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A Texas Real Estate Developer Has a New Financing Trick. But the IRS Doesn't Buy It.

A real estate developer may have invented a creative twist in project financing—but that innovation is now mired in a tax dispute and litigation.

The trouble centers on the Statler Hotel on Commerce Street in downtown Dallas.

Decades after the Jackson Five and Frank Sinatra performed on its stage and long after it became perhaps the first building to pipe music into its elevators, the structure had fallen into disrepair. It sat vacant for 16 years, its insides rotting, at one point facing demolition as Dallas' mayor lobbied to raze it and replace it with a park.

Like many U.S. cities, Dallas has worked over the past decades to revitalize its emptied core, to coax businesses to open offices and developers to build residential spaces.

Aiming to spend money to make money, Dallas ramped up economic incentives to encourage development that might spark economic activity. Its first method—issuing bonds and using the proceeds to seed redevelopment projects—sputtered during the financial crisis. So the city revamped the program, says Denise Rappmund, a senior analyst with Moody's Investors Service, paying incentives for a queue of approved projects.

Today, Dallas' downtown is thriving. In that sense, the program worked. But the messiness of the Statler project highlights the vulnerability of public finance, as municipalities and states struggle to right lopsided balance sheets where liabilities dwarf revenues.

Centurion American Development Group, a Texas real estate developer, decided to capitalize on the city's incentives to renovate the Statler and attached and related properties, including the Old Dallas Central Library. In April 2014, Dallas gave the developer a credit of up to $46.5 million in "tax increment financing," or TIF, basically a property-tax rebate paid out over a set amount of time.

The project's scope expanded, and a $175 million undertaking grew into a $255 million one. Centurion needed to finance the increased cost. What it came up with was apparently an innovation in municipal finance.

Centurion linked up with conduit issuer the Wisconsin Public Financing Authority, a governmental organization that since 2009 has helped others capitalize on tax advantages to finance quasipublic projects.

Through the investment bank Jefferies and the law firm Orrick, Herrington & Sutcliffe, Centurion assigned its TIF revenues to the Wisconsin authority—functionally selling them—which placed the resulting bonds with an investor. Centurion then received $26.5 million, for $41.5 million in future payments.

TIFs are lent as collateral all the time, but they've never been sold, according to the project's

minority owner, Fiamma Statler, another Texas developer working on the project. “No one has ever taken their TIF and then sold it by way of muni bonds for cash now,” says Fiamma’s lawyer Gregory Ziegler of Macdonald Devin.

Developers would love to sell TIFs to get cash at a project’s start, instead of suffering through years of negative cash flow, says Bob Dendy, founder of Elite Financial Management in Dallas, a money manager. “Bundling ’em up and selling them to somebody else at a discounted rate is unique, and may one day be considered ingenious,” he tells Barron’s.

Moody’s rated the bonds Baa3, the lowest rung of investment-grade. The credit-rating agency didn’t have anything to compare it to in its universe of credits because “we don’t rate anything else exactly like it,” says Moody’s senior analyst Rappmund. “What’s different about this was it’s not the city’s TIF issuing this debt—it’s sort of derivative,” she says.

The city of Dallas, in fact, was largely uninvolved.

The creativity initially sparked interest among other developers, Rappmund says, but none of them were as far along in development. That’s important, because for the Statler bond to be paid, the property needed to be operating and generating revenue, with guests arriving and its restaurants humming.

At the time Moody’s reviewed the bonds, the Statler renovation was roughly two-thirds complete.

The project deadline slid, from October 2016 to October 2017, and it opened unfinished. Another extension gave Centurion until this month to complete the project. Tenants moved in; the residences are now about 89% occupied. The Dallas Morning News now operates out of the Old Dallas Central Library. This April, D magazine named the hotel the “community impact deal of the year,” saying it was not just an expensive historic renovation, but a “place to behold.”

Then the Internal Revenue Service took a look at the project’s financing. The agency warned the Wisconsin authority that the issuance “may fail one or more” tax code provisions. In July, the IRS determined that the interest wouldn’t be tax exempt as advertised.

The IRS declined to comment, but those provisions include proceeds going to private use instead of public benefit.

The tax determination, says Dendy of Elite Financial Management, may mean that the buyer of the bonds overpaid by up to $10 million.

The Wisconsin authority is appealing the IRS determination. Andrew Phillips, its lawyer at von Briesen & Roper, underscored that the PFA is simply a conduit, neither underwriting debt nor selling it, and that TIF revenues are unaffected by the IRS determination; the only thing it affects is what PFA pays in interest on the bonds.

But he told Barron’s: “I’ll be perfectly honest with you. I’ve intentionally made it my goal not to know about the Statler project…I just want to make sure PFA comes out of the other side of it.”

In August 2017, the Dallas Morning News reported that the Securities and Exchange Commission was looking into the TIF sale, examining whether investors got full and accurate information and the proceeds were used as promised. The SEC and Centurion declined to comment on the investigation. Lawyers from Orrick, Herrington didn’t return requests for comment.

In August, Fiamma sued Centurion in state court, accusing it of defrauding Dallas taxpayers by using

TIF funds for its own benefit and “artificially marking up the cost of construction” to pocket the money, including “falsifying and manufacturing change orders showing phantom increases in the cost of construction.”

Centurion’s lawyer Gregory Shamoun said through a spokesperson, “The lawsuit has no merit and is without basis in law or fact. Centurion is confident that the city of Dallas will successfully defend against this frivolous lawsuit.”

Fiamma owns 20% of the project, but was fired in early 2016 after objecting to using a construction company owned by Centurion CEO Mehrdad Moayedi. Fiamma founder and CEO Frank Zaccanelli says he didn’t even know about the TIF sale. And, he says in the lawsuit, almost all of the proceeds flowed into an entity formed days earlier with no ties to the project except that it’s also owned and managed by Moayedi.

“What should have been a shining example of how the public benefits from public-private partnership redevelopment projects,” the lawsuit says, “has, sadly, proven only to be yet another dark chapter in the sordid tale of Dallas municipal public office corruption, further unjustly enriching yet another wealthy developer with the public’s money at the expense of the taxpayers.”

Representatives for Dallas declined to comment, but Ziegler, Fiamma’s lawyer, says the city has no imminent plans to make the TIF payments. A Jefferies spokesperson declined to comment.

There may be more problems: Texas stipulates that TIF proceeds go to “project costs,” like paying the architect or pouring concrete. But these were booked as a developer’s fee, according to Fiamma’s lawsuit, which may violate the agreement between Centurion and Dallas, the Texas tax code, or statements in the bond offering.

Ramifications reach beyond Texas. The TIFs ended up with an unidentified Wisconsin pension fund, the lawsuit says. Without the tax deduction, the fund could be out millions of dollars.

And for all of the effort to rejuvenate districts and stitch funding gaps, this deal may leave a hole in Dallas tax revenue, and carve a new one in a Wisconsin pension.

Innovative indeed.

Barron’s

By Mary Childs

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