Legislative Update: The topics covered in this article - namely, Public Facility Corporations - were a widely debated topic this legislative season, drawing out a number of proposed bills, all aimed, in some way, at attempting to address the matters discussed below. H.B. 2071 is awaiting the Governor's signature and is anticipated to take effect September 1, 2023. We've updated this article to discuss H.B. 2071 and have also included information regarding the other proposed legislative actions introduced during the 88th Legislature. This article discusses the impact of Public Facility Corporations prior to the consideration or enactment of these legislative initiatives.

Note from the Authors: In 2020, Heather K. Way, the Clinic Director of the University of Texas School of Law Entrepreneurship and Community Development Clinic published her "Public Facility Corporations and the Section 303.042(f) Tax Break for Apartment Developments," a research report examining a property tax exemption provided to private apartment developers under the Texas Local Government Code. Most of the empirical data appearing in this article is directly attributable to Heather K. Way and the phenomenal amount of research she compiled, analyzed, and examined. If you're interested in learning more about this topic or delving deeper into any of the topics contained herein, we highly recommend reading her research report, linked here.

In lieu of citations, sources have been linked directly in the article itself for the convenience of the reader. We have also attached a list of references, should there ever be an issue with the links. Many people worked to compile the compelling data and analysis related to the matters discussed herein; we appreciate their work and wish to fully attribute and recognize their thoughts, ideas, and words to them as their own. The source materials contain so much more information than we could hope to cover here - please be sure to check them out at your convenience.

PUBLIC FACILITY CORPORATIONS: THEIR IMPACT ON ECONOMIC DEVELOPMENT AND TAXES

By: Megan J. Mikutis and Brandon Morris

A legal loophole in the Texas Local Government Code allows private developers to purchase land in one local jurisdiction, remove it from that jurisdiction's tax rolls through a statutory tax exemption, while partnering with another local jurisdiction which then purchases that land.

SH130 Municipal Management District No. 1, a PFC of approximately 1,100-acres in Travis County, did exactly that through its creation of the Texas Essential Housing PFC ("TEHPFC") in August 2021 – the TEHPFC caused a 30-acre lot, valued at $5 million, to be lawfully removed from Bexar County's local tax rolls. Proponents of PFCs claim that these PFCs are helping to address and alleviate the State's affordable housing crisis.

A 2015 legislative addition to Chapter 303 of the Texas Local Government Code, meant to exchange a property tax break for certain affordable housing concessions, provides tax exemptions for what are known as Public Facility Corporations ("PFCs"). A PFC may be created by a municipality, county, school district, housing authority, or special district.

PFCs are then granted "the broadest possible powers to finance or to provide for the acquisition, construction, rehabilitation, renovation, repair, equipping, furnishing, and placement in service," of "public facilities," a term which includes any real, personal, or mixed property – or an interest in such property – devoted or to be devoted to public use (a "Section 303.042(f) Project").

How Does this Work?

In order to score these Section 303.042(f) Project tax exemptions, a bit of legal leapfrog must be played. Starting from the beginning, it's best explained by first looking at the enabling statute itself – Section 303.042(f) of the Texas Local Government Code.

Section 303.042(f) of the Texas Local Government Code provides that a leasehold interest "shall be treated in the same manner" as a leasehold or other possessory interest in real property granted by an authority under Section 379B.011(b) of the Texas Local Government Code. (This is where the tax exemptions begin to come into play.)

Section 379B.011(b), which applies to defense base development authorities but which - in a previous version of the statute - previously referenced and applied to PFCs, provides that Section 25.07(a) of the Tax Code applies to a leasehold interest granted by a defense base development authority (and, therefore, a PFC) in the same manner as it applies to leasehold interests in real property constituting a project described by Section 505.161 of the Texas Local Government Code.

Section 25.07(a) is the provision requiring leasehold interests of longer than a year to be taxed in the name of the lessee versus the lessor. This makes the leasehold interest taxable if the lessee is not exempt. (This is why the property must be first transferred to the PFC and then leased back to the original private purchaser-developer.)

Section 505.161 of the Texas Local Government Code states that Section 25.07(a) of the Tax Code does not apply to a leasehold or other possessory interest granted by a Type B Economic Development Corporation (and, therefore, a PFC) during the period the corporation (or, PFC) owns projects on behalf of the authorizing municipality. This allows those long-term leasebacks provided by PFCs to the original private purchaser-developer to circumvent the application of local property and sales taxes.

What Does This Look Like in Practice?

To receive the tax exemption, a private developer transfers land to a PFC which then leases back that land to a limited partnership entity controlled by that original private purchaser-developer. The governmental entity sponsoring the PFC – remember, not necessarily in the local jurisdiction in which the land sits – will then typically receive a payment for its participation in the venture. (In the case of out previous example, the TEHPFC, developers will turn over 10-15% of their annual property tax savings, which allows the TEHPFC to generate revenue by removing land from other local jurisdictions' tax rolls.)

A Section 303.042(f) Project will generally appear like a normal land development deal between a governmental entity and developer – until the developer partners with a PFC, thereby causing the development to become tax exempt. This could look like:

1. A private developer pitches an acquisition or new construction of an apartment complex to a public housing authority or other local governmental entity.
2. The private developer and local government staff then negotiate the financial benefits to the local jurisdiction and the affordability restrictions or terms.
3. The local governmental entity's governing body approves the deal.
4. For new construction projects, the private developer sells the land to a PFC, and the PFC leases the land and to-be-built improvements back to a limited partnership entity controlled by the original private purchaser-developer (typically for 75-99 years). For

acquisition projects, the private developer sells the land and improvements to the PFC, which are then leased back to the limited partnership.

FIG. 5

How a PFC Partnership Works for New Construction Projects with a Section 303.042(f) Exemption

Image from Heather K. Way's "Public Facility Corporations and the Section 303.042(f) Tax Break for Apartment Developments" (2020).

5. A 100% property tax exemption is secured on the property from the local jurisdiction's appraisal district.
6. The private developer, via the limited partnership entity, builds and rents out the apartment complex (for new construction projects), with a 100% sales tax exemption on construction materials.
7. At years three-through-five, the private developer and investors typically cash out of the deal, and the leasehold interest is sold to a third party. The PFC can choose to remain in the partnership, which extends the property tax exemption on the property.

This averages approximately $1 million a year in property tax exemptions, per property – or close to $7,400 a year per income-restricted unit. New construction projects may also be 100% exempt from sales tax on construction material purchases, resulting in a one-time exemption of $1.3 million on average per new apartment development.

What are the Long-Term Impacts?

Largely seen in San Antonio and Houston metropolitan areas, developers are pressing into smaller communities to pursue Section 303.042(f) Projects.

In a study conducted by the University of Texas School of Law's Entrepreneurship and Community Development Clinic, it was found that, from 2016 to 2020, 30 Section 303.042(f) Projects were acquired, completed, or under development. The total values of these properties – when completed – will equate to $1.2 billion and will provide a **total property tax exemption of $32 million per year.**

Between 2016 and 2020, 11 of those Section 303.042(f) Projects were established by the Houston Housing Authority, the leading Section 303.042(f) PFC in the State. In late 2022 and earlier this year, the Houston Housing Authority approved at least 27 new Section 303.042(f) Projects, despite Houston Mayor Sylvestor Turner's January-made promise to pause such Section 303.042(f)

Projects. Mayor Turner instructed the pause in favor of establishing and publishing guidelines with criteria that are "in the best interest of the city of Houston and its residents by ensuring housing affordability for those who need it most."

Those 2023 Section 303.042(f) Projects approved by the Houston Housing Authority represented a 13% increase in the number of Section 303.042(f) Projects in Houston. Houston Housing Authority officials said that the Houston Housing Authority's Section 303.042(f) Projects created 12,600 apartments with discounted rents, 5,000 of which had been reserved for households earning 60% or less of the Houston-area's median income. As of mid-February 2023, the Houston Housing Authority had entered into 76 agreements for Section 303.042(f) Projects.

If you'd like to learn more about the Houston Housing Authority's housing options, in April 2023, the Houston Housing Authority launched its "Affordable Housing Houston" website, which provides information to apartment hunters about apartment options offered through the Houston Housing Authority's Section 303.042(f) Projects.

Projections (made in 2020 and based on an estimate of Houston reaching 34 Section 303.042(f) Projects by 2026, less than half of Houston Housing Authority's 76 agreements for Section 303.042(f) Projects) placed Houston's 2026 total loss of annual property tax revenue at approximately $38 million. By 2026, the impact of Houston's Section 303.042(f) Projects is anticipated to cause the City of Houston to lose $8.9 million per year, Harris County to lose $6.4 million per year, local school districts to lose $17.9 million per year, local community colleges to lose $1.6 million per year, and local area hospitals to lose $2.6 million per year.

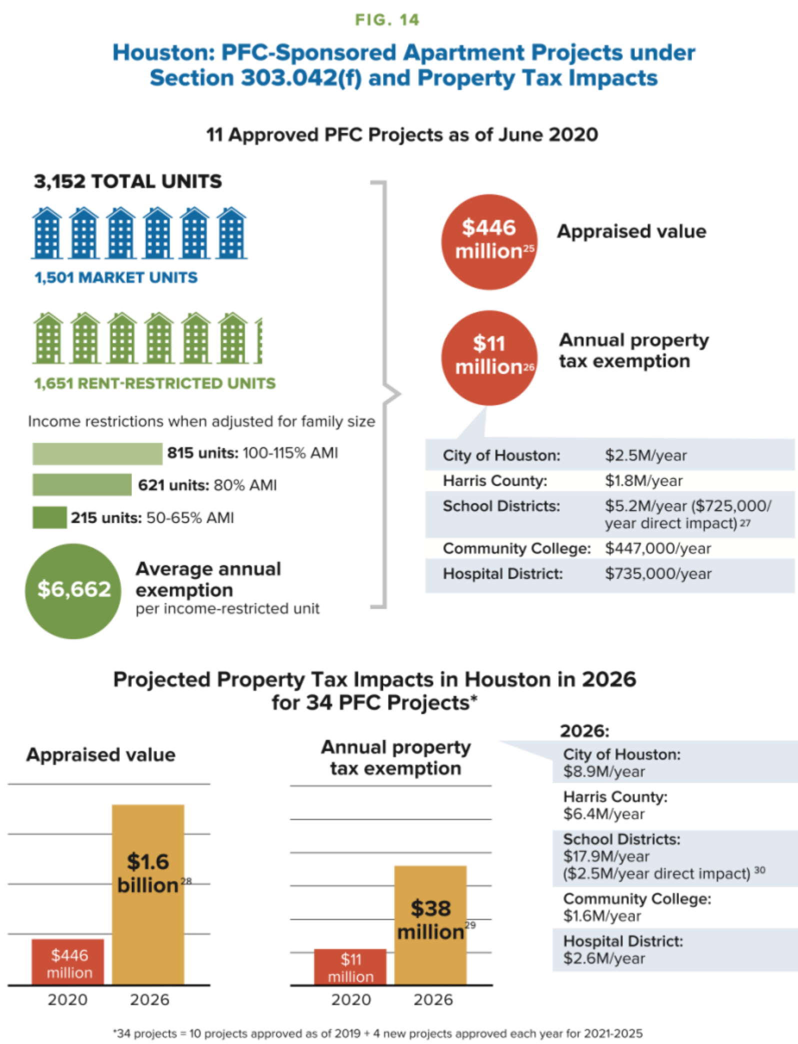

Image from Heather K. Way's "Public Facility Corporations and the Section 303.042(f) Tax Break for Apartment Developments" (2020).

If allowed to continue, Section 303.042(f) Projects could remove approximately $12 billion in property values off the tax rolls by 2026, resulting in a loss of about $326 million a year in revenue to local taxing districts and the State's public education budget.

History & the 88th Legislative Session

Links to those legislative initiatives introduced during the 88th Legislature have been included, below. Prior to discussing H.B. 2071, a brief legislative history might be helpful to understanding today's current legislative context.

Prior to the 2015 additions to Chapter 303 of the Texas Local Government Code, which provided for these Section 303.042(f) Project tax exemptions, a leasehold interest - that being real property leased by a PFC to a private, for-profit developer for more than one year - was largely taxable under Chapter 303 of the Texas Local Government Code and Chapter 25 of the Tax Code.

SB 1861, which passed both chambers of the Legislature, was meant to broaden the applicability of those tax exemptions afforded to Section 303.042(f) Projects. SB 1861 would have further amended Section 303.042(f) of the Texas Local Government Code and would have provided a total tax exemption to multifamily residential developments leased by a PFC to a private, for-profit developer as long as the Section 303.042(f) Project accomplished a "governmental purpose" of the sponsoring governmental entity. "Governmental purpose" wasn't defined in the proposed amendments. SB 1861 did not survive the Governor's veto.

Section 303.042(f) of the Texas Local Government Code was again under scrutiny during the 88th Legislative Session. This time, legislators largely sought to clarify or restrict its scope.

In October 2022, Senator Paul Bettencourt, representative of Senate District 7, which encompasses most of West Harris County, and Chair of the State's Senate Committee on Local Government sought guidance from the Office of the Attorney General regarding the authority of a PFC to acquire leasehold real property outside of the creating entity's jurisdictional boundaries.

In response, Texas Attorney General Ken Paxton issued an opinion on March 8, 2023, which held that a PFC, creating a Section 303.042(f) Project, does have the authority to acquire leasehold real property outside of its creating entity's geographic jurisdiction. Such property would then be tax exempt, even though it's located in another taxing entity's jurisdiction. In other words, the creating entity could reap certain financial benefits through its creation of a PFC but then shift the tax burden to another taxing entity's jurisdiction.

This would put a strain on the local tax rolls and, in particular, school districts and smaller taxing jurisdictions (like MUDs). In Texas, approximately 50% of all property taxes are levied by school districts. By 2026, projections (made in 2020 and based on an estimate of San Antonio reaching 36 Section 303.042(f) Projects by 2026) anticipate that San Antonio's school districts will be losing $24.2 million per year due to the expected annual property tax exemption of $44.8 million caused by the projected Section 303.042(f) Projects.

When large multi-family developments are taken off the tax rolls, a taxing entity is - realistically - left with one of two options: (1) trim the budget or (2) increase the tax rate on the remaining property on the tax roll.

Quickly following the Texas Attorney General's opinion, the Legislature stepped in to address the issue. H.B. 2071 is aimed at eliminating the issue of one governmental entity using a PFC to receive economic benefit from providing tax breaks to private developers within another governmental entity's jurisdiction.

Under the new legislation, a PFC or its creating entity (its "sponsor") could finance, own, or operate a multifamily residential development only if the development was within the sponsor's boundaries; or, in the case of a housing authority, only within the sponsor's area of operation. In other words, a city sponsor can only affect property through a PFC that is within its own territorial jurisdiction, essentially preventing one city from shifting the tax burden to another city by way of a PFC.

When a governmental entity is determining the benefits of low-income housing versus the costs of forgoing property taxes, it makes sense that the benefits and the costs are both borne by the same sponsoring entity. While an issue remains for school districts and the like, citizens now at least have some say in what their city councils or other applicable sponsoring entities approve. It is worth noting that as of the writing of this paper, the Governor has not yet signed H.B. 2071 into law, but assuming it is enacted later this year, PFCs will be prevented from unilaterally imposing the costs of these tax breaks on the citizens of another governmental entity outside their sponsor's boundaries.

A (probably) non-exhaustive list of other legislative attempts to address Section 303.042(f) Projects from this Legislative Session includes:

1. H.B. 738, 88th Leg., 88(R) Sess. (Tex. 2023)
2. H.B. 1556, 88th Leg., 88(R) Sess. (Tex. 2023)
3. H.B. 1634, 88th Leg., 88(R) Sess. (Tex. 2023)
4. H.B. 2964, 88th Leg., 88(R) Sess. (Tex. 2023)
5. H.B. 2966, 88th Leg., 88(R) Sess. (Tex. 2023)
6. H.B. 3568, 88th Leg., 88(R) Sess. (Tex. 2023)
7. H.B. 3879, 88th Leg., 88(R) Sess. (Tex. 2023)
8. S.B. 1278, 88th Leg., 88(R) Sess. (Tex. 2023)
9. S.B. 2434, 88th Leg., 88(R) Sess. (Tex. 2023)

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3. TEX. LOC. GOV'T CODE §§ 303.001–.124.
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