee will receive a credit against its payments in lieu of taxes for any leasehold taxes that are actually paid.

in relying on the inclusion of these amounts to avoid paying taxes on their leasehold estates. The inherent uncertainty of valuing the cost of improvements and in amortizing this cost often can be problematic. Moreover, in certain cases, the lessee in a tax abatement transaction cannot commit to fund additional improvements. For example, an IDB may offer a tax abatement agreement to an existing business to keep that business from moving or from closing. That business may not be in the position to make any new capital improvements, but the retention of the jobs associated with the business may be critical to the community. In this case, the lessee in the tax abatement transaction would not be in a position to commit to fund property improvements to avoid a positive valuation of its leasehold interest.

When a lessee cannot or does not want to rely on the amortized cost of required improvements as rent, the lessee alternatively can request the IDB or HEHB that is serving as the vehicle for the tax abatement to agree to issue its bond or bonds to finance the acquisition and/or improvement of the lessee's project. If the bond-financed structure is used, the lease with the IDB or HEHB will provide for lease payments that are equal to the debt service payable on the bonds being issued to finance the project. If the lessee plans to obtain financing for its project anyway, the bonds can be sold to a bank or another type of lender designated by the lessee to provide that financing.<sup>56</sup> If a lessee did not plan to obtain financing and has adequate funds on hand to pay the cost of the project, the lessee could arrange for the bond to be sold to itself or to a related party.

The bond-financed structure is considerably more complicated than a transaction that only involves a tax abatement lease. In addition to the lease, the issuance of bonds to finance a project requires, at a minimum, drafting a bond purchase agreement, the bonds, and an instrument assigning the lease payments to the bondholder to secure the bonds. The cost of consummating this transaction is therefore higher. Many beneficiaries of tax abatement have concluded, however, that the additional cost is justified in order to establish with certainty the amount of rent payable under the tax abatement lease to minimize the risk that the beneficiary's leasehold interest will be taxed.<sup>57</sup>

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<sup>56</sup> Certain types of projects can be financed by IDBs or HEHBs with bonds that are exempt from federal income taxes. *See* Rev. Rul. 57-187, 1957-1 C.B. 65. For example, certain small manufacturing facilities and low-income housing facilities can be financed with tax-exempt bonds. *See generally* I.R.C. §§ 144 and 142 (West 2000). IDBs and HEHBs also may issue bonds that are not exempt from federal income taxes, but for purposes of establishing rent under a tax abatement lease, it should not matter whether the associated bonds are tax-exempt or taxable for purposes of federal income taxes.

<sup>57</sup> The use of a bond structure also allows the lessee under the tax abatement lease to obtain a deed of trust or mortgage on its own project to secure the bonds if the bonds are being purchased by the lessee or by a related party. Many beneficiaries of tax abatement leases like to have the mortgage as

Therefore, two primary transaction structures exist for documenting a tax abatement transaction. The first (and simpler) structure involves just the lease of the project subject to tax abatement. The second structure includes the use of bonds to finance the project and provides more certainty as to the amount of rent being paid under the lease. In either structure, the key document to implement the transaction is the lease between the IDB or HEHB and the beneficiary of the tax abatement. This lease must be carefully crafted to achieve the results that the parties anticipate.

## V. DRAFTING PITFALLS IN A TAX ABATEMENT LEASE

When drafting a tax abatement lease, there are a number of potential pitfalls that an attorney representing either the lessor or the lessee should consider. Although this type of lease usually is similar in form to a simple commercial lease, these drafting issues generally are unique to tax abatement transactions. A sampling of some of these issues follows.

One issue that often arises in drafting a tax abatement lease relates to the acquisition of the leased project after the tax abatement period ends. For example, if an IDB<sup>58</sup> agrees to abate property taxes on a project for five years, the IDB will usually want the lessee to acquire the project after the five-year period ends so that the board will not have any continued obligations with respect to the property. It is thus tempting for the IDB to insert in the lease a provision automatically requiring the lessee to purchase the project at the end of the five-year period.<sup>59</sup> However, this could be a mistake. By requiring the purchase of the project, the IDB could be deemed to have converted a document that would otherwise be considered a lease into an installment sale contract. As such, the ownership of the project would be deemed to not have been transferred to the IDB, and the project would have been subject to property taxation.

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protection in case of the insolvency of the IDB or the HEHB. As long as the purchase option under the tax abatement lease could still be exercised if the IDB or HEHB becomes insolvent, a deed of trust does not provide substantial additional security. Although a purchase option should still be exercisable in the case of insolvency of the IDB or HEHB that is the lessor under the tax abatement lease, a discussion of the effect of insolvency on the purchase option is beyond the scope of this article.

<sup>58</sup> In discussing drafting issues that relate to tax abatement leases, only leases with IDB are used as examples. However, the same drafting issues would relate to leases involving HEHBs.

<sup>59</sup> If the IDB only has the option to require the lessee to purchase the property, and that purchase is not automatically required under the lease, the option should not cause the lease to be construed as an installment sales contract.

To avoid this problem, the lessee under the tax abatement lease should have the option to purchase the leased property but should not be required to purchase the leased property. To prevent a lessee from failing to purchase leased property at the end of the lease term and leaving the IDB with property that is in a state of disrepair, the IDB may want to include a provision in the lease requiring the lessee to maintain the property in good repair. Therefore, if a lessee attempts to leave an IDB with poorly maintained property at the end of a lease term, the board would at least have a claim against the lessee for breaching the lease.

When an IDB takes title to property, there is also some risk that the board may be named as a defendant in a lawsuit in the event a third party is injured on the property. Moreover, if a lessee contaminates the property with hazardous waste, the board could also be saddled with property that has environmental problems. To address these types of concerns, the tax abatement lease, like most commercial leases, should provide indemnity from the lessee to the IDB for these types of claims. The lease also should require the lessee to maintain commercial liability insurance and to name the board as an additional insured.

Another issue that frequently arises relates to the treatment of expansions of buildings on the leased property. Many industrial sites provide adequate room for expansion, and a lessee may contemplate an expansion even before the initial phase of construction is complete. The lessee obviously will want the expansion to benefit from at least the same tax abatement that the original project received. Because the expansion presumably is located on property that is owned by an IDB, the ownership interest in the expansion would be exempt from taxation.<sup>60</sup> Assuming the expansion is not required by the tax abatement lease, the lessee's leasehold interest in the expansion probably is not subject to taxation because the lessee is paying fair market rent for the expansion. To avoid any future disputes regarding the availability of tax abatement for an expansion, the IDB and the lessee may want to specifically address that issue in the tax abatement lease.

IDBs usually enter into tax abatement leases to attract jobs and capital investment in their communities. The IDB will almost always receive the benefit of the capital investment because the project that is the subject of the lease is usually constructed shortly after the lease is consummated. The IDB may not realize the expected growth in jobs, however, if the lessee's business does not grow as quickly as anticipated or if the lessee's business does not prosper.

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<sup>60</sup> If the lease provides that any expansion is considered the property of the lessee, the lessee would be considered the owner of the expansion, and the expansion arguably would not be exempt from taxation.

In the case job projections are not met by a lessee, the IDB may want to recoup some or all of the tax benefits that have been granted to the lessee. However, such a recapture provision often is troublesome to a lessee who is unable to project job creation with any level of certainty. As a result, if an IDB insists on a recapture provision, the provision is usually crafted to give the lessee significant latitude in reaching its job creation goals.

Similarly, an IDB may agree to enter into a tax abatement agreement with a lessee that is a large, multi-national business because the business has a reputation for providing good wages and a quality work environment. The IDB may not want the lessee to have the right to assign its interest in the lease to another entity without the consent of the industrial development board. On the other hand, the lessee will want to have the unfettered right to assign its interest in the lease in connection with a sale of its business so that it can realize the value of the tax abatement transaction. There is no correct answer for how this issue should be resolved, but the parties should consider this issue as they negotiate a tax abatement lease.

A lessee also will usually want to preserve the right to mortgage the property that is the subject of the tax abatement lease. An IDB typically will not object to a mortgage on the leased property because the lessee may need to mortgage the property to finance the improvements on the property. It is uncertain under the applicable statutes whether an IDB has the authority to mortgage its ownership interest in property to secure a loan by a third party to one of the board's leases. For this reason, a lessee may want to grant a mortgage on property that will be subject to a tax abatement lease before conveying the property to the IDB. At a minimum, if the lessee anticipates that it will need to obtain financing for improvements to the leased property, the tax abatement lease should contain provisions permitting the lessee to grant a leasehold mortgage on its leasehold interest and should provide adequate cure rights under the lease to the lender.

Finally, an IDB may want to include a provision in the tax abatement lease that calls the lessee's attention to the statute requiring that the lessee must file an annual report with the state regarding the tax abatement lease.<sup>61</sup> In this report, the lessee is required to disclose the terms of the tax abatement lease and certain other information.<sup>62</sup> Failure to file the report can result in a \$500 penalty being assessed against the lessee.<sup>63</sup>

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<sup>61</sup> TENN. CODE ANN. § 7-53-305(e) (2003). In addition to the annual filing report, each tax abatement lease should be filed with the state and each city and county that is affected by the lease shortly after the lease is executed. *Id.* § 4-17-303.

<sup>62</sup> *Id.*

While there are a multitude of issues that should be considered in drafting a tax abatement lease, the foregoing highlights some of the more significant issues that should be addressed. As this discussion demonstrates, there are drafting issues that are somewhat unique to tax abatement leases that a careful draftsman should recognize. When these issues are taken into account along with the need to minimize the value of the lessee's leasehold estate, it is clear that the drafting of a tax abatement lease can be a challenging exercise.

## VI. CONCLUSION

The competition for attracting business and industry to Tennessee communities continues to heighten. Companies seeking to locate a headquarters or manufacturing plant have become increasingly sophisticated about the benefits they can extract from communities interested in courting them, and a bevy of consultants offer their services to try to maximize the benefits that are extracted. To compete in this market, Tennessee communities, for better or worse, may need to offer property tax abatement to realize their economic development goals.

At the same time, many cities in Tennessee also are recognizing that their best hope for growth is to redevelop historic commercial districts and Brownfield locations. To attract businesses to these areas, tax abatement is one of the few incentives that cities can offer. Therefore, in both these contexts, tax abatement can be a critical component of a successful economic development program.

As this Article demonstrates, tax abatement legally can be implemented in Tennessee to help achieve these objectives. However, a well-crafted tax abatement lease should address a number of key issues, and the local government and the beneficiary of the tax abatement will have a number of different points to negotiate. Because the local government's and the beneficiary's goal ultimately is the same in these transactions—helping the beneficiary successfully grow its business—an agreement among the parties can usually be reached, and one of the most effective economic development tools that a local government can offer will have been employed.

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<sup>63</sup> *Id.*