

PAYMENTS IN LIEU OF TAXES

A Look at the Long-Term Tax Exemption Law, Problematic Pending Legislation and the School Funding Issue

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The use of PILOTs (payments in lieu of taxes) as promulgated under N.J.S.A. 40A:20-1 et seq., commonly known as the “Long Term Tax Exemption Law,” is a critically important financial arrangement between municipalities and developers for use in blighted areas throughout the state found to be in need of redevelopment. The power given to municipalities to provide this special financial tool comes from Article VIII, Section III, of the New Jersey Constitution. The law recognizes the valuable public purpose of redeveloping and restoring blighted areas, and its express goal is to encourage private capital and private enterprise to restore these deteriorated and neglected areas pursuant to the law’s criteria.

Despite their importance, PILOTs have increasingly been labeled as an unfair economic benefit to private developers at the expense of local school districts and the community at large. And if certain recently proposed legislation to revise PILOTs is adopted, municipalities will be hurt in their ability to attract private investment to blighted areas. Without PILOTs, downtown areas most in need of private investment would be significantly restricted, and the important re-purposing of abandoned corporate campuses would stop.

This memo outlines commonly misunderstood facts regarding the Long Term Tax Exemption Law, issues with the proposed legislation, and a brief analysis of a commonly misunderstood discussion point, school funding.

I. PILOT Facts

- PILOTs under the Long Term Tax Exemption Law are limited to areas designated by the host municipality as

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blighted and in need of redevelopment. The designation process requires public hearings before the municipal planning board and governing body, during which certain findings must be made to support the redevelopment designation.

- Criteria for a municipality to find blight and designate an area in need of redevelopment are set forth in the Local Redevelopment and Housing Law. The municipal designation must withstand heightened scrutiny, especially if challenged by an interested party. This heightened standard protects communities from abuse and unsubstantiated redevelopment designations.
- PILOTs provide a term and annual rate of payment (most often based on the project’s annual gross revenue) that offers certainty to developers with regard to real estate taxes, thereby making private investment feasible in areas that otherwise are viewed as not

economically possible or too risky.

- During a PILOT term, the school district continues to receive its share of real estate taxes for the assessed value of the land. Importantly, where the property is vacant or existing improvements are of little or no value, the district receives no less revenue than before the development. Usually, the revitalization increases land values and assessments, which serves to increase revenue to the school district.
- Minimum annual PILOT payments cannot be less than the property’s annual real estate taxes in the year prior to the PILOT commencement.
- The PILOT revenue paid to the municipality most often meets or exceeds that received by the municipality for its portion under conventional taxes.
- PILOTs are structured as a public-private partnership, where the municipality receives no less than 10 percent of the project’s annual gross revenue; thus, the municipality receives more revenue as the project becomes more successful.
- Qualified developers must incorporate with the state as a limited-dividend entity. Among other requirements, this guarantees that the entity (i) provides annual audited statements to the municipality and state to ensure proper accounting of PILOT obligations and (ii) limits its net annual profit to an allowable rate, with any excess payable to the municipality as additional real estate taxes.
- Redevelopment of an area serves to encourage more redevelopment and

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investment in surrounding areas.

II. Common Criticisms of PILOTS

The most common criticism of a PILOT grant is that the redeveloper often eliminates taxes, thus enabling higher profit at the expense of the municipality and its residents. However, the Long Term Tax Exemption Law explicitly provides that a for-profit developer utilizing a PILOT must be a limited-dividend entity, meaning that retained profit is restricted to the greater of (i) 12 percent or (ii) 1.25 percent plus such developer's APR on the initial permanent mortgage. Excess profits must be remitted to the municipality as an additional tax. This inherent limitation ensures that the municipality and its residents receive any such windfall from the redeveloper.

Another common criticism is that a redeveloper utilizing PILOTS is not subject to state oversight. However, each redeveloper must first have its Certificate of Formation (or similar document) approved by the New Jersey Department of Community Affairs. Such approval ensures that each redevelopment entity has agreed to certain covenants, which, among other things, (i) subjects the redeveloper to municipal regulation, (ii) requires that the entity is organized to serve a public purpose and (iii) limits its operations to the redevelopment project. In addition, the applicable statute requires that PILOT recipients deliver annual audited statements to the municipal governing body, as well as to the Director of the Division of Local Government Services in the Department of Community of Affairs. Thus, the law as currently drafted provides layers of municipal and state oversight.

Critics of tax exemptions also contend that a conflict of interest arises when a municipality is deciding to grant a PILOT. Since the municipality often receives payments in excess of conventional taxes, critics suggest the municipality is likely to approve a PILOT without fully

considering the effect on residents or its school district. However, a municipality and its governing body are required by statute to include in the financial agreement with a PILOT recipient certain findings regarding (i) the benefits of granting the exemption, relative to costs to the municipality, and (ii) an assessment of the importance of granting the tax exemption in obtaining development of the project and influencing locational decisions of potential project occupants.

III. Pending Legislation

Despite the success of PILOTS in encouraging redevelopment, two pending bills seek to amend the Long Term Tax Exemption Law in ways that would drastically reduce the program's efficacy. S867 would require any redeveloper that avails itself of a PILOT to pay prevailing wage rates for the project's construction. S59 would require that municipalities split certain portions of payments with their school districts. That amount would be determined by the number of school children residing in the developer's project. S867 and S59 each pose challenges that could stunt future redevelopment.

S867 is inherently problematic as it adds significant project costs. Remember that a PILOT is only offered to incentivize developers to come to a blighted, and therefore riskier, area. The PILOT is designed to make a project economically feasible, because without the PILOT, dilapidated areas would likely not be rehabilitated. Adding a burdensome cost (such as a prevailing wage rate) minimizes the PILOT's benefit, if not negating it.

While S59 seeks to rectify the important issue of inadequate school funding, it does not address the key issue: fixing the formula that determines school funding allocation at the state level. Governor Murphy has indicated he expects formula changes, and his newly released budget significantly increases

school funding. To amend the Long Term Tax Exemption Law based on a formula that will be changed creates the possibility of (i) future conflict and (ii) lack of efficacy. In addition, the law already includes safeguards aimed at ensuring a municipality does not grant a PILOT that harms its school district funding. Finally, we note that S59 is unworkable for projects that include units for sale to third-party purchasers.

IV. The School Funding Issue

As mentioned above, pending legislation would require municipalities to disburse a portion of PILOT revenue to its local school district as well as its regional school district to which it sends pupils. While it is true a municipality currently receiving a PILOT is not required to disburse those funds to the district (relative to the new improvements), the solution proposed by S59 seeks to address a symptom of the problem, not the underlying issue.

First, a word on school funding in New Jersey is instructive. Pursuant to the New Jersey Constitution, the legislature is required to "provide for the maintenance and support of a thorough and efficient" public school system. The legislature passed the School Funding Reform Act ("SFRA") in 2008 to satisfy this obligation. While the law is extremely complex, in short the state is charged with determining each district's budget to ensure a thorough and efficient education, which is referred to as the Adequacy Budget. Funding to achieve that budget is derived from three sources: (1) Local Cost Share, (2) Equalization Aid and (3) Categorical Aid. The Local Cost Share represents the portion of the Adequacy Budget for which a municipality is responsible, while Equalization Aid and Categorical Aid are state-funded. It is important to note that SFRA has not been adequately funded by the state in many districts since its initial adoption.

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Now, understanding that a municipality is aware of its SFRA obligation to meet the Local Cost Share portion of the Adequacy Budget, one can see the Long Term Tax Exemption Law takes steps aimed at preventing abuse of PILOTs at the expense of school districts. As mentioned above, the law states that agreements granting a developer a PILOT must include certain findings by the municipality, including its determination as to “the relative benefits of the project to the redevelopment of the redevelopment area when compared to the costs, if any, associated with the tax exemption[.]” This cost-benefit analysis clearly should involve some thought by municipal representatives as to SFRA budgetary obligations. Non-residential developments would not impact the Adequacy Budget or Local Cost Share; thus, a non-residential development should not affect a municipality’s ability to budget appropriately to meet SFRA requirements. Further, the increase to the Adequacy Budget or Local Cost Share caused by a residential development could be reasonably estimated based on the prior year’s per-pupil average, which again, allows a municipality to budget appropriately to meet SFRA requirements.

Where a failure of a municipality to budget appropriately occurs (whether or not due to a PILOT grant), it is possible that the town could not fund its Local Cost Share, which would result in an increase in municipal taxes (subject to the 2 percent property tax increase cap). However, the solution is not to inhibit redevelopment that rehabilitates and invigorates the economy, but to ensure that municipal budgets use all sources of revenue appropriately. This becomes a municipal government issue, which should be addressed by local officials.

Critics also suggest that the grant of PILOTs has two negative effects on state taxpayers as it relates to school funding. First, because PILOT revenue

is not accounted for in the town’s ratable base, the town’s wealth is artificially deflated, which increases the amount of state aid for school funding, thus harming statewide taxpayers. Another criticism is that when a town fails to fund its Local Cost Share, the state becomes responsible for the shortfall (through what is called Adequacy Aid), a burden (which again) ultimately falls to taxpayers. However, in each of these instances, requiring that a portion of the PILOT be directed to the school district does not solve the issue, only a symptom of the problem. That is because there is no guarantee that a municipality will be able to fund its Local Share Cost based on a per-pupil payment out of the PILOT.

Finally, we reiterate that in light of the imminent amendment to the school funding formula to be proposed by Governor Murphy’s administration, a wait-and-see approach is most appropriate before seeking to change the Long Term Tax Exemption Law. The new formula may eliminate this issue entirely, or in the alternative, create new problems that would not be addressed by S59 or other legislation proposed in advance of the new funding formula.

THE NO. 1 CAUSE OF STRUCTURAL FAILURES

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other common problems associated with improperly compacted fill such as slope failures, retaining wall failures, and drainage problems.

In summary, diligent practices regarding structural fill material include:

1. Check prospective land for existing undocumented fill
2. Check fill quality and use proper fill placement methods
3. Use the proper equipment for fill compaction
4. Test and document fill density
5. Utilize a geotechnical engineer as needed

Structural failures caused by fill material are avoidable. Proper fill placement will help protect a home builder’s liability and hard-earned reputation.