Arizona Revises Tax Incentive Program: Does an Incentive Still Exist to Do Urban Infill Development?

By James M. Susa

James Susa examines whether Arizona's recent changes in the GPLET (Government Property Lease Excise Tax) still provide a sufficient incentive for developers to continue constructing new facilities or significantly renovating old properties.

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Introduction

Arizona counties and cities provide economic incentives to developers to construct new improvements, or significantly renovate old improvements. The counties or cities take title to the property and relieve the developers of any *ad valorem* property taxes because Arizona's law exempts all government owned property from *ad valorem* property taxes.[1] The developer then leases the improvements from the county or city for a nominal sum per year. Lease terms are often 25 years. Recent changes have diminished the value of the incentives. Whether the diminished incentives are still appealing enough to encourage development remains to be seen. This article discusses the evolution of the incentives from inception in 1996 to today.

Typical Structure of the Incentive

The tax incentives were designed to address two specific issues. The first is the departure of businesses from downtown areas. The second is the development of vacant land on the outer edges of a city or in a rural part of a county. The city desires to have downtown business sites renovated, extensively, to generate sales tax dollars. The county desires to have rural portions developed, leading to additional residential housing demand.

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The typical structure of the incentive calls for a development agreement to be approved by the city or county. The agreement provides for the developer to either construct a sizeable improvement on vacant land, thereby energizing the surrounding area with economic activity, or to renovate an existing building. After the construction or renovation is complete, title is transferred to the city or county for no consideration. At the same time, a long-term lease is executed with the city or county and the developer to use the improvement for some commercial purpose. The lease provides for a nominal sum as rent. The lease also provides for the developer to terminate the lease agreement at any point with the payment of some nominal sum. This termination provision is important for post 2010 leases as explained further below.

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During the period of the lease, the property will not be subject to *ad valorem* property taxation. Upon termination of the lease, the property is conveyed from the city or county to the developer for a nominal sum. At that point, *ad valorem* property taxes are then imposed on the property just like any other commercial property.

In lieu of a property tax on the property leased to the developer, Arizona enacted a non-*ad valorem* excise tax in 1996.[2] The excise tax is titled *Government Property Lease Excise Tax* and referred to by its acronym "GPLET." Rather than base taxation upon value, the GPLET bases taxation on the square footage of the improvements.[3] The GPLET tax rate also varies by improvement usage. For instance, the tax rate set in 1996 was $1 per square foot for a one-story office building, $1.75 per square foot for a retail building, $1.50 per square foot for a hotel building and so forth. These rates also decreased 20 percent every 10 years resulting in zero tax due for an improvement 50 or more years old. Finally, if certain conditions were met, the GPLET was reduced to zero—entirely abated—for up to an eight-year period. The GPLET structure was highly favourable to developers resulting in numerous GPLET-eligible projects being completed. In all likelihood downtown Phoenix and Tucson would be deserted without GPLET eligible projects being approved in the late 1990s.

Tax Rates Increased to Slow GPLET-Eligible Projects

Arizona amended the GPLET tax rate statute to make the tax rates a little less favourable to the developers in 2010.[4] The rates were increased substantially and the new rates applied to all transactions occurring after May 2010. Those occurring before June 2010 were grandfathered in at the old rates and with the 20-percent rate reduction. For comparison, the tax rate for a one-story office building was increased from $1 to $2 per square foot. The tax rate for retail space was increased from $1.50 to $2.51 per square foot. Further, the tax rates were indexed for inflation.[5] Finally, the 20-percent reduction in the tax rate for each decade of the improvements age was restricted to not apply to transactions after May 2010. The purpose of the 2010 amendments was to counter the proliferation of GPLET-eligible projects. After a slow start under the new taxation scheme in the late 1990s, the request, and then approval, of GPLET-eligible projects soared, particularly in the downtown locations of several Maricopa County cities.[6]

Incentives Restricted Further by New Legislation

Arizona again restricted the benefits of GPLET-eligible transactions in 2017.[7] This was done, in part, to protect the tax base for cities and counties. It was also done to provide some parity between established businesses that were already burdened by the *ad valorem* property tax and those GPLET-eligible businesses. Even with the changes made in 2010, developers were still receiving a substantial tax benefit by entering into development agreements subject to the GPLET. The 2017 legislation tempered, again, the GPLET tax benefits. Two key changes from the 2017 legislation are discussed below.

Before the current legislation, it was the responsibility of the lessee to prepare and submit a GPLET tax form once a year. The form was submitted to the county treasurer. Based on the information provided, the amount of actual tax could vary significantly.[8] It was not uncommon to see inaccurately completed GPLET forms. Unfortunately, the county treasurer does not have resources to audit such forms. The new legislation shifts the GPLET form completion requirement to the city or county. The hope is to have far more accurate forms submitted timely to the county treasurer.

Another change is that the lease term may not exceed eight years if the original transaction is subject to an abatement of the GPLET. The original 1996 GPLET

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legislation allowed a city, but not a county, to abate the GPLET amount for a period of up to eight years if certain criteria were met by the developer.[9] The developer was rewarded with both an abatement of the GPLET for eight years and also the ability to then pay the GPLET for additional years under a very long-term lease with the city. The new statute gives the developer a choice of either (a) the eight-year abatement or (b) no abatement, but a lease term exceeding eight years. The days of having both have ended.

Mathematical Comparison over the Years

To illustrate the tax benefit from the GPLET program, consider the following example. A downtown Phoenix office building has 272,000 square feet and is 10 stories high.[10] For the 2017 tax year, the building has a full cash value of $30,200,400.[11] If the parcel was subject to *ad valorem* property taxation, the 2017 property tax would be $528,188.[12]

By contrast, if the parcel were subject to a 25-year lease and the GPLET applied, then depending on when the parcel became subject to the GPLET, the 2017 tax amounts would be as follows (presumes no eight-year GPLET abatement applies) (see Table 1):

Table 1

	1997	2011	2017
Square footage	272,909	272,909	272,909
Tax rate in 2017	1.05[1]	3.41	3.41
GPLET amount	286,554	930,619	930,619

1 ARS §42-6203(A)(1)(c) sets the tax rate at $1.75/SF for office buildings with eight or more stories. That amount is reduced by 40% because the GPLET transaction has existed for 20 years. ARS §42-6203(A)(2)(b).

The example highlights the considerable tax benefit under the 1996 GPLET tax rates compared to the *ad valorem* property tax, just over half the tax burden using the GPLET structure. It also highlights the distinct disadvantage of using the 2011 (and 2017) tax rates for this transaction where the GPLET structure produces a tax almost twice the *ad valorem* property tax. The conclusion is that unless the eight-year GPLET abatement is available for this particular parcel, the developer would fare better to simply pay the *ad valorem* property tax and avoid the additional costs of obtaining the city's agreement to a development agreement for the parcel.

Additionally, if the eight-year GPLET abatement is obtained by the developer, it is important that the developer has the right after the eight years to terminate the lease and take title back to the property because the GPLET amount would likely exceed the *ad valorem* property tax amount at that point. If no such termination provision is contained in the lease, the developer will be required to pay the higher GPLET amount until the lease expires. Additionally, for a 2017 transaction, the developer could not have a lease term exceeding the eight years if the abatement applied. In this example, the GPLET amount exceeds the property taxes after the abatement expires. However, there could be cases where the property taxes would be far more than the GPLET amount but the developer would be limited to only the eight-year lease period and would then have to pay regular property taxes thereafter.

Time will tell if the legislative efforts have struck the important balance among the competing interests of a city and/or county wanting to stimulate development, the needs of the taxing jurisdictions to generate tax revenues, and fairness to existing businesses who do not receive the GPLET benefit.

Conclusion

The GPLET was enacted in 1996 to replace an *ad valorem* property tax based upon the value of the private possessory interest in a government-owned property. That taxing system had been ruled unconstitutional. At first, the GPLET created similar tax benefits to the invalidated possessory interest property tax. At present, the impact of the 2010 and 2017 changes to the GPLET calls into question the financial benefit to a developer to propose a transaction that will be subject to the GPLET. Time will tell if the legislative efforts have struck the important balance among the competing interests of a city and/or county wanting to stimulate development, the needs of the taxing jurisdictions to generate tax revenues, and fairness to existing businesses who do not receive the GPLET benefit. Sometimes the pendulum swings too far to the other side.

ENDNOTES

1 Arizona Revised Statutes ("ARS") §42-11102 exempts federal, state, county and municipal property from taxations.

2 Laws 1996, Chapter 349.

3 ARS §42-6203 setting the tax rate per square foot.

4 Laws 2010, Chapter 321.

5 For 2017, the one-story office rate is $2.20 and the retail rate is $2.76.

6 The Arizona Department of Revenue is required to maintain a public database of all GPLET-eligible transactions. ARS §42-6202(D). The City of Phoenix has over 200 GPLET-eligible transactions on that database. The City of Tempe has 40 GPLET-eligible transactions and the City of Scottsdale has 10 GPLET-eligible transactions. Almost all of these transactions were entered into before the 2010 legislative changes in the tax rate occurred.

7 Laws 2017, Chapter 120.

8 Factors such as the lease inception date, the improvement size and the improvement's usage, all had significant impact on the actual tax determined on the form.

9 ARS §42-6209 lists the requirements. The general requirements are that the property be within a single central business district in a city and that the development results in an increase in property value of at least 100 percent.

10 Maricopa County parcel number 112-21-072C, located at 236 N. Central Avenue in downtown Phoenix.

11 In 2015, Arizona changed the calculation methodology for *ad valorem* property tax from applying two tax rates to two different values (full cash and limited) to applying one tax rate to one value (limited). For purposes of this illustration, the old system will apply.

12 Full cash value ($30,200,400) times the assessment rate for commercial property (0.18) times the secondary tax rate for the tax district (0.060478) plus the limited property value ($9,147,785) times the assessment rate for commercial property (0.18) times the primary tax rate for the tax district (0.121114) equals $528,188.

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