



ENGLEHORN V. STANTON—BACKGROUND

Executive Summary

When Phoenix tops Manhattan, Seattle, Los Angeles, Boston, and Silicon Valley in net office space leasing, you have to wonder: Does Phoenix really need to subsidize real estate developers?

The City seems to think so. In spite of over \$4 billion invested in downtown Phoenix since 2007, the City continues to give away taxpayer money. The City just agreed to give more than \$8 million to a private developer to subsidize a 19-story multi-million-dollar “micro-apartment” building. The furnished micro-apartments will be tiny (350 to 600 square feet) and expensive (an average of \$1,350/month). Phoenix taxpayers will have to pay more—or see City services slashed—to cover the subsidized project.

But the framers of Arizona’s Constitution banned crony subsidies—so the Goldwater Institute is suing to stop this latest unconstitutional gift.

In exchange for trivial lease payments, the City is letting Denver-based Amstar/McKinley pay zero property taxes for 8 years—not a single penny for almost a decade. Then, the City has promised another 17 years of reduced taxes to this developer—which guarantees higher taxes for everyone else. This scheme is called the Government Property Lease Excise Tax or GPLET (pronounced “jeep-let”) and its abuse is rampant in Phoenix, Tempe, and other cities. GPLET hides property from the tax rolls and unfairly shifts the tax burden to existing residents and businesses.

A shell game designed to hide politically preferred property from the tax rolls, GPLET guts local tax revenues and leaves taxpayers statewide to backfill the difference in school, hospital, and county budgets. The game works like this: a developer conveys land to a city, the city declares it “blighted,” and then the city leases it back to the developer. Voila, the land is now government property, exempt from property taxes. In theory, the developer would owe the excise tax for leasing government property, but in reality GPLET is routinely abated for at least eight years. Meaning favored developers pay no tax at all for almost a decade.

GPLET abatements leave gaping holes in school-district, community college, hospital, and county budgets, which rely on property-tax revenues for their bread and butter. But funding rules

mean that the state general fund must make up the difference. That means taxpayers in Tucson are paying to subsidize luxury high-rises in downtown Phoenix, and folks in Yuma are paying developers to put up office buildings on Tempe Town Lake. That's unfair, and it's unconstitutional.

The Arizona Constitution doesn't allow governments to give special subsidies to preferred developers because that sort of crony corporate welfare starts a race to the bottom to see which government can give away the most taxpayer dollars for the flashiest project. Instead, the Constitution allows broad-based economic development policies that apply to everyone, such as mandating that all property taxes be equal among similar properties and prohibiting the government from handing out gifts or special privileges to businesses.

If Arizona cities think property tax rates are too high, they should lower tax rates for everyone, not use GPLET to let the politically connected few avoid paying any property taxes at all.

Worse still, the new micro-apartment subsidy is based on bogus blight. GPLET is supposed to be limited to the worst parts of town. But Phoenix hasn't updated its downtown blight findings since 1979—despite decades of rapid growth in the area.

Because GPLET violates the Gift, Uniformity, Conveyance, and Special Law Clauses of the Arizona Constitution, Goldwater Institute attorneys are representing Phoenix taxpayers in a lawsuit to put a stop to GPLET abuse statewide.

The Problem

The Arizona Government Property Lease Excise Tax (GPLET), A.R.S. § 42-6201–6210, was established in 1996.¹ GPLETs allow cities, towns, counties, and county stadium districts to lease government-owned tax-exempt property to private parties, the government then collects a lease excise tax in lieu of property tax. In theory, this would create a revenue stream where none existed before. And because GPLETs are determined by factors such as square footage and primary use of the property rather than the value of the property, the excise tax is dramatically lower than property tax, creating a win-win situation for both parties—the government gets a new revenue stream, and the private party gets a substantial discount on taxes, theoretically allowing it to invest more money into the community. In practice, however, the exchange is rarely so earnest. GPLET laws allow governments to abuse their tax-exempt status by taking ownership of private property—which is naturally subject to property taxes—only to then turn around and lease it back to the private party, creating a special tax break for the lessee and a lower revenue stream for the government rather than a brand-new revenue stream.

But it gets worse.

¹ *Special Audit Report of the Government Property Lease Excise Tax*, Arizona Auditor General, Dec. 22, 2015, available at: https://www.azauditor.gov/sites/default/files/15-307_Report.pdf.

Under A.R.S. § 42-6208, many lessees are exempt from paying GPLET *at all* based on the nature of the property improvement. This means there is a long list of lessees who are not subject to the excise tax, like World View in Pima County (because it is leasing “[p]roperty that is used for or in connection with aviation”²). In fact, based on a review of government property improvement leases in 2014, almost half of the lease agreements were exempt from paying GPLET—meaning no taxes were collected.³

But wait, it gets even worse.

Even for property not on the permanent tax-free list, most lessees don’t pay taxes at all for eight years.⁴ Under A.R.S. § 42-6209, municipalities can relinquish GPLETs for eight years if (1) the property is in a “slum or blighted area” within a central business district, and (2) the development will result in a one hundred percent increase in the property value. This makes it very easy for a private party to meet the standard in cities like Phoenix, where private owners sitting on vacant lots within the central business district can easily increase their property value simply by building anything on the land, which is exactly what is happening in this case.

The GPLET setup is bound to fail.

First, because GPLETs are so much lower than property taxes, GPLET revenue distributed to other taxing entities is also much lower.⁵ This results in higher tax rates for everyone else to help offset lost revenue from GPLETs and GPLET abatements.⁶ Compounding this problem is the fact that GPLETs are rarely assessed properly because the lessee—not the government—is responsible for calculating the tax.⁷ In fact, in a random sample of twelve GPLET leases, the

² A.R.S. § 42-6208(5).

³ *Special Audit Report of the Government Property Lease Excise Tax*, Arizona Auditor General, Dec. 22, 2015, available at: https://www.azauditor.gov/sites/default/files/15-307_Report.pdf.

⁴ Jennifer Stielow, *My Turn: The Truth about Phoenix's Property Taxes*, May 5, 2016, available at <http://www.azcentral.com/story/opinion/op-ed/2016/05/05/phoenix-property-taxes-stielow/83853586/>.

⁵ Jennifer Stielow, *My Turn: The Truth about Phoenix's Property Taxes*, May 5, 2016, available at <http://www.azcentral.com/story/opinion/op-ed/2016/05/05/phoenix-property-taxes-stielow/83853586/>.

⁶ Jennifer Stielow, *My Turn: The Truth about Phoenix's Property Taxes*, May 5, 2016, available at <http://www.azcentral.com/story/opinion/op-ed/2016/05/05/phoenix-property-taxes-stielow/83853586/>.

⁷ *Special Audit Report of the Government Property Lease Excise Tax*, Arizona Auditor General, Dec. 22, 2015, available at: https://www.azauditor.gov/sites/default/files/15-307_Report.pdf.

Arizona Auditor General found that lessees incorrectly calculated GPLET liability in eleven of those leases, resulting in a loss of \$236,556 in GPLET revenue.⁸ This means that school districts don't receive all the GPLET revenues due to them.⁹

It could be better, but it isn't.

There are two situations in which GPLET deals could result in either a new or higher revenue stream. In the first, the government owns vacant property, which it leases to a developer, who then improves the land and subsequently pays the excise tax because the property is not exempt and does not qualify for an abatement. This would produce a new revenue stream. In the second situation, a developer owns vacant property that it conveys to the government, which then leases the property back to the developer, who then improves the land and subsequently pays the excise tax because the property is not exempt and does not qualify for an abatement. This would produce a higher revenue stream because the GPLET on the improved property would be higher than the property tax for the vacant land. The problem with these hypotheticals is that they hardly ever materialize. In a special report describing the many problems with GPLET, the Arizona Auditor General only found one lease that resulted in higher revenues.¹⁰

In reality, GPLET is routinely abated for eight years, which means that favored developers pay no excise tax at all for almost a decade. When the government relinquishes taxes on multi-million-dollar properties like the 19-story behemoth at issue in this case, everyone but the crony developer loses. GPLET abatements leave gaping holes in school-district budgets, which rely on property-tax revenues for their bread and butter. And because funding rules require that the holes be filled with money from the state general fund, taxpayers in Tucson are paying to subsidize luxury high-rises in downtown Phoenix, and folks in Yuma are paying developers to put up office buildings on Tempe Town Lake. That's unfair, and it's also unconstitutional.

The Law

The Arizona Constitution doesn't allow governments to give special subsidies to preferred developers because that sort of crony corporate welfare starts a race to the bottom to see which government can give away the most taxpayer dollars for the flashiest project. Instead, the

⁸ *Special Audit Report of the Government Property Lease Excise Tax*, Arizona Auditor General, Dec. 22, 2015, available at: https://www.azauditor.gov/sites/default/files/15-307_Report.pdf.

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¹⁰ *Special Audit Report of the Government Property Lease Excise Tax*, Arizona Auditor General, Dec. 22, 2015, available at: https://www.azauditor.gov/sites/default/files/15-307_Report.pdf.

Constitution allows broad-based economic development policies that apply to everyone, such as mandating that all property taxes be equal among similar properties and prohibiting the government from handing out gifts or special privileges to businesses. If Arizona cities think property tax rates are too high, they should lower tax rates for everyone, not use GPLET to let the politically connected few avoid paying any property taxes. Fortunately, provisions in the Arizona Constitution—including the Conveyance, Gift, Uniformity, and Special Law Clauses—as well as statutory limits on GPLET and competitive-bidding requirements make these types of deals illegal.

Conveyance to Evade Taxation

In 1980, voters amended the Arizona Constitution to prevent exactly this sort of shell game that transfers property only to avoid taxes. Article 9, § 2(12) of the Arizona Constitution provides that “[n]o property shall be exempt [from property taxes] which has been conveyed to evade taxation.”

The GPLET agreement shamelessly flouts this provision: “City acknowledges and agrees that the intention of the Parties is for all of the Site and eligible improvements on the Site subject to the Lease be subject to the Government Property Lease Excise Tax (“GPLET”) (and not to ad valorem taxation) during the term of the Lease and for the GPLET to be abated for a period of eight (8) years.”¹¹

The stated purpose of the agreement is to evade property tax. The developer is conveying its property to the City for no other reason and in violation of the Arizona Constitution.

Gift Clause

The Arizona Constitution prohibits state or local government from subsidizing or lending money to private companies. The “Gift Clause” makes it illegal for the County to “give or loan its credit in the aid of, or make any donation or grant, by subsidy or otherwise, to any . . . corporation.”¹² The Arizona Supreme Court made clear in a previous Goldwater Institute lawsuit that this means public expenditures must be for public purposes, not private—and when the government does pay a private entity with taxpayer money, the government must receive something of adequate value (“consideration”) in return. Indirect benefits—such as general economic improvement—are not enough to satisfy this rule.¹³

¹¹ Disposition and Development Agreement between the City of Phoenix, Arizona, and Amstar/McKinley LLC § 303.

¹² ARIZ. CONST. art. IX, § 7.

¹³ *Turken v. Gordon*, 223 Ariz. 342, 224 P.3d 158 (2010).

Subsidizing a privately owned high-rise apartment complex by gifting over \$8 million in property taxes, is not a public purpose. Taxpayers lose millions, and the profits flow to the private owners and investors—“depleting the public treasury by giving advantages to special interests.”¹⁴

And the City receives nothing of consequence in exchange for this multi-million dollar subsidy. Although the GPLET agreement requires the developer to pay rent to the City, the rent payments will never exceed the value of the favorable tax treatment. Thus, the developer receives a windfall, paid for by taxpayers—which is exactly what the Gift Clause prevents.

Uniformity Clause

The Arizona Constitution’s Uniformity Clause requires property taxes to be equally for all similar property.¹⁵¹⁶ It is a basic principle of fairness that prevents governments from playing games with property tax rates to favor their cronies.

Here, the City substituted the GPLET for property tax to try to avoid the Uniformity Clause. Because of the GPLET lease, the property at issue in this case won’t be taxed at the same rate as other apartment buildings in the same zip code, much less within the territorial limits of Phoenix. As a substitute for ad valorem property taxes, GPLET is only available to certain properties, and the abatement of GPLET is available to even fewer properties.¹⁷

This is the opposite of uniformity. Here, one high-rise apartment building pays zero taxes because of the GPLET abatement, while other apartment buildings pay the GPLET rate, while still other apartments pay the full property tax rate for class four property.¹⁸ The only real difference among the properties is whether and how much they are subsidized by the City. This is exactly what the Uniformity Clause prohibits.

Special Law Clause

¹⁴ *Wistuber v. Paradise Valley Unified Sch. Dist.*, 141 Ariz. 346, 349, 687 P.2d 354, 357 (1984) (citations omitted).

¹⁵ *Miners & Merchants Bank v. Board of Sup’rs of Cochise County*, 55 Ariz. 357, 361, 101 P.2d 461, 462-463 (Ariz.1940) (citing *Gila Meat Co. v. State*, 35 Ariz. 194, 276 P. 1).

¹⁶ Article 9, § 1 of the Arizona Constitution (the “Uniformity Clause”)

¹⁷ A.R.S. § 42-6209.

¹⁸ A.R.S. § 42-12004.

The Special Law Clause is a further limit on governments' ability to play with tax rates or "[g]rant[] to any corporation, association, or individual, any special or exclusive privileges, immunities, or franchises."¹⁹

An ordinance is an impermissible special law unless "(1) the classification is rationally related to a legitimate governmental objective, (2) the classification is legitimate, encompassing all members of the relevant class, and (3) the class is elastic, allowing members to move in and out of it."²⁰

In this case, Phoenix enacted City Ordinance S-42353 to execute the GPLET agreement with the developer. The ordinance, by its very nature, does not address a general matter related to the City's police powers. Instead, it creates a special class of one (the developer) to give the only member of that class a special privilege under an agreement that can only apply to the single class member.

The classification of this single member *is only* rationally related to a private and illegitimate interest. A special subsidy that allows a single private developer to avoid taxes is simply not a legitimate governmental objective. The classification is also inelastic because it only includes and will only *ever* include one person (i.e., no one else can ever become part of that class).

According to the City, one purpose of the GPLET agreement is to further its Downtown Area Redevelopment and Improvement Plan. But if Phoenix wants to redevelop and improve its downtown area, surely this goal would be better secured through the application of a general law that encourages multiple developers to compete and develop multiple projects. When the City enacts a special law that only benefits a single private developer, favoritism and cronyism thrive, taxpayers suffer, and fair competition becomes impossible. This is exactly why special laws are forbidden under the Arizona Constitution.

Mandatory Competitive Bidding

Arizona statutes also mandate a process of competitive bidding when a city leases property, in order to prevent favoritism, fraud, public waste, and unconstitutional subsidies by encouraging free and full competition.²¹

Because the developer agreed to convey its property to the City, the City—as legal owner of the property—is required to solicit bids before it can enter into an exclusive lease agreement with the developer, who has the exclusive option to purchase the property. Just like the constitutional

¹⁹ Article 4, pt. 2, § 19.

²⁰ *Town of Gilbert v. Maricopa County*, 213 Ariz. 241, 246, 141 P.3d 416, 421 (App. 2006).

²¹ A.R.S. § 9-402

protections discussed above, Arizona statutes do not allow the sort of preferential treatment that this deal relies on—and for exactly the same reason: “The potential for a subsidy is heightened when, as occurred here, a public entity enters into the contract without the benefit of competitive proposals.”²²

Arbitrary and Capricious Blight Designation

GPLET is supposed to be limited to the worst parts of town. But Phoenix hasn’t updated its downtown blight designation since 1979—despite decades of rapid growth in the area.

The definition of blight is extraordinarily broad and a city’s declaration of blight is often rubber-stamped by the courts. But here Phoenix didn’t even bother to pretend to make a realistic blight determination.

Despite billions of dollars of investment over the last ten years, the City did not take a fresh look at the blight designation when it approved the GPLET deal. Instead, it relied on its outdated 1979 declaration of slum and blight. In fact, the area in which the property is located is the site of tremendous economic activity, include several apartment and condo projects. Because the area is not slum or blighted, the City’s reliance on the 1979 declaration of slum and blight is arbitrary, capricious, and an abuse of discretion.

Case Logistics

The plaintiffs in this case are Phoenix residents, taxpayers, and business owners.

The subsidized development is next door to Plaintiff Angel’s Trumpet Ale House. The family owned-business has been employing dozens of workers since 2011, but the proposed 19-story apartment complex will tower over its quaint patio. Building the massive structure could endanger Angel’s Trumpet’s very existence—with a huge crane swinging across the property line and dangerous excavations required for the skyscraper’s footings. And if it does survive construction, Angel’s Trumpet will see its taxes continue to rise to subsidize the business next door.

The defendants are Phoenix city officials acting in their official capacities.

The case was filed in the Superior Court of Arizona in Maricopa County on March 1, 2017.

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²² *Turken*, 223 Ariz. at 350 ¶ 32.

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