

# City and County Options for Creative Financing: PFDs, PDAs and 501(c)(3)s

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Washington Economic Development Association's Spring Conference – April 15-16, 2003

# City and County Options for Creative Financing: PFDs, PDAs and 501(c)(3)s

## ALTERNATIVE FINANCING MECHANISMS

While cities and counties look first to traditional means to construct, finance and operate capital facilities, in recent years they have also looked to alternative approaches available under existing law to meet public policy goals. Under the right circumstances, public facilities districts, public development authorities and non-profit corporations, for example, offer potential advantages not available through traditional means. Some of these advantages include: new sources of revenue, limited liability for the city or county, more entrepreneurial decision making, opportunities for private citizen involvement and alternative contracting methods. At the same time, many of these alternative structures are subject to the same legal constraints as cities and counties. The purpose of this paper is to identify and compare the advantages and disadvantages of these alternative approaches to assist decision makers in weighing their options.

### Traditional Means

For the purpose of this discussion, the term “traditional means” means ownership, development and financing of a capital facility by a city or county. It implies that legislative decisions will be made by a city council or board of commissioners, that the facility will be a “public work” subject to competitive bidding and prevailing wages, that it will be constructed under the auspices of and managed by personnel of the city or county, and that all processes will be subject to public disclosure conducted at the pace and under the scrutiny of normal public decision making. Consideration of alternatives to this approach is not meant to evade public process or reduce public policy standards; it is only to suggest that these goals can be met in other ways and with potential advantages.

### Public Development Authorities

Public development authorities or PDAs can be established by cities or counties pursuant to state law to perform public functions. PDAs are instrumentalities of their creating jurisdiction. They are often created to manage the development and operation of a single project, which the city or county determines is best managed outside of its traditional bureaucracy and lines of authority. The particular project may be entrepreneurial in nature and intersect with the private sector in ways that would strain public resources and personnel. For example, the Pike Place Market is a Seattle PDA and essentially acts as the landlord to scores of retail establishments and nonprofit services provided in a series of historic buildings. The City has determined that day-to-day operations of such an enterprise is best managed by professionals independent of the City, given the untraditional nature of the enterprise and the importance of responding to the unique needs of the private retail marketplace. PDAs can issue tax-exempt bonds, but have no power of eminent domain or taxing authority.

### Public Facilities Districts

Public Facilities Districts or PFDs can be established by cities or counties pursuant to state law for the limited purpose of developing certain regional facilities, such as convention or special events centers. In addition, they can contract with other public agencies such as cities, counties and other PFDs to develop such facilities. PFDs are authorized to impose a local sales tax credited against the state sales tax and thus can contribute significant new special revenues to certain public projects.

Their ability to impose this tax is subject to numerous legal constraints and their independence creates both opportunities and issues that need to be fully understood.

### Nonprofit Corporations

Nonprofit corporations are entities that are independent of government. They can enter into contracts with governments and under certain circumstances can issue tax-exempt bonds for projects that will eventually be owned by government. In addition to the potential of providing tax-exempt financing to a project, they offer the opportunity to shift the risks and costs of construction away from the government. They can bring private resources and decision makers to the transaction that might otherwise be unavailable.

### Comparisons

	Cities-Counties	PDA's	PFDs	Nonprofits
General Authority	Title 35 RCW Title 36 RCW	RCW 35.21.730	Ch. 35.57 RCW Ch. 36.100 RCW	Title 24 RCW
Eminent Domain	Yes	No	No	No
Taxing Authority	Yes	No	Yes	No
Subject to Open Public Meetings	Yes	Yes	Yes	No
Subject to Lending of Credit Constraints	Yes	Yes	Yes	No
Governance	Elected Councils	RCW 35.21.745	RCW 36.100.020 RCW 35.57.010	RCW 24.03.095
Tax-Exempt Contributions	Yes	Yes	Yes	Yes (if 501(c)(3))

### Assessing the Options

The following are a list of questions with some discussion to help assess whether an alternative structure could be useful and if so, which structure might best serve the needs of the city or the county. Many of these choices depend on the specific fact situation including the nature of the facilities being considered, the availability of personnel within the city or county to be involved with such projects, the willingness of members of the private sector to participate, specific funding sources, political climate, etc., and thus the examples are meant to be illustrative only.

What is the project to be owned, constructed and operated? Most PDAs in Washington are involved in single projects and the charter, bylaws and composition of the board are focused on the particular features of that project. In Seattle, for example, there are multiple, separate PDAs, each with a very limited and focused scope of activities, funding sources, and board chosen for the specific type of project. Some PDAs have broader mandates, e.g. general economic development, and thus could be involved with multiple projects. Regardless of the potential scope of PDA activities, each financing is likely to be project-based, rather than cross-collateralized, in the absence of a robust source of general revenues made available from the city or county or other sources. PFDs are by their nature focused on particular types of regional projects that can be funded from their specially authorized local sales taxes. PFDs generally focus on one project, though it is conceivable to have more than one eligible project within the jurisdiction of the PFD. Nonprofit corporations are often formed to accomplish a particular project and for financing purposes are usefully limited to single assets to avoid bankruptcy problems.

Would the project be benefited by private sector involvement? PDAs, PFDs and nonprofit corporations provide the opportunity to involve private sector participants in meaningful project decision making. Sometimes individuals in the private sector have particular experience, expertise or credibility that would benefit a public project, but they are unwilling to participate because participation involves politics, dealing with the bureaucracy, or entering a foreign and perhaps intimidating public culture. The appointment of such individuals to a PDA, PFD or nonprofit board may be of enormous benefit to the project. It may relieve the elected officials of the city or county from the responsibility of day-to-day decision making for the project and free the decision making with respect to the project from the political pressures of city hall or the county courthouse. If done carefully, these alternative structures can balance the independence of private decision making with the transparency of public decision making.

Can more than one model be used for a project? By contract or interlocal agreement, the respective assets of various entities can be brought to a transaction. For example, a tourist facility may need sales taxes from a PFD and lodging taxes from a city, as well as the support of board members from the hospitality industry. The project may be leased from a public owner or a private nonprofit. The project may itself be a unit in a condominium composed of various units owned by public and private entities. Various roles with respect to construction, ownership and operations can be allocated by agreement between entities, subject to various state statutes and the state constitution, in particular the prohibition against gifts of public funds and the lending of public credit.

Are these projects subject to public bidding and prevailing wages? If the project is built on public land and will be publicly owned, it will be a public work subject to public bidding or alternative public procurement procedures and prevailing wages. If the project is constructed and owned by a private entity on private land but more than 50% will be used by the public, then its construction is subject to prevailing wages. If the project is built on private land with private funds, but is sold on a turnkey basis upon construction to a public entity, it is probably not subject to public procurement procedures but would be subject to prevailing wages. These are complicated issues of interpretation and potential disagreement.

Can a city or county maintain control over a PFD, PDA or nonprofit corporation? Through contracts, including leases and interlocal agreements, oversight, accountability and control can and should be clearly specified. Nonetheless, each of these entities does have a degree of autonomy, and enforcement of contractual rights and obligations against them may be problematic in a public setting. In short, the arms length relationship between a city or a county and a PFD, PDA and/or nonprofit corporations can both protect the city and the county from liability and financial risk and cause it to have less control that it would enjoy if it acted traditionally and alone. The city or county will need to weigh the advantages of this distance with the disadvantages of reduced control, and mitigate the risk through clear legal provisions and, when possible, prudent appointments.

## **Conclusion**

There are a number of potential alternative structures that provide possible advantages to a city or county contemplating the development of major public facilities. The advantages and potential disadvantages are dependent on a spate of variables that change from project to project and jurisdiction to jurisdiction. Nonetheless, there are enough examples of successful projects and alternative structures that decision makers should consider whether to proceed in less traditional ways.

## PUBLIC DEVELOPMENT AUTHORITIES

### A. What Are Public Development Authorities?

Public development authorities, or PDAs, are public corporations created by a city or county to perform a particular public purpose or public function specified in the ordinance or resolution creating the PDA and its charter. RCW 35.21.730. Although PDAs may be created for a general purpose, PDAs are more often created for a specific project or undertaking reflected in the PDA's charter.

### B. Why Are Public Development Authorities Formed?

PDAs are created to (1) administer and execute federal grants or programs; (2) receive and administer private funds, goods or services for any lawful purpose; and (3) to perform *any lawful public purpose or public function*. RCW 35.21.730(5). PDAs are frequently created to undertake a specific project or activity requiring focused attention. PDAs tend to be more entrepreneurial than their sponsoring municipality, involving private sector participants as board members or partners. PDAs allow municipalities to participate in projects that they may be otherwise disinclined to partake in due to project risks and competing priorities of the municipality.

### C. What Powers Do Public Development Authorities Have?

The powers of a PDA are provided in chapter 35.21 RCW. PDAs may:

- Own and sell real and personal property;
- Contract with a city, town or county to conduct community renewal activities;
- Contract with individuals, associations, corporations, the State of Washington and the United States;
- Sue and be sued;
- Loan and borrow funds and issue bonds and other instruments evidencing indebtedness;
- Transfer funds, real or personal property, property interests or services;
- Engage in anything a natural person may do; and
- Perform all types of community services.

### D. How Are Public Development Authorities Formed?

A city or county may form a PDA by passing an ordinance or resolution approving the PDA's charter. The charter will include the PDA's name, scope of the project or purpose, the term of the PDA, and board characteristics. The charter may provide for municipal oversight and limit the liability of the creating municipality. Because PDAs are separate legal entities, all liabilities incurred by the PDA must be satisfied exclusively from the assets of the PDA, except as otherwise agreed by contract. PDA

creditors do not have any right of action against or recourse to the creating municipality, or its assets, on account of the PDA's debts, obligations, liabilities or acts or omissions.

**E. How Are Public Development Authorities Governed?**

The PDA's charter establishes the PDA's governing body composition, size, and nomination process. The PDA's charter also usually determines the term of the PDA. The charter may include a sunset provision, which may automatically dissolve the PDA upon completion of the project or its financing. Alternatively, if the PDA has a broader mandate encompassing numerous phases of an ongoing project or a general endeavor, the PDA's existence may be indefinite. PDA staffing, administrative costs, and oversight requirements may vary as the particular undertakings differ.

The creating municipality will have limited control over the PDA, but will not be relieved of all oversight responsibility. By statute, the city or county must oversee and control the PDA's operations and funds in order to correct any deficiency and to assure that the purposes of each project are reasonably accomplished. The municipality may further specify the level of autonomy, oversight, accountability, and control it will have over the PDA in the PDA's charter or in any contracts or leases the municipality executes with the PDA.

**F. What Type of Projects Can Public Development Authorities Construct, Operate and Finance?**

A PDA may undertake any "public purpose" specified in its charter. Examples of projects include developing the Seattle Art Museum, assisting in the development of the Museum of Flight at Boeing Field in King County, developing City Hall on Mercer Island, restoring Officers' Row in Vancouver, managing the Pike Place Market in Seattle, and developing the Convention Center in Bellevue.

**G. What Resources Do Public Development Authorities Have?**

PDA's do not have the power of eminent domain or the authority to levy taxes. RCW 35.21.745. A PDA may borrow funds or issue tax-exempt bonds. Despite broad authority to undertake various projects, PDA financing is generally project specific. To facilitate access to the financial markets, PDA project financings are often backed by a city or county guarantee, typically in the form of a contingent loan agreement.

**H. Can Public Development Authorities Issue Tax-Exempt Bonds?**

PDA's can issue tax-exempt bonds pursuant to RCW 35.21.735. As noted above, PDA's do not have taxing authority, and so can pledge only project, grant or other revenues to repay bonds.

In order to access financial markets at attractive rates, PDA project revenue bonds are often backed by a city or county guarantee or contingent loan agreement. If the agreement is contingent in nature, it should not be a debt of the city or county for the purposes of constitutional and statutory debt limitations, but will need to be identified on the city or county financial statements.

There are numerous federal tax law considerations that a PDA must take into account when financing a project through tax-exempt debt. For the bonds to be tax-exempt, the project must be used for a public purpose, as opposed to a private activity, and must be repaid from public funds and not

private sources. Any private management contract must meet the safe harbor provisions under the federal tax code.

#### **I. What Are Examples of Recent Public Development Authority Projects?**

Recent projects completed by PDAs include the Village Square project completed in two phases by the Seattle Chinatown-International District Preservation and Development Authority (“SCIDPDA”), a PDA created by The City of Seattle. The project includes affordable family housing, a Seattle Parks Department recreation center and Seattle Public Library branch, as well as senior housing, retail space and space for health and social service non-profit agencies.

The Foss Waterway Development Authority, a PDA created by the City of Tacoma, facilitates redevelopment of previously contaminated areas of Tacoma’s Foss Waterway, entering into agreements with private developers interested in developing parcels in a manner consistent with the City’s plan for the Waterway.

The Seattle Art Museum is a tenant in the museum owned by the Museum Development Authority, a PDA formed by The City of Seattle. The PDA Board is composed in part of members nominated by the Seattle Art Museum. The PDA is undertaking an expansion of its space. Washington Mutual, the Seattle Art Museum and the PDA are planning for joint development of a 40-story downtown tower that would provide new corporate headquarters for the bank and allow the museum ultimately to triple in size.

#### **J. What Are the Disadvantages and Advantages of Forming a Public Development Authority?**

A potential disadvantage of forming a PDA is the relatively low level of control the creating city or county has over the PDA or the project. Although the creating municipality has oversight responsibilities for PDA operations to assure the purposes of the PDA are fulfilled, generally the creation, management, and facilitation of the project is in the hands of the PDA’s governing board. Despite contract or charter provisions providing for oversight and control over the PDA, the PDA remains autonomous. The lack of control over the project and the PDA, however, may be beneficial for the city or county for it reduces liability and financial risk for the city or county. A PDA also provides a vehicle for a city or county to support a project without diverting city or county staff to the undertaking and to attract private citizens to serve on the PDA board.

#### **K. What Legal Requirements Apply to Public Development Authorities?**

Generally, a PDA is subject to all “general laws regulating local governments, multimember governing bodies, and local government officials.” RCW 35.21.759. Such legal requirements include, but are not limited to, compliance with the following laws:

- To be audited by the State auditor and to be subject to various accounting requirements provided by chapter 43.09 RCW;
- Open public record requirements under chapter 42.17 RCW;
- Open public meetings and other public process laws as provided in chapter 42.30 RCW;

- Public works requirements under chapter 39.04 RCW;
- Competitive bidding and prevailing wage laws provided in chapter 39.04 RCW;
- Local government whistleblower laws as provided in chapter 42.41 RCW;
- The prohibition on using PDA facilities for campaign purposes under RCW 42.17.130; and
- The Code of Ethics for municipal officers under chapter 42.23 RCW.

A PDA is also subject to constitutional constraints imposed on local governments, primarily limiting the use of public funds. Article VIII, Sections 5, 7 of the Washington Constitution prohibit the lending of public credit or gift of public funds to private entities, with limited exceptions. Furthermore, Article VII, Section 1 and Article VIII, Section 6, require that public debt be incurred and taxes levied exclusively for public purposes. Such constitutional constraints are often triggered when a PDA is formed to encourage private sector investment.



## **PUBLIC FACILITIES DISTRICTS**

### **A. What Are Public Facilities Districts?**

Public facilities districts (“ PFDs”) are municipal corporations created by a city or county to perform specific statutory functions. RCW 35.57.010 (the “City PFD statute”); 36.100.010 (the “County PFD Statute”). Under the City PFD Statute, PFDs can also be created jointly by a number of contiguous cities or by a combination of such cities and counties. Cities in King County are not eligible to create PFDs.

Unlike PDAs, PFDs are limited by statute to certain purposes. PFDs created under the City PFD Statute may only develop and operate “regional centers”. Regional centers are defined to include “convention, conference, or special events center, or any combination of facilities, and related parking facilities, serving a regional population constructed, improved, or rehabilitated after July 25, 1999, at a cost of at least \$10,000,000, including debt service.” RCW 35.57.020(1).

PFDs formed under the County PFD Statute have slightly broader powers. County PFDs are authorized to develop and operate sports facilities, entertainment facilities and convention facilities in addition to “regional centers” as defined above, together with contiguous parking facilities. In other words, County PFDs can develop and operate sports, convention and entertainment facilities that do not meet the \$10 million threshold and other specific requirements for regional centers (note, however, that the nonvoted sales tax under RCW 82.14.390 can only be used for qualifying regional centers, regardless of whether the tax is collected by a City PFD or a County PFD).

### **B. Why Are Public Facilities Districts Formed?**

PFDs are created to fulfill these statutory purposes: that is, to develop and operate regional centers or, in the case of County PFDs, to develop and operate other sports, entertainment or convention facilities. Since 1999, a number of PFDs have been formed to access the nonvoted sales tax that has been available under RCW 82.14.390 for regional centers. Because convention and special event centers typically are difficult to finance only from project revenues (i.e., they ordinarily require some level of tax or other subsidy, at least initially), PFDs have been formed to help finance these projects.

### **C. What Powers Do Public Facilities Districts Have?**

The powers of City and County PFDs are provided in the City PFD Statute and the County PFD Statute, respectively. PFDs may engage in any of the following:

- Acquire, construct, own, remodel, maintain, equip, re-equip, repair, finance, and operate one or more regional centers (in the case of County PFDs, this authority is broadened to include sports facilities, entertainment facilities and convention facilities that don't meet the regional center definition);
- Buy or lease property;

- Enter into contracts, specifically including contracts with any city (or county, in the case of County PFDs) for the purpose of exercising any powers of a community renewal agency under chapter 35.81 RCW as well as management contracts with a public or private entity;
- As municipal corporations, to enter into interlocal agreements under chapter 39.34 RCW (in the case of County PFDs, this authority is to “enter into agreements under chapter 39.34 RCW for the joint provision and operation of such facilities”);
- Impose charges and fees for the use of its facilities;
- Accept gifts, grants, and donations;
- Impose the following taxes: nonvoted sales tax, voted sales tax, parking tax, and admissions tax (County PFDs have the further authority to impose voted lodging taxes as well as voted property taxes);
- Issue general obligation bonds (subject to debt limitations) and revenue bonds;
- Use design-build and GCCM supplemental alternative public works contracting procedures in connection with regional centers (either alone or by a City PFD in conjunction with a City); follow an RFP process to secure services by means of a service provider agreement; and follow procedures contained in RCW 43.19.1906 and 43.19.1911 for other purchases, contracts for purchase, and sales.

In addition to these specific powers, PFDs have the usual powers of corporations for public purposes, including without limitation, hiring staff and suing/being sued. Limitations on authority are often set forth in the ordinance/resolution forming the PFD or in the PFD charter.

#### **D. How Are Public Facilities Districts Formed?**

A city or county may form a PFD by ordinance or resolution. PFDs formed by more than one city (or a combination of cities and counties) are formed by interlocal agreement. The statute does not specifically contemplate the approval of a charter to govern the PFD, but most PFDs have charters and bylaws that fulfill this purpose.

#### **E. How Are Public Facilities Districts Governed?**

The City PFD Statute and the County PFD Statute set forth the procedures for selecting boards of directors to govern PFDs. City PFD boards consist of five or seven members (depending on whether they are single city, multi-city or combined city-county PFDs) selected by the city council (or county commissioners), a portion based on recommendations from local organizations such as local chambers of commerce, local economic development councils, and local labor councils.

County PFD boards also consist of five or seven members (depending on ratio of the population of the largest city in the county to total county population). Specified numbers of the members are appointed by the county council and, in some cases, the largest city’s council and other boardmembers. In the case of the Washington State Major League Baseball Stadium PFD, specified numbers of members of the board are appointed by the governor and the county executive subject to confirmation by the county council. If a County PFD imposes a lodging tax, then the board must include a representative of the lodging industry. The authority that cities and counties have to appoint PFD boardmembers is a key control, under the City PFD Statute and the County PFD statute, over the PFD.

## **F. What Type Projects Can Public Facilities Districts Construct, Operate and Finance?**

As noted above, City PFDs are authorized only to do regional centers. County PFDs are also authorized to do other convention, entertainment and sports facilities and contiguous parking. Regional centers are specifically defined in the City PFD Statute. PFDs can develop more than one regional center, but each regional center must satisfy the following requirements embedded in the regional center definition.

- Convention, conference, or special events centers (the statute was amended in 2002 to add a definition for special events center: “a facility, available to the public, used for community events, sporting events, trade shows, and artistic, musical, theatrical, or other cultural exhibitions, presentations, or performances”);
- Related parking facilities;
- Serving a regional population;
- Constructed, improved, or rehabilitated at a cost of at least \$10 million, including debt service;
- Conclusively presumed to serve a regional population if the total public cost is at least \$10 million.

RCW 82.14.390 allows PFDs to impose a 0.033 percent nonvoted sales tax to be used to finance regional centers. The tax is not a new tax from the perspective of taxpayers, as it operates as a credit against the amount that would otherwise be remitted to the state. RCW 82.14.390 places additional restrictions on regional center projects financed with this tax:

- The PFD must have been created before July 31, 2002;
- The PFD must commence construction of the regional center project before January 1, 2004;
- The facility must be financed over no more than a 25-year period (because the tax expires when the bonds issued for the construction of the regional center and related parking facilities are retired, but not more than 25 years after the tax is first collected);
- The amount of sales tax collected by the PFD must be matched with a one-third match from other public or private sources (not including other nonvoted PFD taxes). The match can be in cash or in-kind. The match is measured against collections, and so presumably can be met (and must be adjusted) over time as collection occurs.
- If both a County PFD and a City PFD impose the tax within the same area, the City PFD tax is credited against the County PFD's tax.

A number of legal issues arise with respect to PFDs: whether a particular obligation is a debt of the PFD for the purposes of statutory debt limitations, whether the PFD can serve as a conduit funder (or must have an ownership interest in the facility financed), what qualifies for the required match under RCW 82.14.390, what is required to satisfy the January 2004 deadline for commencement of construction, how to accommodate the unusual PFD statutory authority to issue general obligation and revenue bonds, what constitutes a qualifying regional center, and how to address the credit risks associated with sales and lodging tax-backed bonds. There are additional legal, policy and financing issues that arise in any public/private transactions such as issues regarding the selection of private

partners, gift of public funds questions, whether the project is a public work requiring competitive bidding, whether prevailing wages must be paid by the contractor, and the allocation of construction and operating risk.

#### **G. What Resources Do Public Facilities Districts Have?**

Unlike PDAs, PFDs have the power to impose both voted and nonvoted taxes. Like PDAs, PFDs also have authority to generate project revenues from user fees. Resources include:

- Charges and fees for the use of facilities
- Gifts, grants, and donations
- State sales tax credit (up 0.033% of the sales price; Regional Centers only)
- Voter-approved lodging taxes (County PFDs only)
- Voter-approved excess property tax levies (County PFDs only)
- Admission taxes (up to one cent on twenty cents of admissions charges; Regional centers)
- Parking taxes (up to 10%; Regional centers)
- Voted sales taxes (up to two-tenths of 1%)

#### **H. Can Public Facilities Districts Issue Tax-Exempt Bonds?**

PFDs can issue tax-exempt or taxable bonds, either as general obligation bonds or as revenue bonds. General obligations are backed by the full faith, credit and resources of the PFD and are subject to statutory debt limitations. Any bonds backed by taxes are ordinarily viewed as debt subject to these limitations. Revenue bonds are not debt for the purposes of these debt limitations and are backed by net revenues of the project financed. PFDs may issue double-barreled bonds (for example, backed by both tax receipts and net project revenues).

Tax-exempt financing can reduce the cost of developing a regional center or other project. There are numerous federal tax law considerations that a PFD should take into account in order to take advantage of this resource. Generally, for bonds to receive tax-exempt status, the project financed by the bonds must be used for a public purpose, as opposed to a private activity, and must be repaid from public funds and not private sources. Any management contract with a private party must meet the safe harbor requirements under the federal tax code.

#### **I. What Are Examples of New Public Facilities Districts?**

The oldest Washington PFD is the Spokane PFD, formed in 1989 to complete the Spokane Veterans Memorial Arena (the Spokane PFD is currently planning a number of improvements including an expansion of the Spokane Convention Center; the Fair and Expo Center Grandstand to be developed in partnership with Spokane County; and CenterPlace at Mirabeau Point to be developed in partnership with the new City of Spokane Valley). The King County major league baseball stadium was also developed by a PFD (and the County PFD Statute has a number of special provisions that apply to just baseball PFDs).

A large number of PFDs have been formed since 1999 to take advantage of the nonvoted sales tax available under RCW 82.14.390 for regional centers that commence construction by January 1, 2004.<sup>1</sup>

- Bellingham-Whatcom County PFD (created July 2002). The Bellingham-Whatcom County PFD is working to complete a cultural center, including the renovation and expansion of the Mount Baker Theatre. Other projects may include the partial renovation of the Whatcom Museum; and the future conversion of the existing Bellingham Library building for Museum uses, such as for a Children's Museum and exhibit space.
- Snohomish County PFD (formed July 2001). The Snohomish County PFD jointly provides a number of regional centers with other City PFDs: the Everett Arena and related parking facility, the South Snohomish County Conference Center to be built in Lynnwood, and the Edmonds Centre for the Performing Arts. The Edmonds PFD, the Everett PFD, and the City of Lynnwood/South Snohomish County PFD are the City PFDs formed to complete these joint projects. The Everett PFD has issued interim financing for its project in the form of commercial paper backed by a bank letter of credit.
- Benton County PFD (formed July 29, 2002). Following a model similar to the Snohomish County PFD, the Benton County PFD was formed to support regional center projects completed jointly with City PFDs, such as the Kennewick PFD, the City of Prosser PFD, the City of Richland PFD, and the City of Pasco PFD. The Kennewick PFD is working to develop a convention center, while the Richland PFD is developing a campus of special events facilities including a historical museum, an interpretive center for the federal Hanford Reach National Monument and a tribal cultural center.
- A number of PFDs in Thurston County are also working on joint endeavors. The Lacey PFD was created in July 2002 and the Capitol Area Regional Public Facilities District was formed in June 2002 (by Thurston County and the Cities of Lacey, Olympia, and Tumwater). The Olympia project is a new conference center in downtown Olympia; the Lacey project is a sports complex.
- Grays Harbor County PFD (formed July 15, 2002). The Grays Harbor County PFD is working with the City of Ocean Shores to develop a new convention center in Ocean Shores. The City is considering a private/public transaction with a private developer interested in building hotel and other tourism facilities in Ocean Shores.
- Greater Tacoma Regional Convention Center PFD (formed October 12, 1999). The Tacoma PFD consists of Pierce County as well as the cities of Tacoma, Fife, Lakewood, and University Place. The PFD has financed a new convention and trade center. The City of Tacoma has issued two rounds of commercial paper financing for the project, backed by bank letters of credit. The financing was structured to include both general obligation and revenue components, to minimize impacts on the City's debt capacity.

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<sup>1</sup> Thanks to Alison Henshaw, Administrative Assistant, Bellingham-Whatcom Public Facilities District for compiling a list of all current PFD projects. The list included in this portion of the paper was drawn from Alison's materials.

- Vancouver PFD (formed October 18, 1999). The Vancouver PFD is working to develop a hotel and convention center. The City has also formed a PDA to assist in the transaction, which includes a number of public/private features.
- Yakima Regional PFD (formed in July 2001). The Yakima Regional PFD includes the Cities of Selah, Union Gap and Yakima. The Yakima Regional PFD is expanding the Yakima Convention Center. The City of Yakima issued LTGO bonds to finance the improvements, to be repaid with PFD nonvoted sales tax revenues.
- Cowlitz County PFD (formed December 27, 1999). The project is a Regional Conference and Special Events Center.
- Kitsap PFD (formed May 15, 2000). The Kitsap PFD is involved in two joint regional center projects: a Conference Center in Bremerton and a special events center at the Kitsap County fairgrounds. The projects have been financed through LTGO bonds issued by Kitsap County, to be repaid with nonvoted sales taxes collected by the PFD.
- Skagit Regional Public Facilities District (created August 14, 2001). The Skagit PFD is developing a performing arts and conference center in conjunction with and on the campus of Skagit Valley Community College. The Skagit PFD sold its general obligation sales tax bonds on April 1, 2003.

#### **J. What Are the Disadvantages of Forming a Public Facilities District?**

Because of the limited statutory purposes of PFDs, PFDs can only be used in limited circumstances. In the case of City PFDs, and in the case of any PFD project financed with the nonvoted sales tax, projects must be relatively large (at least \$10 million), must be either a convention/conference or special events center and must be underway (ready to start construction by January 1, 2004). Also, because the nonvoted sales tax is only available for PFDs created before July 31, 2002, the window for creating new City PFDs is essentially closed. A PFD could still be formed, but it would not be able to access the nonvoted sales tax, which has been the real attraction in forming PFDs in recent years.

Another disadvantage of forming a PFD is the relatively low level of control the creating city or county has over the PFD and any PFD project. Although the creating municipality holds the power of appointing all or a portion of the members of the PFD board, generally the development, management, and operation of projects is in the hands of the PFD's board. Contract or charter provisions may provide for oversight and control over the PFD. The practical utility of these controls may be limited. Should the city or county desire to take steps to enforce charter or contract provisions it will need to do so in a public setting, which may prove contentious. Likewise, any action to replace board members could be contentious in a public setting. The lack of control over the project and the PFD, however, may be beneficial for the city or county as it reduces liability and financial risk to the city or county.

**K. What Legal Requirements Apply to Public Facilities Districts/Public Facilities Districts?**

As a municipal corporation and taxing district, PFDs are subject to all laws that apply to such entities, including open public record requirements under chapter 42.17 RCW; open public meetings and other public process laws as provided in chapter 42.30 RCW; the prohibition on using PFD facilities for campaign purposes under RCW 42.17.130; to be audited by the State auditor and to be subject to various accounting requirements provided by chapter 43.09 RCW; and ethics requirements applicable to municipal officers under chapter 42.23 RCW.

A PFD is also subject to constitutional constraints imposed on local governments, primarily limiting the use of public funds. Article VIII, Sections 5, 7 of the Washington Constitution prohibit the lending of public credit or gift of public funds to private entities, with limited exceptions. Furthermore, Article VII, Section 1 and Article VIII, Section 6, require that public debt be incurred and taxes levied exclusively for public purposes. Such constitutional constraints are triggered particularly when a public/private partnership is formed due to the private sector involvement.

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# TAX-EXEMPT FINANCING BY NONPROFIT CORPORATIONS

By Cynthia M. Weed

## I. GENERAL BACKGROUND

States and political subdivisions are authorized, under federal tax law, to issue obligations, the interest on which is exempt from federal income taxation (“tax-exempt bonds”). Each state has statutes and administrative rules that outline the terms under which tax-exempt bonds may be issued. There are circumstances, however, when a political subdivision would prefer not to issue bonds for a project. These reasons may be legal, practical or political. A facility may qualify for tax-exempt financing, because of its use by a governmental entity; nevertheless, the governmental entity elects not to finance the project with its own tax-exempt bonds. An alternative method of obtaining tax-exempt financing is available under the Internal Revenue Code. This method of financing is commonly referred to as “63-20” financing. The term “63-20” comes from the Department of Treasury Revenue Ruling which first described and authorized this type of tax-exempt financing (in 1963).

In a 63-20 financing, a nonprofit corporation (qualified under the nonprofit corporation laws of a state) may issue tax-exempt debt for the purpose of financing facilities as long as certain requirements are met. The most well-known requirement is that title to the facilities must be transferred to a governmental entity when the debt is retired. Revenue Ruling 63-20 and all of the subsequent positions of the Internal Revenue Service, have been compiled in a subsequent official announcement, Revenue Procedure 82-26. (See “Federal Tax Issues” below).

Interest on 63-20 debt is exempt from federal income taxation. The cost of capital is, therefore, lower than it would be in the conventional capital markets.

Historically, 63-20 debt was primarily used for nonprofit corporations, qualified under Section 501(c)(3) of the Internal Revenue Code, to access the tax-exempt bond market. For example, Kadlec Hospital in Kennewick issued tax-exempt bonds in the 1970s to finance its hospital expansion. More recently, 501(c)(3) organizations in Washington have the option of obtaining tax-exempt financing through: (i) Washington Health Care Facilities Authority; (ii) Higher Education Facilities Authority, or (iii) Washington State Housing Finance Commission. WSHFC is the general issuer, with health care facilities and higher education facilities directed to the other issuers respectively. There are circumstances, however, when a nonprofit corporation will prefer not to use these issuers. In these cases, a 63-20 financing remains as a viable option.

63-20 debt is sold as tax-exempt bonds generally in the same financial markets as governmental tax exempt bonds. The interest rates may be comparable, depending upon the credit strength of the collateral security.



The tenant of a facility is required to be either a governmental entity or a charitable organization (qualified under Section 501(c)(3) of the Internal Revenue Code). *But see* III.

Other Tax Considerations Affecting Tax Exemption. An underwriter may underwrite long term (20 years or more) bonds issued by the nonprofit corporation. The credit support for the bonds comes from the lease of the facility to the governmental agency. The bonds may be issued on a nonrecourse basis to the nonprofit corporation, *i.e.*, the bonds would be secured solely by lease revenues. In a nonrecourse financing, the owners of the bonds would have no recourse against any other assets of the corporation.

## II. FEDERAL TAX LIMITATIONS

63-20 financing is specifically authorized by federal tax law and, therefore, is subject to the limitations established by the Internal Revenue Service. Revenue Procedure 82-26 is a compilation, in a single document, of all of the Internal Revenue Service positions concerning Revenue Ruling 63-20. Based upon this Revenue Procedure, the requirements of Revenue Ruling 63-20 are as follows:

### A. Not for Profit

The issuer of the bonds must be organized under the general nonprofit corporation law of the state, and its articles of incorporation must provide that it is not organized for profit. The state of incorporation must be the same as the state where the facilities to be financed are located.

### B. No Private Inurement

The articles of incorporation must provide that none of the corporation's income may inure to the benefit of any private person.

### C. Public Activities

The activities of the corporation must be essentially public in nature. This requirement is automatically met if the activities and purposes of the corporation are permitted under the general nonprofit corporation law of the state.

### D. Location of Facilities

The facilities financed by the bonds must be located within the geographic boundaries of the political subdivision on whose behalf the bonds are being issued or, if outside such boundaries, there must be a substantial economic nexus between such facilities and the political subdivision.

### E. Finance Tangible Property

All of the original and investment proceeds of the bond issue must be applied to tangible real or personal property, costs of issuance, underwriters' discount, interest during construction, or to fund a reserve. There are several significant points made with regard to this requirement:

1. The bonds must be sized so as to take into account the fact that there will be earnings available from the investment of bond proceeds during the construction period.
2. There is no five percent insubstantial portion as is available for private activity bonds. However, up to \$5,000 of excess bond proceeds is permitted so as to allow for rounding of the size of the bond issue.
3. Bond proceeds cannot be used to finance working capital. Likewise, bond proceeds may not be used to purchase an existing facility from a person who will continue to use the facility after the bonds are issued.
4. Any excess bond proceeds remaining after construction is completed must be treated in the same manner as provided in Revenue Procedure 79-5 (invest at bond yield until used to purchase or call bonds at par).
5. Since only tangible property may be financed, bond proceeds must not be applied to intangibles such as mortgages or student loans.
6. Personal property may be financed. Before publication of Revenue Procedure 82-26, the Internal Revenue Service had allowed 63-20 bonds to be used to finance personal property only if such property were an integral part of a real property financing (e.g., a hospital financing could include the beds, x-ray equipment, etc.). Now, there can be a 63-20 financing of personal property alone.
7. No more than two percent of the bond proceeds may be used to pay for costs of issuance or underwriter's discount.

**F. Political Subdivision Approval**

The political subdivision on whose behalf the bonds are being issued must, before the date of issuance, approve both the nonprofit corporation and the issuance of the particular bonds. Although the Revenue Procedure is not explicit, it appears that the governing body of the political subdivision (as opposed to its chief executive officer) must make the approval. Such approval must occur within one year of the date of issuance of the bonds, although a single approval of a series of bond issues for a single project over a five-year period is acceptable.

**G. Beneficial Interest in Corporation**

The political subdivision on whose behalf the bonds are being issued must have a beneficial interest in the nonprofit corporation. This is satisfied if one of the following is true.

1. The political subdivision (or an instrumentality thereof) has exclusive use and possession of 95% or more (measured by fair rental value) of the facilities financed by the bonds (including any additions to such facilities). Such exclusive use and possession must extend for the full term of the bonds, or any refunding bonds, or any bonds issued to finance improvements to the facilities.

or

2. The nonprofit corporation has exclusive use and possession of 95% or more (measured by fair rental value) of the facilities financed by the bonds (including any additions to such facilities), and the political subdivision on whose behalf the bonds are issued controls the nonprofit corporation. The political subdivision is deemed to control the nonprofit corporation if the political subdivision appoints or approves 80% or more of the directors of the corporation, and the political subdivision has the power to remove, for cause, any director and appoint the successor. Officials of the political subdivision who serve as ex-officio directors count toward satisfying the 80% test.

or

3. The political subdivision on whose behalf the bonds are issued has the right to acquire, at any time, unencumbered title and exclusive possession of the property financed by the bonds (including any additions thereto) by paying a sum sufficient to defease the bonds. This alternative is intended to apply where neither the political subdivision nor the nonprofit corporation has exclusive use and possession of the facilities financed by the bonds, or, even if the nonprofit corporation does have exclusive use and possession, it is not controlled by the political subdivision (e.g., an industrial development bond where a private person or entity is the lessee of the facilities, or the financing of a hospital for an organization that is not controlled by the political subdivision). The problem posed by this alternative is that the private user runs the risk of being removed at any time if the political subdivision is able to defease the bonds (the private user is allowed 90 days to vacate the facilities after defeasance).

#### **H. Option to Purchase Upon Default**

The political subdivision on whose behalf the bonds are issued must have the option of buying the facilities in the event of default on the bonds. The political subdivision would have to pay an amount sufficient to defease the bonds. This will enable the political subdivision to prevent a default sale of the property. The political subdivision must be given 90 days notice before it must exercise this option to buy, and another 90 days before it must actually pay for the facilities. This option to buy is not necessary where the political subdivision has been the exclusive user of the facilities financed by the bonds.

#### **I. Title Vesting**

The political subdivision on whose behalf the bonds are issued must receive full legal and unencumbered title to the facilities upon retirement of the bonds for no additional consideration. In this regard, the political subdivision may not share its title with any other person, even another political subdivision. Therefore, the nonprofit corporation may not issue on behalf of more than one political subdivision. This appears to be more restrictive than the prior position of the Internal Revenue Service. The vesting of unencumbered title requires that all leases and management contracts cease upon discharge of the bonds. However, the Internal Revenue Service has indicated that it will issue a

favorable ruling where, at the end of the term of the bonds, the user of the facilities has the option to lease the facilities for the then fair rental value. Finally, it is not necessary for title vesting to occur upon discharge of temporary financing of five years or less, as long as title vesting will occur upon discharge of the permanent financing.

**J. Resolution to Accept Title**

In order to assure the political subdivision's good faith intention to accept title to the property at the end of the term of the bonds, the Internal Revenue Service requires that, before the bonds are issued, the political subdivision adopt a resolution agreeing to accept future delivery of unencumbered title to the property.

**K. Improvement and Refunding Bonds**

Any subsequent bonds issued by the nonprofit corporation to improve the facilities or to refund the original bonds must mature no later than the last maturity date of the prior bonds that were issued to originally provide the facility. This assures that title vesting will not be indefinitely deferred by issuing subsequent series of bonds. Furthermore, the prior issue must be redeemed within 90 days of the date of issuance of the refunding bonds. These requirements need not be fulfilled if the political subdivision has exclusive use and possession of the facilities.

**L. Insurance Proceeds**

Any insurance proceeds received as a result of damage or destruction to the facilities financed by the bonds (including any additions thereto) must be used to prepay bonds or reconstruct the facilities or be remitted to the political subdivision on whose behalf the bonds were issued. This assures that a fully operational facility will vest in the political subdivision upon discharge of the bonds.

**M. Residual Value**

At the time of issuance of the bonds, it must be determined that the fair market value of the facilities financed by the bonds is estimated to be, upon maturity of the bonds, at least 20% of the original cost of the facilities without regard to inflation. Similarly, it must be determined at the time of issuance of the bonds that, on the date of maturity of the bonds, at least 20% of the useful life of the facilities will remain. With regard to items like equipment, which generally will have a useful life that is shorter than the term of the bonds, this requirement may be met by requiring that such equipment be maintained and replaced periodically, such that the replacement property will, upon maturity of the bonds, have at least 20% residual value and life. The residual value and life tests need not be met if the political subdivision has had exclusive use and possession of the facilities for the term of the bonds.

**N. Conveyance of Title**

Upon defeasance of the bonds (other than by issuing a 63-20 refunding bond), the political subdivision may agree to convey its interest in the property to any other person, provided the political subdivision had not agreed or committed, before the defeasance, to convey its interest in the property. However, if the political subdivision is conveying its interest in the property to a person who was a user of the

property before the defeasance occurred, or related to such person, then such conveyance or agreement to convey must not occur any earlier than 90 days after the defeasance. For example, if a charitable organization has been the lessee of facilities financed by a 63-20 bond issue, this organization could acquire title to the facilities (thereby, negating any title vesting in the political subdivision) by causing a defeasance of the bonds and, 90 days later, having the political subdivision convey its future right to title. During the 90-day period, the charitable organization is at risk that the political subdivision will, at the end of that period of time, refuse to convey its interest in the property to the organization. On the other hand, if the person who desires to acquire the facilities had not been the user of those facilities prior thereto, the defeasance and conveyance could occur simultaneously.

### **III. OTHER TAX CONSIDERATIONS AFFECTING TAX EXEMPTION**

The primary purpose of a 63-20 financing is to obtain tax exempt rates, thereby lowering interest costs. The Internal Revenue Code includes a wide variety of tests and requirements that must be met and observed throughout the term of a bond issue in order to maintain tax exempt status.

In a 63-20 financing, one of the critical requirements involves compliance with “private use” requirements. Interest on private activity bonds is not excludable from gross income under Section 103(a) of the Internal Revenue Code of 1986 (the “Code”) unless the bonds are qualified bonds (for example, qualified 501(c)(3) bonds or an exempt facility bond provided for by Section 142 of the Code). The purpose of the private activity bond tests is to limit the volume of tax-exempt bonds that finance the activities of nongovernmental persons (persons or entities other than state or local governmental units). The private activity bond tests serve to identify arrangements that have the potential to transfer the benefits of tax-exempt financing, as well as arrangements that actually transfer these benefits. Bonds generally are private activity bonds if they meet both (1) the private business use test and (2) the private payment or security test.

The private business use test relates to the use of the proceeds of the bonds. The test is met if more than 10% of the proceeds of the bonds are used in a trade or business carried on by a nongovernmental person. For this purpose, use of the financed property is treated as the use of the bond proceeds. In addition, indirect as well as direct uses of the proceeds are taken into account.

The private payment or security test relates to the nature of the security for, and the source of, the payment of debt service on the bonds. Payments are taken into account under this test if they are derived from the financed property used for a private business use as well as if debt service on the bonds is secured by an interest in the financed property used for a private business use. The present value of these private payments is compared to the present value of the debt service to be paid over the term of the bonds. If the present value of the private payments is more than 10% of the present value of the debt service on the bonds, the test is met.

If the bonds will be private activity bonds, then the limitations imposed by the Code with respect to private activity bonds must also be considered. In a “dock/wharf/airport financing, the facilities financed with bond proceeds must be government owned. They may subject to a lease, provided that the lease does not exceed 80% of the useful life of the facilities financed. In addition, the lessee must make an irrevocable election not to take depreciation with respect to the financed facilities. Dock and wharf facilities do not require a volume-cap allocation.

## IV. SECURITY FOR BONDS

### A. General or Limited Obligation of Issuer

In a 63-20 financing, the bonds are issued by the nonprofit corporation (“issuer”). In a *traditional* financing, the issuer of the debt is the party primarily responsible for the repayment of the debt. This is *not required*, however, in a 63-20 financing. If an issuer with substantial assets is available, the issuer may issue debt and pledge its full faith and credit (thereby adding real value, in addition to the value of the tax-exempt financing to the debt issue). What may be more likely, however, is that the project seeking tax-exempt financing (outside of the government umbrella) is intended to be financed on the basis of “cash-flow”, i.e., cash flow from the project and the project itself.

The issuer may be an existing nonprofit corporation or a new corporation formed for the express purpose of financing this project. If the goal is to structure a “cash flow” project, the formation of a new nonprofit corporation is generally preferable. This suggestion is based upon experience with rating agencies and/or bond insurers. If the issuer owns substantial assets and has a long-term operating track record, the rating agencies/insurers are more likely to view the project favorably. For the vast majority of nonprofit organizations, outside the pale of large operating “charitable” hospitals, the organization may not have continuity of management and substantial financial reserves.

If an issuer does not add significant financial support to the project, then the credit enhancers/rating agencies will consider whether the other unrelated activities of the issuer have the potential to adversely affect the financing. Does the issuer retain the right to incur second liens on the project? Do the other activities of the issuer carry financial risk? What would be the impact of the bankruptcy of the issuer? The latter issue generally presents the most compelling case for creating a new nonprofit corporation to act as the issuer. Federal bankruptcy law permits certain types of leases to be rejected (terminated) in bankruptcy. If the lease revenues from the project are the primary source of repayment for bonds, then any risk of rejection of the lease, particularly a risk that would arise from unrelated activities of the issuer, is not acceptable. For this primary reason, therefore, a new nonprofit corporation may be preferred as the issuer.

If a new, nonprofit corporation is formed, the charter may be specifically designed to finance a single project or a limited number of projects on a nonrecourse basis. See *V. Other Tax Issues Affecting the Selection of a Nonprofit Issuer*.

### B. Structure of the Debt

In order to access the tax-exempt market, the debt is commonly denominated as “bonds”. Since the debt is corporate, however, there is more latitude available in structuring the debt than would be available in a typical municipal bond issue. There are some market-driven conventions that may be anticipated, e.g., the most customary term for municipal bonds is 20 years. Another, more important characteristic of the municipal bond market is the risk-averse nature of the market. In a public offering, an investor in municipal bonds typically seeks an essentially risk-free investment. Although credit quality impacts pricing somewhat, the most significant factors in pricing are market issues. Tax-exempt bonds sold in public offerings are always investment grade. There is no public market for tax-exempt junk bonds.

If bonds are sold as a public offering, the bonds generally will need to have obtained an investment grade rating from one or more of the traditional rating agencies for municipal bonds, e.g., Moody's Investors Service, Standard & Poor's and/or Fitch. The bonds may be secured solely by the project, or they may be secured with third party credit enhancement, e.g., a policy of municipal bond insurance or letter of credit. Bonds may qualify for an investment grade rating on the basis of their intrinsic credit strength or with the assistance of credit enhancement. Credit enhancement in the tax-exempt market is generally provided by a policy of municipal bond insurance or a letter of credit issued by a bank. Municipal bond insurers include MBIA Insurance Corporation, Ambac Assurance Corporation, Financial Guaranty Insurance Company, and Financial Security Assurance Inc. The insurers are highly rated (generally AAA by the rating agencies) and the addition of a policy of municipal bond insurance permits a bond issue to be rated on the basis of the insurer's ratings. Bond insurance is generally noncancellable, extends for the full term of the bonds and is obtained by paying a single premium at the time bonds are issued. The insurance premium is a closing cost.

Letters of credit are issued by foreign or domestic banks having a rating of A or better. The letter of credit is an undertaking by the bank to pay debt service directly or upon nonpayment by the issuer. The issuer enters into a reimbursement agreement with the bank. On the basis of the letter of credit, the bank's credit rating is assigned to the bonds. Letters of credit typically have a term of five to seven years, and the governmental sponsor or nonprofit, as the case may be, would be required to obtain a new letter of credit or an extension of the existing letter of credit prior to the expiration date. Letter of credit fees are paid annually and are traditionally priced as a percentage of the credit amount.

The credit enhancer will apply its own underwriting criteria to the bonds and the collateral and, will, if it is satisfied that the transaction has little risk of default, issue a credit enhancement. The credit enhancement (i) acts as a short-cut for investors who make investment decisions relying upon the prior due diligence of the credit enhancer; (ii) provides a recognizable name as the basis for making the investment (e.g., a tax exempt fund with a requirement that all securities be rated triple-A).

### **C. The Project as Security**

If the security for the bonds is based primarily upon the viability of the property/project, the investor (or the credit enhancer in a credit enhanced deal) will focus on the intrinsic value of the property/project as well as projected cash flow.

The project security must be in place at the time of debt issuance and must remain in place so long as the bonds are outstanding. Accordingly, the credit evaluation examines the project from the date of funding through the date of maturity of the bonds. If bond proceeds will be used to pay construction costs, the credit examination will extend to the construction period as well as the period of operations.

The security may be summarized as follows:

1. Prior to completion of the project.
  - a. **Contractor.** The contractor will probably be required to be substantial, with significant experience and capital. The contractor should be able to demonstrate bonding capacity sufficient to undertake the project.

- b. **Payment, Performance and Completion Bonds.** The contractor may be required to obtain full bonding for the project, insuring against all risks, including those risks identified as *force majeure* (acts of God).
  - c. **Developer Guaranty.** During the course of construction, completion risk may be assumed and performance guaranteed by a developer (who has substantial assets or maintains a credit rating from a national rating agency).
- 2. **Mortgage on the Project.** Title to the property is held by the nonprofit corporation, with title insured by a policy of title insurance. The bonds are secured by a first mortgage (trust deed) on the property. A lender's policy of title insurance (with reinsurance if appropriate) will insure (i) the issuer's title to the property and (ii) the first lien of the mortgage on the property/project. The mortgage may also include a security interest on personal property, if any, financed with the proceeds of the bonds.
  - 3. **Lease Revenues.** Rent payments made under a lease with the governmental sponsor or other 501(c)(3) organization would constitute the principal security and assurance for repayment during the term of the bonds following completion of the project.

#### **D. Role of the Trustee**

The issuer's role in the financing may be limited. It is not expected that the issuer will (i) hold and invest bond proceeds, (ii) make disbursements to pay project costs, (iii) maintain books and records with respect to the bonds, or (iv) hold and administer project collateral. When bonds are issued, the issuer would enter into a trust indenture with the trust department of a bank or trust company. Under the indenture, the bank/trust company will perform these functions. All collateral would be pledged or assigned by the issuer to a bank trustee on the date of closing and issuance of the tax-exempt bonds. The trustee would be responsible for administering construction, insurance and the operating contracts for the term of the bonds, enforcing developer guarantees or warranty claims and assuring the collection of rent and payments to the bondholders during the term of the bonds. Following the closing, therefore, the issuer may have a minimal role, if any, in the construction and operation of the project.

#### **V. OTHER TAX ISSUES AFFECTING THE SELECTION OF A NONPROFIT ISSUER**

The issuer must be a nonprofit corporation. Such an organization may also be exempt from federal income tax as a result of being described in § 501(c)(3) of the Code. An existing nonprofit corporation with an operating history may qualify for a loan in the conventional manner. This loan may be converted into a 63-20 financing, assuming that the nonprofit corporation is willing to abide by the tax limitations described in the foregoing sections. Thus, an ordinary, conventional bank loan may be booked by a bank as a tax-exempt, bank-eligible loan. In the alternative, a bank could determine to add its letter of credit to the transaction, thereby making the corporate bonds more marketable.

In the alternative, a project may qualify for tax-exempt financing because it will be used by a governmental entity or a nonprofit corporation qualified under Section 501(c)(3) of the Internal Revenue Code. In this case, the nonprofit corporation is selected or formed for the sole purpose of acting as the tax-exempt bond issuer; the tenant or project user is providing the credit support for the repayment of



the loan. The nonprofit issuer should meet certain federal tax requirements. The issuer should not be a private foundation, but rather is an organization whose exempt charitable purposes will be furthered by its participation in the financing, and one who will view its participation in the financing as being in furtherance of its exempt charitable purposes rather than a way to raise funds for the organization.

If an issuer engages in certain activities that are unrelated to its exempt charitable purposes, it may be subject to the federal tax on unrelated business income on the income resulting from such activities. It may be subject to such tax if: (i) it engages in a trade or business that is unrelated to its exempt charitable purposes; or (ii) it acquires a facility with debt and then leases such facility to a third party in such a manner that the lease is not in furtherance of the issuer's exempt purposes.<sup>2</sup> If an issuer's nonexempt activities are substantial enough in comparison to the issuer's exempt activities, the issuer could also lose its exempt status altogether. Thus, it is crucial that the issuer's activities relating to the financing of a facility for the local governmental sponsor or other 501(c)(3) organization be conducted in furtherance of the issuer's exempt charitable purposes. It is not sufficient that such activities be in furtherance of charitable purposes that are generally described in Code § 501(c)(3); such activities must be in furtherance not only of such purposes but also of the exempt charitable purposes of the issuer.

During the issuer selection process, the purposes of the organization stated in its governing documents (its articles of incorporation if the organization is a corporation) and described in its application for recognition of exempt status filed with the Internal Revenue Service should be reviewed. The activities of the issuer in connection with the financing must be in furtherance of the issuer's stated exempt purposes. For example, in the case of financing an educational building for a governmental tenant, the issuer's exempt purposes might include providing support for the governmental tenant in its educational activities. In addition, the issuer should view its participation in the financing as an activity that is in furtherance of its charitable purposes and not as a way in which to raise funds for the issuer. In practical terms, this means that the issuer should be willing to incur some costs in connection with the financing rather than expecting to be paid and make a profit for participating in the transaction.

Other factors will need to be reviewed in connection with the financing and could affect the selection of an issuer. For example, state and local taxes, including income and property taxes, need to be reviewed for their impact. Also, the internal governing rules of the issuer will affect the ease with which the financing documents involving such issuer can be negotiated and approved. Thus, it may be preferable to work with an issuer that has a small governing board that can easily hold meetings where a quorum will be present.

## **VI. FORMATION OF A NONPROFIT CORPORATION**

One or more people may form a nonprofit corporation by selecting a name and executing and filing articles of incorporation with the Secretary of State. At a minimum, the articles of incorporation must include the name of the corporation, a statement of the purpose and governing law of the corporation, and the name and address of the agent of the corporation. The articles of incorporation should be

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<sup>2</sup> There is currently some question as to whether investment of bond proceeds during construction of a facility or as part of a reserve fund required by the financing gives rise to taxable unrelated business income.

signed and acknowledged by the incorporators, or by the initial directors, if those directors are named in the articles. The nonprofit corporation is formed upon filing of the articles and payment of a filing fee, and, unless otherwise provided in the articles of incorporation, will continue in existence perpetually.

At the initial meeting of the directors, the directors should fix the time and place of meeting, adopt by-laws, approve a corporate seal, if desired, determine the corporate address, authorize other organizational matters and choose officers of the corporation. Corporations are required to have a chairman of the board or a president or both, a secretary, a chief financial officer, and such other officers as are stated in the bylaws or determined by the board of directors to be necessary.

## **VII. CONCLUSION**

At a time when there are declining resources available to meet expanding infrastructure requirements, a 63-20 financing enables governmental agencies, such as port districts, cities or counties, working in partnership with the private sector to satisfy demands for additional capital facilities in a very cost effective manner. Under a 63-20 financing, a governmental entity or appropriate nonprofit corporation can access the tax exempt capital markets. In the case of a governmental entity, the governmental entity may avoid the practical, legal and political problems associated with the construction of its own facilities or the issuance of its own debt — and with the added benefit of receiving unencumbered fee title to the facilities once the bonds are retired.

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# PUBLIC/PRIVATE PARTNERSHIPS

## By Jay A. Reich

### I. INTRODUCTION

“Public/private partnerships” is a colloquial term encompassing a broad range of cooperative activities between the public and private sectors. Heralded during the 1980’s and 1990’s as a way of making the public sector more efficient, these activities included the privatization of traditional governmental functions such as the operation of prisons, sewage treatment plants, and municipal motor pools through private contracting. In many states they involved the direct investment of public dollars in private enterprises to stimulate business development and thereby create jobs and deepen the local tax base. They also included the issuance of industrial revenue bonds, which provided tax exempt financing for private capital expenditures in accordance with the Internal Revenue Code.

In Washington, public/private partnerships have been viewed with skepticism in the past because of provisions in our state constitution that prohibit the giving or lending of public credit or funds except for the necessary support of the poor and the infirm. See WASH CONST. art. VIII, § 5, 7. These constitutional limitations were most narrowly construed in 1974 in Port of Longview v. Taxpayers, 84 Wn. 2d 475, 527 P.2d 263 (1974), amended by 85 Wn. 2d 216; 533 P.2d 128 (1975), where a unanimous Supreme Court ruled that even conduit financing—where no public moneys were used or put at risk—was constitutionally prohibited. See Port of Longview, 85 Wn. 2d at 225; 527 P.2d at 268. By 1982, the citizens of Washington had changed the constitution to permit industrial development bonds, but in a series of cases beginning in 1978 the court began to reexamine its own interpretations of the Constitution. In Johnson v. Johnson, 96 Wn. 2d 255, 264-65, 634 P.2d 877, 882 (1981), Justice Utter acknowledged the untenable position the Court had found itself in:

Judicial approaches should be reexamined when the court creates several technical exceptions to preexisting holdings or when the holdings are differently applied for no significant reason. The presence of inconsistent analyses or exceptions suggest the approach may have outlived its relevance or was improvidently fashioned. Our checkered approach to section 5 problems mandates a reexamination of this area.

...

Examining this area of law can only lead to the conclusion that its evolution is contrary to the genesis of section 5. That provision, and ones similar to it, arose in the nineteenth century in response to reckless government subsidization of public and communication projects. . . . These private ventures were highly speculative and many failed, leaving government entities, and thus the taxpayer, either holding worthless stock or liable for large, inadequately secured debts.

Id. (internal citations omitted). Reaching back to the historical roots of Article VIII, Sections 5 and 7, the Court has recently fashioned a series of more pragmatic rules that protect against the evils of public subsidy witnessed in the nineteenth century, while establishing a foundation for public/private partnership in the twenty-first century. See Jay A. Reich, Lending of Credit Reinterpreted: New Opportunities for Public and Private Sector Cooperation, 19 Gonz. L. Rev. 639 (1983-1984); Hugh

Spitzer, An Analytical View of Recent “Lending of Credit” Decisions in Washington State, 8 U. Puget Sound L. Rev. 195 (1985).

In the last twenty years there has been a careful testing of the limits of public/private partnerships in Washington. The State Supreme Court has clarified the circumstances under which private entities could constitutionally benefit from public investments, most recently in cases involving the Seattle baseball stadium and the Spokane parking garage. In each case the constitutionality of the public/private arrangements was upheld, providing some guidance to the limitations and possibilities of these types of transactions. See CLEAN v. State, 130 Wn. 2d 782, 928 P.2d 1054 (1996); CLEAN v. City of Spokane, 133 Wn. 2d 455, 947 P.2d 1169 (1997).

At a time when federal, state and local funds are very limited and the demands for infrastructure investment are enormous, it is important to understand and explore how limited public funds can be leveraged by private dollars. Our local and state governments have been asked to do more with less, and we as their attorneys have been asked to be creative about stretching these precious public resources. Public/private partnerships offer additional opportunities to develop public facilities and tax revenues, and knowledgeable municipal attorneys can play a key role in shaping mutually beneficial relationships.

## II. MODELS

### A. Contracts

The most traditional use of public funds in conjunction with the private sector involves the public acquisition of goods and services from the private contractors. Few would question the transfer of public funds to the private sector to build roads and sewers, despite the fact that the contractors providing such goods and services as well as private owners of land located near such facilities are undoubtedly enriched by such public expenditures.

On the other hand, governments have also sought to contribute funds to worthy causes that did not fall into the constitutionally permitted category of providing “necessary support to the poor and the infirm.” For example, the court struck down a county payment to an agricultural fair, which was operated by a nonprofit corporation. See Johns v. Wadsworth, 80 Wn. 352, 141 P. 892 (1914). For the past several decades cities and counties as well as the State have sought to give “grants” to arts organizations in support of their capital and operating needs.

In recent years the court has developed a rule by which to judge the constitutionality of payments of public dollars to private entities. The court has determined that a transfer of public money that benefits a person or entity that is neither poor nor infirm is not prohibited so long as there is no “donative intent” on the part of the government entity. Adams v. University of Wash., 106 Wn. 2d 312, 327, 722 P.2d 74, 82 (1986). If the transfer is not a gift, then it is not prohibited. To determine whether a payment is a gift, the court looks to whether the government will receive consideration in return. The court gives great deference to a determination by the legislative body of the government entity making the placement that the consideration is adequate. The courts will only review the determination of the legislative body and conclude that the transfer is constitutionally prohibited if the consideration is clearly inadequate. See CLEAN v. State, 130 Wn. 2d 782, 797-800, 928 P.2d 1054, 1061-62 (1996); City of Tacoma v. Taxpayers, 108 Wn. 2d 679, 701-05, 743 P.2d 793, 804-06 (1987); Adams, 106 Wn. 2d at 326-28, 722 P.2d at 81-82 (1986).

This evolving legal principal has been extremely helpful to attorneys advising municipal corporations. Whenever a municipality seeks to transfer public funds to a private entity for a purpose that is not for the necessary support of the poor and the infirm, the municipality should be advised to make clear findings with supporting evidence that it values what it is getting in return for the expenditure. In the baseball stadium cases, the court approved the expenditure of public funds to build the stadium because, among other things, the baseball team was obligated to pay rent, maintain the facility and provide a baseball team. See CLEAN v. State, 130 Wn. 2d at 798-99, 928 P.2d at 1062. Similarly, in a recent informal letter from an assistant Attorney General regarding the expenditure of public funds to acquire the Pine Street Garage, the Attorney General pointed to a number of public benefits that The City of Seattle had determined was of equal to or greater value than the amount it would spend to acquire the garage. See Memorandum from Mary Jo Dias, Assistant Attorney General, to Jan Jutte, Assistant Director, State Auditor's Office, April 10, 1998 ("Dias Memo").

If the municipality determines that it is receiving valuable consideration for its expenditure, then the fact that private parties are being incidentally benefited is not critical to the constitutionality of the transaction. This is a central concept of public/private partnerships, because the private partner is unlikely to participate unless it benefits from the transaction. If such private benefit were ultimately determinative of whether the transaction is constitutional, few public private partnerships could withstand constitutional challenge. The courts have determined that the critical question is whether the governmental entity received value for its expenditure, not whether any private entities benefited either directly or indirectly.

#### **B. Conduits**

Conduit financing involves the use of a governmental entity to borrow on behalf of a private entity and thereby provide to the private entity the lower interest rates of tax-exempt financing. Because these transactions involve debt and credit, they may implicate the constitutional prohibition on the lending of public credit to private entities. The courts have held in a number of cases that a carefully designed conduit transaction is not constitutionally prohibited.

The analysis begins with transactions involving federal funds that are transferred to a municipal corporation for subsequent disbursement to private entities. For example, in the Model Cities Program of the 1970's municipalities acted as conduits for federal funds going to private anti-poverty contractors. The Attorney General determined that the Constitutional prohibition does not apply to federal funds and therefore if the dollars can be segregated from state and local public funds, there is no constitutional issue. See Op. Att'y Gen. No. 18, at 5 (1973); WASH. REV. CODE 35.21.730 to .757.

Conduit financings involving tax exempt bonds have been upheld along similar lines. Typically, a private entity seeks financing for a private purpose that is recognized by the Internal Revenue Code as eligible for tax exempt financing. The Code requires that the funds be borrowed by a governmental entity and permits the borrowed funds to be loaned to the eligible private entity. It is the private entity that must repay the loan to the lenders or bond investors. The municipality is involved in the transaction only because federal tax law requires it. There is no public money used or credit loaned because the government entity is not guaranteeing the debt of another. While the court struggled with this distinction in Port of Longview v. Taxpayers, 85 Wn. 2d 216, 230-31, 527 P.2d 263, 270-71 (1974), it resolved the matter in subsequent cases. So long as the borrowed money and the repayments are segregated from the public treasury and the public issuer of bonds is not liable to repay the private debt, there is no constitutional prohibition of these transactions. Indeed, these conduit financings are so obviously distinguishable from the transactions that the framers of the Constitution sought to prohibit

that the court ultimately had no difficulty in distinguishing and upholding them. See, e.g., Washington Econ. Dev. Fin. Auth. v. Grimm, 119 Wn. 2d 738, 748-50, 837 P.2d 606, 611-12 (1992); Washington State Hous. Fin. Comm'n v. O'Brien, 100 Wn. 2d 491, 498-500, 61 P.2d 247, 251-52 (1983); Washington Health Care Facilities Auth. v. Spellman, 96 Wn. 2d 68, 74-76, 633 P.2d 866, 869-70 (1981); Washington Health Care Facilities Auth. v. Ray, 93 Wn. 2d 108, 110-15, 605 P.2d 1260, 1261-64 (1980).

### C. Partnerships

Municipal corporations rarely enter into partnerships due to concerns about constitutional limitations. While Article XII, Section 9 specifically prohibits public ownership of stocks, there is no explicit prohibition of partnership with a private entity. Nonetheless, because being a partner in a general partnership exposes each partner to joint and several liability, a municipal corporation could be held liable for the actions of its private partner. This could arguably be interpreted as a lending of the municipality's credit and would therefore be prohibited. The courts have found that the framers of the constitution sought to minimize municipalities' "risk of loss" and to make certain that control over that risk is not in the hands of a private entity. A public entity may take appropriate risks, but it must maintain control of its financial exposure. See Washington State Hous. Fin. Comm'n, 100 Wn. 2d at 498-500, 671 P.2d at 251-52; Johnson v. Johnson, 96 Wn. 2d 255, 267-68, 634 P.2d 877 (1981) (plurality opinion); State ex rel Washington Navigation Co. v. Pierce County, 184 Wn. 414, 425, 51 P.2d 407, 412 (1935),

Municipal corporations have entered into statutorily authorized contractual arrangements with attributes of a partnership where liability of the municipality has been limited and control over risk can be asserted. See, e.g., Public Util. Dist. No. 1 v. Taxpayers, 78 Wn. 2d 724, 479 P.2d 61 (1971). Furthermore, housing authorities have entered into limited partnership arrangements where the housing authority is the general partner and the limited partner cannot impose liability on it. This is done frequently in transactions involving the federal low income house tax credit, where the limited partner is a tax credit investor that contributes equity to the partnership controlled by the housing authority in return for the tax credit. See I.R.C. § 42 (West 1994 & Supp. 1998). Public development authorities have similarly entered into limited partnerships where they are the sole general partner or a limited partner.

### D. Leases

Leases of municipal property are arguably similar to contracts for purposes of constitutional analysis. When the municipal corporation is the lessor, it must receive as lease payments an amount that constitutes adequate consideration for the property rights involved, taking into consideration all aspects of the lessee's obligations. For example, in King Co. v. Taxpayers, 133 Wn. 2d 584, 601, 949 P.2d 1260, 1269 (1997), the court specifically examined whether the Mariners' lease payments were adequate consideration for the lease of public property to the baseball team. It found that the Mariners' sizable financial contribution, profit-sharing plan, twenty-year lease obligation, maintenance requirement, and obligation to pay insurance met the test of legal sufficiency. The court emphasized the importance of deferring to the public lessor's judgment of the adequacy of the consideration unless it was "grossly inadequate" to avoid the "burdensome precedent of judicial interference with government decision making." Id. at 597 (quoting City of Tacoma v. Taxpayers, 108 Wn. 2d 679, 703, 743 P.2d 793 (1987)). See also, Clean v. State, 130 Wn.2d 782, 799, 928 P.2d 1054 (1996). Conversely, as a lessee, the municipality may not pay more than a fair market rate, or the excess could be deemed a prohibited gift.

Lease arrangements raise a host of ancillary issues (discussed below) that are statutorily driven including, whether payments by a municipal lessee count against municipal debt limitations, whether the project is a public work and requires competitive bidding, and whether prevailing wages must be paid by the contractor.

#### **E. Joint Development**

Joint public and private development of a project can take a number of forms and raise a number of important constitutional and statutory questions. As land costs increase and growth management policy puts a premium on efficient and dense use of urban property, coincident and interrelated public and private physical development is becoming more important. Common examples include a public parking garage built beneath a private museum, retail complex or housing development, and co-location of retail ventures, low or moderate income housing, and transit terminals. These transactions could involve subdivision or condominiumization of the project, joint development agreements providing for design approval and phasing, financing through a true lease or financing lease, options to purchase, and a host of other arrangements that are common to private sector development. The concepts identified above: consideration, liability, and control which implicate the state constitution, as well as the statutory issues of competitive bidding, prevailing wages, and tax liability, need to be identified, understood and reflected in the documentation controlling these transactions.

### **III. LEGAL ISSUES**

#### **A. Constitutional**

There are numerous state constitutional issues—primarily prohibitions on the use of public funds—that are critical in evaluating and ultimately structuring public/private partnerships. At various times any one of the following constitutional provisions may be directly or indirectly involved:

1. Art. VIII, §§ 5, 7. These sections are usually read together and generally prohibit the lending of public credit or the gift of public funds to private entities, except for the necessary support of the poor or the infirm. See Washington Health Care Facilities Auth. v. Ray, 93 Wn. 2d 108, 115, 605 P.2d 1260, 1261-64 (1980). They are relevant whenever there is any transfer of public funds to a private entity or the suggestion that the public sector is guaranteeing the debt or credit of a private entity.
2. Art. VII, § 1. This section prohibits the contracting away of taxing power, and may be relevant where tax forgiveness for private parties is contemplated as part of a transaction. It may also be implicated where taxes are sought to be avoided because they may be characterized as “private payments” under the Internal Revenue Code and cause a public project to lose its tax exempt funding as in the case of admissions taxes or parking taxes.
3. Art. VII, § 1; Art. VIII, § 6. These provisions require that public debt be incurred and taxes levied exclusively for public purposes. Their application is analogous to the prohibition on the gift of public funds, though arguably they go further than simply prohibiting transfers where there is “donative intent” to the ultimate purpose of the expenditure. See Clean v. State, 130 Wn.2d 782, 792-797, 928 P.2d 1054 (1996).

4. Art. VII, § 1. This provision provides for the uniform levy of property taxes and would prohibit the exemption of property taxes when not authorized by the constitution. Uniformity does not apply to the exemption of excise taxes, however, for certain classes of private activities.
5. Art. VII, § 9. This provision provides for the assessment of private property that is specially benefited by a public improvement. It can be used to provide for the tax exempt financing of public improvements that provide benefit to private property owners.
6. Art. XII, § 9. This provision prohibits public ownership of private stock and limits how public private partnerships can be structured.

#### **B. Statutory Authority**

Even if a contemplated action by a municipal corporation could withstand constitutional challenge, it can only be undertaken if the municipal corporation is authorized to take such action. The law is not entirely clear on the inherent authority of various municipal corporations to act in the absence of explicit authority granted by the State. Many courts have stated the general rule that municipal corporations have implicit authority to do only what is necessary to accomplish what has been explicitly granted. See, e.g., Granite Falls Library Capital Facility Area v. Taxpayers, 134 Wn. 2d 825, 834; 953 P.2d 1150, 1154 (1998). On the other hand, cities of the first class have all of the authority of the state that is not preempted or prohibited by the state or home rule charter. See Chemical Bank v. Washington Pub. Power Supply Sys., 99 Wn. 2d 772, 792-93, 666 P.2d 329, 340 (1983); Winkenwerder v. City of Yakima, 52 Wn. 2d 617, 622, 328 P.2d 873, 877 (1958). As a municipal corporation, the first class city's authority is generally understood as being limited to those powers expressly granted, and to those essential to the declared objective and purposes of the city. Municipal attorneys generally take the position that public corporations created by a city or county pursuant to WASH. REV. CODE 35.21.730 to .757 have no more authority than the municipal corporation that created them.

#### **C. Indebtedness**

The state constitution as well as state statutes limit the amount of debt municipal corporations may incur with and without a public vote. See WASH. CONST. art. VIII, § 6; WASH. REV. CODE 39.36.010 to .900. If a transaction obligates the municipal corporation to make future payments of public funds, it is important to determine whether such an obligation constitutes a debt for purposes of calculating the municipality's debt limitation. Often this question will turn on the characterization of the transaction as either a true lease or a financing lease, or a contingent obligation. See WASH. REV. CODE 35.42.200. Furthermore, obligations which will require the municipality to borrow funds in the future can only be fulfilled if that future borrowing is within the municipality's debt limitation at the time the obligation arises.

#### **D. Public Bidding**

If the public/private arrangement involves the construction of a building or utility infrastructure, it is important to determine whether the project is a "public work" as defined under WASH. REV. CODE 39.040.010 and subject to public bidding. Depending on a number of factors, it has been estimated that the public bidding of a contract can increase the price of such contract by as much as 25-30%. In many joint development projects therefore, significant cost advantages can be realized by the public entity if public bidding is not required. Said another way, from the private sector, significant costs will be added to a project involved with the public sector.



WASH. REV. CODE 39.04.010 provides that “[t]he term public work shall include all work . . . executed at the cost of the state or of any municipality, or which is by law a lien or charge on any property therein.” *Id.* (emphasis added). There is no case law interpreting the phrase “lien or charge on any property”, but the Attorney General has construed it to cover cases where a contractor would have a lien against the property of a public body, but for the lien exemption enjoyed by public property. *See* Op. Att’y Gen. No. 2, at 4 (1983). Similarly, the courts have not interpreted the phrase “executed at the cost” of a public agency. The Attorney General has noted, however, that it would be contrary to the public policy of chapter 39.12 of the Revised Code to allow its requirements to be easily circumvented. *See* Op. Att’y Gen. No. 17 (1988) (stating that a lease-leaseback arrangement should not change a project’s status as a public work); *but see* Op. Att’y Gen. No. 18 (1996) (exempting the Washington State Convention and Trade Center from competitive bidding requirements because of legislation that required incompatible actions); Dias memorandum (deciding that the garage was not “executed at the cost” of the city because the city bore no risk during the project’s construction or interim operation).

In determining whether a project is a public work, a court must interpret relevant factors including whether the land on which the project will be constructed is owned by a public or private entity, whether the public party has financial risk during construction, whether progress payments are being made by the public party, and the relative sizes of the public and private portions of a joint development project.

#### **E. Prevailing Wage**

It is also important to determine whether the project is subject to prevailing wage under WASH. REV. CODE 39.12. Any project that the state or municipality “causes to be performed by a private party through a contract to rent, lease, or purchase at least fifty percent of the project by one or more state agencies or municipalities” shall comply with the state’s prevailing wage statute. WASH. REV. CODE 39.04.260. While this provision may not have as significant an economic consequence as a public bidding requirement, it can be very important to the economics of the project. This may be especially true for a project with significant constraints on its ability to pay debt service. For example, affordable housing projects designed for households with very low incomes have limited capacity to earn rents and repay debts. In addition, the failure to pay prevailing wages and to follow the rules for proving that such payments meet applicable rules may cause public controversy and prevent the use of a portion of project funds for other parts of the project. In major urban projects, the use of union labor as a practical or a political necessity, has made the legal issue moot.

#### **F. State and Local Taxes**

There are a host of state and local tax issues that arise in public/private transactions that can have significant affects on the economics of the project. These include:

1. Property tax exemptions available to public projects but not private projects. *See* WASH. REV. CODE 84.36.010.
2. The leasehold excise tax which arises when a private entity leases public property. *See* WASH. REV. CODE 82.29A.030, .040;
3. Real estate excise taxes that are imposed when projects are purchased by private parties. *See* WASH. REV. CODE 82.46.030.

4. Specific tax exemptions such as the exemption available for property owned by a housing authority under WASH. REV. CODE 35.82.210.
5. Special excise tax exemptions for parking garages leased under WASH. REV. CODE 35.42.010, .090

As in any private sector transaction, careful structuring of the project can reduce its cost.

**G. Federal Tax Issues**

Section 103 of the Internal Revenue Code of 1986, as amended, provides for the exemption from gross income of the interest on certain municipal bonds. Such tax-exempt financing during construction can significantly reduce the cost of construction and reduce the ongoing interest cost of debt. The tax exemption turns on a number of factors that are beyond the scope of this paper, but among the key factors is whether the project financed by the debt is used for a “public purpose” or a “private activity,” and whether the debt is repaid from “public” or “private” sources. Again, how the transaction is structured can determine whether it is eligible for less expensive, tax-exempt financing.

**H. Unintended Consequences**

It is worth noting in conclusion that public/private partnerships, regardless of their form or economic advantage to the private or the public sector partners, merge two cultures with very different motives, measures of success, language, and expectations of privacy and public scrutiny. What may be understood as efficient and market driven from the perspective of the private sector may be perceived by critics as devoid of thoughtful public process, fraught with risk, and motivated by greed. To some extent these differing perspectives reflect a lack of understanding and imagination, perhaps by both cultures, but to some extent they reflect a real difference of values. Furthermore, these differences and these misperceptions become the fodder for the popular press. Often these projects are complex and difficult to understand upon a cursory review. The fact that the private sector partners to such a transaction are motivated primarily by profit should not be a surprise. There would be no private participation without the possibility of profit. Nonetheless, these projects are vulnerable to a kind of populist rhetoric and public scrutiny that is difficult for elected officials to withstand and private entrepreneurs to tolerate. This is not to suggest that such projects, if done carefully, are illegal or not worth the effort; it is only to suggest that the parties involved must understand that for both sides this may not be business as usual.