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TO: **Lancaster County Commissioners**

FROM: **Kegel Kelin Almy & Grimm LLP**

RE: **Taxability of Marriott Hotel**

DATE: **April 11, 2005**

Based on concern for taxpayers and to help ensure that critical issues are addressed as part of the Convention Center decision making process, you requested our opinion on the taxability of the Marriott Hotel.

1. <u>Legal Opinion Summary</u>

Under the new financing plan, the Marriott Hotel will be subject to real estate tax.

A key factor is that the Redevelopment Authority of the City of Lancaster ("RACL") will hold legal title to the hotel, but the title will be subject to a 20-year lease purchase agreement, pursuant to which the hotel developer and tenant – Penn Square Partners ("PSP") – will earn profits during the lease term and obtain title after 20 years for a final payment of $2.25 million. That amount is far below the hotel's projected market value.

Further, the Pennsylvania Supreme Court has made clear that the purpose of Redevelopment Authorities is to acquire and rehabilitate blighted buildings, and then return them promptly to the tax rolls. Nothing suggests the purpose of Redevelopment Authorities is to keep buildings off the tax rolls until 20 years after they have been rehabilitated.

Based on Pennsylvania law governing Redevelopment Authorities and the taxability of publicly owned property, as interpreted by the courts to date, the Marriott Hotel will be subject to local real estate taxes under the circumstances surrounding the new financing plan.

It is important to stress that a determination of taxability depends on analysis of all relevant facts and documents. The opinion expressed in this memorandum is based on the facts known to us through information provided to the County by RACL and PSP. However, the information provided to date is incomplete. It does not include a copy of any 20-year lease purchase agreement or other documents associated with the property acquisition and use. In addition, PSP has refused to answer questions posed by the Commissioners that would provide additional information relevant to the determination of taxability. A variation in facts from those currently known to us and described in this memorandum could change the conclusion as to taxability.

2. <u>Potential Loss Summary</u>

If real estate taxes are owed on the hotel, then pursuant to the latest financing plan, the City of Lancaster will be responsible for such payments. As a result, City taxpayers would lose the following funds:

- The City would not receive real estate taxes on the hotel for 20 years. This equates to a ***revenue loss of approximately $4.5 million,*** based on PSP's assumptions that the fair market value of the hotel property would remain at $28.3 million for 20 years and real estate tax rates will increase 2.5% annually for 20 years.

- The City would be required pay real estate taxes on the hotel to Lancaster County and the School District of Lancaster for 20 years. Based on PSP's assumptions of a fixed $28.3 million assessment for 20 years and 2.5% annual tax increases for 20 years, and that $3.7 million in guaranteed aggregate payments in lieu of taxes are all paid by PSP, if PSP does not exceed its aggregate 12% profit projection, this equates to a ***liability of approximately $9.5 million.***
- Under these assumptions, City taxpayers stand to lose approximately ***$14 million.***
- It is possible the loss could be higher. In this regard, several specific possible scenarios are notable. First, PSP has indicated total guaranteed payments in lieu of taxes of $3.7 million. Although these have been referred to as "guaranteed payments," the nature of the guarantee has not been explained. If conditions to the guarantee exist and are not satisfied, the potential loss increases by $3.7 million to $17.7 million.
- The potential loss would also increase if tax rates increase more than 2.5% annually, or if the tax assessment of the Marriott Hotel exceeds $28.3 million.
- Conversely, the potential loss would decrease to the extent PSP exceeds its 12% aggregate profit projection and makes some or all of its "participation payments" to RACL.
- In addition to the loss resulting from taxability of the Marriott Hotel, City taxpayers are exposed to potential liability to pay part of proposed $12 million in Act 23 bonds. This liability will arise if additional state sales tax, state hotel

occupancy tax, and state personal income tax generated as a result of operation of the hotel do not equal debt service requirements on the $12 million bond, or if General Assembly appropriations over the next 20 years do not fully cover all approved Act 23 grants.

- It is also possible the loss could increase if so-called "common areas" of the project used by both the Marriott Hotel and the Convention Center are found to be taxable. Because many issues relating to such joint use have not been finally decided, this memorandum does not attempt to quantify the possible additional cost to City taxpayers if such areas are determined in whole or part to be taxable.

3. <u>How Will the Tax Immunity Issue Arise?</u>

It is important to stress that this tax immunity issue can be raised without any action by the County or the School District of Lancaster.

- The property is currently taxable. After transfer of title to RACL, it can apply to the Lancaster County Assessment Board for tax immunity. At that time, RACL will be required to present to the Board all relevant facts, including the 20-year lease purchase agreement and other documents associated with the property acquisition and use. Whether or not any other party intervenes in this proceeding, the Board will decide if the Marriott Hotel is taxable before the commencement of for-profit operations, based on the parties' written agreements.
- If the Assessment Board concludes that prior to for-profit operations the hotel is tax immune, the Board could still on its own initiative, without challenge by any

party, remove the immunity status from the Marriott Hotel after construction is complete and PSP begins for-profit operations.

- The issue could also arise from a legal challenge. The School District of Lancaster or Lancaster County could challenge the immunity claim. That challenge would be made first to the Assessment Board, then on appeal to the Lancaster County Court of Common Pleas and thereafter to the Commonwealth Court.
- Because Act 23 requires PSP to pay all applicable real estate taxes on the hotel, the proposed financing plan that shifts this duty to the City appears to violate Act 23. As part of the Act 23 grant process, this violation might be raised by the Department of Community and Economic Development ("DCED"), a taxpayer, or another interested party. Similarly, this could be raised by a taxpayer challenging the City's guarantee of the Act 23 grant under the Local Government Unit Debt Act.

4. <u>Key Facts</u>

The Lancaster County Convention Center Authority (the "LCCCA") and PSP have for several years planned to construct and operate a convention center and hotel complex near Penn Square in downtown Lancaster. PSP owns the former Watt & Shand building, and LCCCA owns adjacent properties. Under the latest proposal, RACL will purchase the Watt & Shand property, create a condominium for the Marriott Hotel construction, and enter the lease purchase agreement under which PSP will operate the hotel.

Until December 2004, the plan had been for the convention center to be publicly owned, exempt from local real estate taxes, and operate at a loss; whereas the hotel was to be privately owned, subject to local real estate taxes, and generate a profit for the private developer PSP.

a. Changes in December 2004

In December 2004, this concept changed. Under the December 2004 plan, LCCCA was to remain as owner and operator of the convention center. However, the December 2004 plan called for RACL to hold title to the hotel, subject to a 20-year lease agreement with PSP. Pursuant to the lease agreement, PSP would pay as rent all debt service and costs incurred by RACL, and receive legal title to the hotel after 20 years without any additional payment. Thus, according to the December 2004 plan, for 20 years the hotel would be "publicly owned," but generate a profit for the private developer PSP, who would "own" the hotel upon making its final lease payment. See Minutes from LCCCA public meeting on December 16, 2004.

In conjunction with this changed plan, two new financing approaches were announced in December 2004.

First, RACL was to apply for a grant from DCED, pursuant to the Infrastructure Facilities Improvement Program created by Act 23 of 2004. 12 Pa. C.S.A. § 3401 to § 3406. Under Act 23, DCED can provide annual grants for up to 20 years, which reflect the estimated amount of additional state sales tax, state hotel occupancy tax, and state personal income tax generated as a result of operation of the hotel. RACL would use these annual grant funds to pay the debt service over 20 years on a $12 million bond offering used to finance part of the cost of the Marriott Hotel. If DCED initially approves the Act 23 grant, it must review and renew the grant payments after three years. At that point, DCED can reduce the amount of the annual grants if

the amount of incremental taxes resulting from operation of the Marriott Hotel does not equal the debt service on the $12 million bond. Further, full payment by DCED of a 20-year grant under Act 23 is dependent on continued appropriations by the General Assembly throughout that period at a level adequate to fund all approved Act 23 grants. To the extent Act 23 appropriations do not fully fund all approved grants, all approved recipients will receive a proportionately reduced payment from DCED.

If there is a shortfall between the amount RACL must pay toward debt service on the $12 million bond and the amount of the DCED annual grant under Act 23 – either due to inadequate generation of additional taxes by the hotel or inadequate appropriations by the General Assembly – the City of Lancaster must make up that difference pursuant to a guarantee.

Notably, Act 23 requires that if a private entity is the "user" of the project funded by Act 23 (as in this situation, where PSP will be the user of the Marriott Hotel), it cannot hold title to the project during the period of Act 23 funding. 12 Pa. C.S.A. § 3406(b)(7). Therefore, PSP cannot hold title to the Marriott Hotel throughout the 20-year period of Act 23 funding.

Further, and very critically, Act 23 requires PSP as the project user to sign a contract agreeing "to timely pay all Commonwealth and local taxes and fees." 12 Pa. C.S.A. § 3406(b)(11). This provision makes clear that, as a condition of receiving Act 23 funds, the project user must pay any applicable local real estate taxes, and cannot be relieved of that obligation by the title holder or local taxing authorities. In addition, this section makes clear that ***Act 23 does not create tax immunity or tax exemption for projects that are funded through Act 23 grants.***

The second proposal announced in December 2004 was for RACL – as the holder of title to the Marriott Hotel – to claim immunity from local real estate taxes for the hotel because title would be held by an instrumentality of the Commonwealth. However, after PSP's attorneys advised that such a claim of immunity would be subject to legal challenge, ***PSP concluded it would not proceed with the project subject to this risk.***

b. <u>TIF Act Approach Initiated in February 2005</u>

Still desiring a means to abate real estate taxes on the hotel, PSP turned in February 2005 to the TIF Act. Pursuant to the TIF Act, RACL sought approval of a "project plan" from the City of Lancaster, the School District of Lancaster and Lancaster County. The TIF Act is a law designed to encourage development. It expressly establishes a means by which a developer can avoid real estate taxes, subject to advance review and approval of the project by local taxing authorities. Under the TIF Act, increased real estate taxes generated from the increased tax assessment on the property after construction of the hotel would be diverted from the three taxing authorities, and instead would pay the debt service on $10 million of bonds used to help finance hotel construction. Any taxing authority approving the TIF would receive only the amount of real estate taxes based on the assessed value of the property before construction. All additional real estate taxes resulting from an increased assessment would be used to fund debt service on $10 million of bonds.

As part of the TIF proposal, PSP promised to make specified additional annual payments to the City and the School District in lieu of taxes, and to make even further "participation payments" to the extent its overall profit on the Marriott Hotel exceeds 12%.

As part of evaluating the TIF proposal, on March 11, 2005, the County Commissioners issued 57 detailed questions regarding the project, and requested written responses that could be shared with the public. LCCCA provided written responses to some questions, but PSP did not provide any responses (except for some verbal information in a private meeting with one of the Commissioners). The School District did not approve the TIF as proposed by RACL. The School District instead approved a modified TIF requiring additional payments to the School District that were not included in RACL's proposal.

On March 24, 2005, PSP stated that as a result of the County Commissioners' questions and the School District's decision to approve only a modified plan, it would halt further action on the TIF. Although the TIF application is not formally withdrawn (and technically is still "pending"), neither RACL nor PSP have taken the requisite steps under the TIF Act to move the process forward.

c. <u>Return to December 2004 Plan, But With Two Important Changes</u>

Instead, on March 28, 2005, PSP returned to the concept initially proposed back in December 2004, but with two important twists.

The first major difference between the latest proposal and the December 2004 plan is that after an initial 20-year lease (during which PSP will pay all debt service and RACL costs except for taxes and litigation), PSP will now have the right to receive title to the hotel for $2.25 million, instead of simply receiving title after its final lease payment. Still, this amount is considerably lower than the anticipated market value of the hotel in 20 years. PSP has previously indicated that the anticipated market value in 20 years will be between $28.3 million and $44 million, depending on profitability of the hotel.

Thus, the proposed arrangement is not a true lease, but rather a lease purchase through which PSP builds nearly complete equity in the property over the 20-year term. PSP's President, Nevin Cooley, has acknowledged this arrangement with RACL is not a true lease, and that through its final $2.25 million payment PSP "is basically paying off a mortgage." Lancaster Intelligencer Journal, March 29, 2005, page A-1.

Notably, this lease purchase arrangement with a nominal buyout by the tenant after 20 years is very different from the lease for the new baseball stadium in downtown Lancaster, where the baseball team tenant builds no equity in the property over its 20-year lease, and where the lease provides the tenant use only for baseball activities and reserves to the government owner use of the facility for community activities at other times.

The second major difference in the new financing plan as compared to the December 2004 proposal is that RACL (rather than PSP) has now assumed the obligation to pay all local real estate taxes applicable to the Marriott Hotel, with the City guaranteeing RACL's tax payment obligation. PSP required that the City incur this risk, because PSP remained unwilling to do so (just as it had been unwilling to do so in December 2004). Accordingly, the new plan provides that if the Marriott Hotel is taxable, PSP will not make any additional payments toward the tax liability beyond the payments it had promised under the TIF proposal. Instead, under this new financing plan, if the hotel is taxable the City of Lancaster will (a) forego real estate taxes on the hotel, and (b) guarantee the full payment of real estate taxes on the hotel to the School District and the County.

RACL provided City Council the pages at Attachment 1 to this memorandum to explain the financial risk to the City. As indicated on the table of figures, these calculations are based on

the following assumptions: (a) projected tax assessment of the completed hotel (a fixed assessment of $28.3 million for 20 years); (b) projected future real estate tax rates (2.5% increase per year); and (c) receipt of all $3.7 million in "guaranteed" payments in lieu of taxes by PSP to RACL.

Accepting these assumptions for the moment, the materials at Attachment 1 illustrate that if PSP does not exceed an average profit goal of 12%, and the Marriott Hotel is found to be taxable, the City of Lancaster would incur the following losses:

- The City would forego its share of real estate taxes on the property. Although not shown on this chart, PSP previously estimated the City's share of real estate taxes on the hotel as approximately ***$4.5 million*** over 20 years; ***plus***
- The City would be obligated to pay the School District and the County a total of over ***$9.5 million*** in taxes over 20 years.

Therefore, if the Marriott Hotel is taxable and PSP does not exceed a 12% average profit, the City will lose ***$14 million*** over the course of 20 years based on the assumptions at Attachment 1. If the assessment of the hotel exceeds $28.2 million, the average annual tax increase exceeds 2.5% or PSP does not make all its "guaranteed" $3.7 million payments to RACL, the loss will exceed $14 million.

When and if PSP exceeds a 12% aggregate profit, it will ***start*** to make the "30% Participation Payments" shown at Attachment 1, but ***only*** to the extent its aggregate profits exceed 12%. ***The materials at Attachment 1 do not explain how high PSP's aggregate profit must be for it to make all $7.5 million in Participation Payments.*** Even if all $7.5 million is

paid, though, if the Marriott Hotel is taxable the City will still incur a loss of about $6.5 million (approximately $4.5 million of its own taxes not collected, and $2 million of taxes paid to the School District and County), and perhaps even more if PSP's assumptions of a fixed $28.2 million assessment and 2.5% tax rate increases are not fulfilled.

As indicated above, other factors could expose the City to an even greater loss.

Therefore, whether the Marriott Hotel is taxable is a very important question for the City (which will lose considerable funds if it is taxable), as well as for the School District and the County (which will gain considerable funds if it is taxable) – and for City taxpayers.

d. <u>Loss of Tax Immunity or Tax Exemption Not Uncommon (if Private Use)</u>

In considering whether the Marriott Hotel will be taxable, it is worth noting that it is not uncommon for properties that are immune or exempt from real estate tax to lose that status, and become fully or partially taxable because the use of such property has become "private" rather than "public." For instance, in Lancaster County alone, there are (according to a list recently produced by the Lancaster County Assessment Office) 352 properties owned by government bodies or other tax exempt entities that are partially taxed and partially non-taxable.[1] Of those properties, 35 are owned by government entities. These include Southern Market (owned by Lancaster City, and where City Council meets, but partially taxable due to commercial leases that produce revenue to the City), Chester County Solid Waste Authority (a landfill that is immune from taxation, but with excess land that is taxable), the Lancaster Airport Authority (generally exempt, but with farmland that is taxable) and Lancaster County (parkland on

[1] The list of 352 properties provided by the Assessment Office represents only properties that are partially taxable and partially non-taxable. In addition, other properties owned by tax exempt entities are 100% taxable.

Chickie's Hill Road is generally exempt, except for farmland that is part of the County's property). Further, once the Assessment Office addresses the County's recent acquisition of the Armstrong Building at 150 North Queen Street, that property will be taxable to the extent it is leased to private commercial businesses.

In all of the foregoing examples, the government-owned building is taxable to the extent it is utilized for a "private purpose" rather than for a "public purpose." The following legal analysis explains how Pennsylvania courts have consistently made such a distinction in determining whether property owned by a public body is subject to local real estate tax.

5. <u>Legal Analysis: The Marriott Hotel Will Be Taxable</u>

The Marriott Hotel will not be immune or exempt from real estate taxes owed to the City, the County and the School District. Therefore, if City Council guarantees RACL's obligation to pay real estate taxes on the hotel for 20 years (as proposed), the City will be required during that period to forego its own taxes on the Marriot Hotel, and also to pay taxes on the hotel to the School District and the County. As explained above, this will involve a very substantial cost to the City and its taxpayers.

As an instrumentality of the Commonwealth, RACL normally enjoys immunity from local real estate tax. However, through the new financing proposal, RACL will lose its immunity on the Marriott Hotel. By entering a 20-year lease purchase agreement that provides PSP public financing of debt service on hotel construction costs, and then grants PSP the right to acquire title of the hotel after 20 years for $2.25 million – a figure far below the property's projected fair market value – RACL is serving primarily a private interest, rather than the public interest. Regardless of whether the public interest is served incidentally through this financial plan, the

hotel will be taxable because the direct and paramount effect of such financing is to further a private interest. In addition, for the same reason that RACL's arrangement with PSP serves primarily a private rather than a public interest, the Marriott Hotel will not be exempt from local real estate taxes.

a. Overview of Tax Immunity and Tax Exemption Issues

Local real estate taxes may not be imposed on property that is either ***immune*** from tax or ***exempt*** from tax. The Pennsylvania Supreme Court has distinguished between these two terms as follows:

> [W]e note that there is an important distinction between assertion of immunity as opposed to exemption. Property is immune from taxation if the taxing body has not been granted the authority to levy a tax. On the other hand, an exemption does not implicate the authority to tax, but rather excludes specified property from taxation.

Delaware County v. Berks County, 626 A.2d 528, 530 (Pa. 1993).

Notwithstanding this valid distinction between tax immunity and tax exemption, the test used by courts to determine whether real estate is taxable is essentially the same regardless of whether immunity or exemption is at issue – in both instances the question comes down to whether use of the property is for a "public" purpose or a "private" purpose.

For example, the Pennsylvania Constitution permits the General Assembly to exempt from taxation the following: "That portion of public property which is actually and regularly used for public purposes." Pa. Const. Art. VIII, § 2 (a)(iii). Pursuant to that constitutional authorization, the General Assembly enacted Section 204 of The General County Assessment Law, which exempts from local taxation "[a]ll . . . public property used for public purposes, with

the ground thereto annexed and necessary for the occupancy and enjoyment of the same." 72 P.S. § 5050-204(a)(7).

The Commonwealth Court addressed both tax immunity and tax exemption of real estate in Southeastern Pennsylvania Transportation Authority ("SEPTA") v. Board of Revision of Taxes, 777 A.2d 1234 (Pa. Cmwlth. 2001). In SEPTA, the Court held that "[a]n agency of the Commonwealth is entitled to complete immunity from taxation as long as it acts in accordance with the powers granted to it. When an agency acts outside of the scope of the powers granted the immunity is lost." Id. at 1237.

SEPTA operates a public transportation system in Southeastern Pennsylvania. It had leased space in its building in downtown Philadelphia to various commercial tenants. Noting that SEPTA is generally immune from taxes as an agency of the Commonwealth, the Court observed that the question on taxation concerns whether renting realty to commercial entities is "consistent with SEPTA's purpose of running a transportation system." SEPTA at 1238.

On this point, the Court looked to the law under which SEPTA is organized, 74 Pa. C.S. § 1711. The Court noted that SEPTA has the statutory authority to lease real property to tenants, and also has the power to raise revenue. However, because such activities are not directly connected to SEPTA's central purpose, the Court held there is no tax immunity for a facility that is rented to commercial tenants:

> All agree that the purpose of SEPTA is to operate a transportation system in Southeastern Pennsylvania. While SEPTA is free to lease its real estate to tenants and is under direction to raise revenue, clearly the leasing of real estate, solely to raise revenue, is not an activity connected to SEPTA's purpose.

> Therefore, SEPTA property leased to commercial tenants is not immune from taxation.

Id. at 1238.

After holding that SEPTA had lost its immunity on property that is subject to commercial leases, the Commonwealth Court ruled that based on the same distinction between a private and public use, the property was not entitled to an exemption from real estate tax: "Because serving as a commercial landlord is not an authorized purpose of SEPTA, the exemption . . . does not apply." Id. at 1239.

Similarly, in granting tax exempt status to a building owned by a borough and leased to a county for use by district justices, the Commonwealth Court concluded that such use serves a public rather than a private use, but that no exemption would exist if the tenant was a commercial enterprise:

> [T]he fact that property of a public body is leased to another entity, even a private party deriving profit therefrom, will not defeat the tax exemption if the property is being used for the specifically authorized public purpose for which it was acquired. The controlling test for tax exemption is not whether the property or part of it has been leased out, but whether ***the use of the property so leased is for a public purpose.*** . . . [T]he crucial point is ***not whether the public body is benefited by the use of the leased property but whether the use is, in fact, public.***
>
> Where the primary and principal use to which property is put is public, the mere fact that income is incidentally derived from the use of the property does not affect its character as property devoted to a public use. On the other hand, property that is owned by a tax-exempt entity is ***taxable if the property is used for commercial purposes or is rented to a lessee for a purely business enterprise and not a public use.***

Wesleyville Borough v. Erie County Board of Assessment Appeals, 676 A.2d 298, 302 (Pa. Cmwlth. 1996) (emphasis added).

More recently, the Commonwealth Court explained that in determining whether the lease of a public building to a private enterprise results in taxation, the key is whether "the lessee's use of the public property is furthering the purpose of the governmental agency from which the lessee rents the property." Board of Property Assessment, 797 A.2d 414, 419 (Pa. Cmwlth. 2002) (facilities that sold candy and alcoholic beverages at county-owned airport and were operated by private tenants are exempt from real estate tax, because such businesses are reasonably necessary for efficient operation of airport and therefore serve a public purpose).

There are many other cases in which property owned by public bodies has been determined taxable based on private use. See e.g., Pier 30 Associates v. School District of Philadelphia, 493 A.2d 126 (Pa. Cmwlth. 1985) (tennis courts owned by the City and sublet to a private party but available for public use are taxable); Reading Municipal Airport Authority v. Schuylkill Valley School District, 286 A.2d 5 (Pa. Cmwlth. 1972) (airport hangars owned by Airport Authority and leased to commercial users are taxable). One particularly relevant case is City of Pittstown Redevelopment Authority Appeal, 44 Pa. D. & C. 2d 425 (Luzerne County 1967), which declared taxable a property acquired by a redevelopment authority and leased back to the prior owner for continued operation of a private business.

This distinction between public and private use of real estate owned by the government arises not only where taxability of property is directly at issue, but also where courts evaluate whether private use of public property is legally permissible. For instance, where a parking authority proposed constructing a parking garage and apartment towers subject to a lease-purchase arrangement that was extremely advantageous to a private party (including tax exempt status for the property during the term of the lease), the Supreme Court held the agreement was

improper and stopped the project. The Court concluded that a private party, rather than the public, was the "primary and paramount beneficiary" of the lease-purchase agreement. Price v. Philadelphia Parking Authority, 422 Pa. 317, 339, 221 A.2d 138, 150 (1966).

In Price, the Supreme Court found that the notwithstanding any incidental benefit to the public that might result from the proposed construction project, the private developer would be the chief benefactor of the advantageous lease purchase arrangement:

> By what is essentially a ***sale and leaseback arrangement***, National [the private developer] will be able to finance its site costs through the medium of long term public financing, with all the benefits which attend such an arrangement, not generally available to other private commercial developers. . . . And by the use of its ***exclusive option to acquire the garage facility in the future***, National is able to defer such major capital investment to a much later date and to ***accumulate revenues generated by the parking facility, the concourse and ground level commercial rentals for the cost of acquisition.***
>
> To this extent, the Academy House Project involves ***substantial public financing of a private endeavor.*** Irrespective of any benefit that the public may ultimately derive, it cannot be denied that a significant ingredient of the transaction is the use of the Parking Authority as a ***conduit by which a private developer is able to lighten substantial burdens***, both economic and regulatory, which would otherwise devolve upon it.
>
> There is therefore presented on this record a ***substantial degree of public involvement and investment in a private profit making venture***. . . . [T]he record fails to disclose any benefit to the public of more than a limited and incidental nature.

Id., 422 Pa. at 335-336, 221 A.2d at 148-49 (emphasis added).

After evaluating all factors, the Supreme Court concluded the "totality of these circumstances leads us to conclude that ***the public is not the primary and paramount beneficiary***" of the proposed project, and prohibited the proposed lease purchase arrangement with the private developer. Id., 422 Pa. at 339, 221 A.2d at 150 (emphasis added).

The foregoing cases make clear that in evaluating whether the Marriott Hotel will be subject to local real estate tax, the central issue is whether the public is the "primary and paramount beneficiary" of RACL's proposed lease purchase arrangement with PSP, and whether such arrangement primarily and directly furthers RACL's statutory public purpose.

b. RACL's Statutory Purpose

RACL was created in 1957, pursuant to Pennsylvania's Urban Redevelopment Law. 35 P.S. § 1701 to § 1719.2. The Urban Redevelopment Law provides that each county and municipality in Pennsylvania may create a Redevelopment Authority, and empowers such Authorities to engage in a variety of activities for the public purpose of "the elimination of blighted areas through economically and socially sound redevelopment of such areas." 35 P.S. § 1702. Permitted activities to effectuate that public purpose include the power to purchase, own, hold, clear, improve, manage, lease and sell real estate within a redevelopment area. 35 P.S. § 1709.

It is important to note, though, that the statutory authority of RACL to engage in such activities is not without limits. A Redevelopment Authority only has power to act for a public purpose. An Authority's actions "must carefully be examined under the facts of each case" to discern whether it is acting for a public purpose or instead for a private purpose. Redevelopment Authority of City of Erie v. Owners or Parties in Interest, 1 Pa. Cmwlth. 378, 391, 274 A.2d 244, 251 (1971).

In an early case that challenged the constitutionality of the Urban Redevelopment Law, the Pennsylvania Supreme Court explored the underlying public purpose of Redevelopment Authorities. In Belovsky v. Redevelopment Authority of City of Philadelphia, 357 Pa. 329, 54

A.2d 277 (1947), the Court held that the Urban Redevelopment Law is constitutional, and that Redevelopment Authorities may acquire, develop and transfer property for the purpose of restoring blighted areas.

The Supreme Court cautioned, though, that once a Redevelopment Authority has improved a blighted property, the public purpose of redevelopment has been achieved, and the Authority should then transfer the property to private, taxable ownership. In contrasting the ***temporary*** ownership by Redevelopment Authority to the ***long-term*** ownership by a Housing Authority, the Supreme Court emphasized that a Redevelopment Authority should transfer property to a private, taxable interest promptly after the public interest of redevelopment has been achieved:

> [P]laintiff misconceives the nature and extent of the public purpose which is the object of this [Urban Redevelopment Law] legislation. That purpose . . . is not one requiring a continuing ownership of the property as it is in the case of the Housing Authorities Law . . . but is directed solely to the clearance, reconstruction and rehabilitation of the blighted area, and ***after that is accomplished the public purpose is completely realized.*** When, therefore, the need for public ownership has terminated, ***it is proper that the land be re-transferred to private ownership.***

Belovsky, 357 Pa. at 340, 54 A.2d at 282 (emphasis added).

Later in its opinion, the Supreme Court again stressed that after a Redevelopment Authority has rehabilitated a blighted building, the Authority's public purpose has been accomplished and the property should be promptly transferred to a private party:

> Indeed, so far from it being legally objectionable that property acquired by eminent domain be resold or re-transferred to private individuals after the purpose of the taking is accomplished, the law ***actually requires*** that property be taken by eminent domain ***only to the extent reasonably required*** for the purpose for which

> the power is exercised and ***upon cessation of the public use the public ownership is properly discontinued.***

Id., 357 Pa. at 341, 54 A.2d at 283 (emphasis added, citation omitted).

The Commonwealth Court has twice relied upon the foregoing language of the Supreme Court in Belovsky to uphold the taking of property by a Redevelopment Authority through eminent domain, subject to the retransfer of such property to a private developer who had agreed to rehabilitate the property. In re City of Scranton, 132 Pa. Cmwlth. 175, 572 A.2d 250 (1990); Franklin Town Project of Philadelphia v. Redevelopment Authority of the City of Philadelphia, 19 Pa. Cmwlth. 272, 339 A.2d 885 (1975).

Therefore, based on the language of the Urban Redevelopment Law, the leading Supreme Court decision in Belovsky and its Commonwealth Court progeny, it is clear that the purpose of Redevelopment Authorities is to acquire and rehabilitate blighted buildings, and then promptly return the buildings to the tax rolls.

Nothing suggests the purpose of Redevelopment Authorities is to acquire and restore blighted buildings, and thereafter keep them off the tax rolls for another 20 years.

c. Public Purpose of Redevelopment Authorities is Not Served in this Situation

Unlike other situations involving Redevelopment Authorities addressed above, RACL does not propose to transfer title of its property to a private party promptly upon achieving its statutory public purpose of acquiring, demolishing, or restoring a blighted building. Rather, RACL intends to maintain title to a newly constructed hotel for another 20 years – during which time PSP will make a profit operating the hotel and acquire nearly all the equity in the property through its lease purchase arrangement – and then transfer title back to PSP for a price

substantially below the hotel's projected fair market value. As PSP President Nevin Cooley has acknowledged, this arrangement is basically equivalent to PSP "paying off a mortgage." Lancaster Intelligencer Journal, March 29, 2005, page A-1.

Under these circumstances, it is clear that PSP is the "primary and paramount beneficiary" of the 20-year lease purchase agreement, and that any spin-off benefit to the public derived from its arrangement with RACL is merely incidental to PSP's private gain.

d. Act 23 and the TIF Act Do Not Support Tax Immunity of the Hotel

Act 23 and the TIF Act provide further indication that the Marriott Hotel will be subject to local real estate taxes.

There are two reasons RACL is taking title to the hotel: (1) The project is ineligible for Act 23 funding if PSP (as the private "user") holds title to the building, therefore RACL is holding title for the 20 years of proposed Act 23 funding; and (2) PSP hopes to avoid paying real estate taxes on its for-profit hotel by sharing RACL's tax immunity.

Very importantly, as to the first reason, Act 23 expressly provides that PSP as the project user must "timely pay all Commonwealth and local taxes and fees." 12 Pa. C.S.A. § 3406(b)(11). ***Therefore, Act 23 makes clear that RACL's holding title of the hotel to obtain Act 23 funding does not allow PSP to utilize RACL's shields of immunity to avoid paying local real estate taxes.***

As to the second reason, the case law makes clear tax immunity does not apply where the primary beneficiary of the ownership is a private entity.

It is also important to note that the Pennsylvania Constitution expressly authorizes the Pennsylvania Legislature to enact laws providing tax exemption for a limited period of time to

encourage improvement of deteriorating property. Pa. Const. Art. VIII, § 2(b)(iii). The legislature enacted the TIF Act to provide such tax exemption, but in doing so expressly required approval by local taxing authorities. Thus, Pennsylvania law provides an avenue for PSP to obtain tax exemption for the Marriott Hotel despite its private ownership interest. PSP, though, has decided to abandon this route specifically provided by Pennsylvania law.

e. RACL's "Naked Title" to the Hotel Will Not Result in Tax Immunity

In a similar situation where a government agency held mere "naked title" to property but a private party was the true beneficial owner, the Supreme Court of Pennsylvania held that property owned by the Commonwealth or its instrumentalities is entitled to tax immunity "only where the Commonwealth does in fact have rights of control over the premises consistent with ownership." Appeal of Owen J. Roberts School District, 500 Pa. 465, 457 A.2d 1264 (Pa. 1983).

In Owen J. Roberts, the owners of a 162 acre estate called "Welkenweir" deeded the property to West Chester State College, which is owned by the Commonwealth of Pennsylvania. As part of the transfer, the former owners retained a life estate to Welkenweir, permitting them full use, possession, and enjoyment of the property. The Supreme Court stated that where the Commonwealth holds only "naked title" to the property, there is insufficient basis to permit tax immunity on property. Id., 500 Pa. at 472, 457 A.2d at 1268. Further, the Supreme Court ruled that because of the life estate retained by the former title holders, the mere deed transfer did not render the property immune from real estate tax:

> [A]n owner of real estate cannot transfer the registered title to another, retaining the beneficial interest to himself and thereby escape liability for taxes. Such a

> transfer is no more acceptable when the Commonwealth's immunity from taxation by its political subdivisions is used to shelter a private party.

Id., 500 Pa. at 471, 457 A.2d at 1267 (citations omitted).

As with the property in Owen J. Roberts that was conveyed from private to public ownership, the Marriott Hotel property will not enjoy tax immunity simply because RACL will hold "naked title" for 20 years, pursuant to an arrangement benefiting primarily the private interests of PSP.

Rather, based on the court decisions discussed above, the Marriott Hotel property will be taxable – just like the industrial property a redevelopment authority acquired from and leased back to a former owner in Pittstown Redevelopment Authority Appeal; just like the offices acquired by SEPTA and leased to commercial tenants in SEPTA v. Board of Revision of Taxes; just like the tennis courts owned by the City and subleased to a private party in Pier 30 Associates v. School District of Philadelphia; just like the airport hangars owned by the airport authority and leased to private entities in Reading Municipal Airport Authority v. Schuylkill Valley School District; and just like the 352 Lancaster County properties mentioned above that are owned by tax exempt bodies but partially taxable based on private use.

Based on the facts summarized above, the Marriott Hotel property does not meet the requirement of use for a public purpose like the municipal office space leased to the County for district justices in Wesleyville Borough v. Erie County Board of Assessment Appeals or like the airport food service facilities in Board of Property Assessment.

6. Conclusion

Based on the facts known to us and summarized in this memorandum and Pennsylvania law as interpreted by the courts to date, our opinion is that the Marriott Hotel will be subject to real estate tax. Review of prior cases indicates it is likely that a court presented with this issue will determine the property to be taxable based on these facts.

ATTACHMENT 1 TO KKAG LEGAL OPINION DATED APRIL 11, 2005

The Redevelopment Authority of the City of Lancaster ("RACL") is before the Finance Committee of the City Council of Lancaster requesting approval and recommendation to the full City Council of Lancaster an ordinance approving a limited guaranty by the City for potential shortfalls in debt service which may result if payments by Penn Square Partners ("PSP") to RACL are insufficient to pay debt service as a result of RACL loss of tax immunity.

In order to promote the redevelopment of Penn Square with a full service 294 room Marriott hotel and a convention center, RACL has agreed in principal to acquire the hotel tower from PSP, construct the hotel unit and certain common elements to be used by both the hotel and the convention center, and lease the hotel tower to PSP for a period of 20 years. To make the hotel program financially feasible, RACL will be required to own the hotel tower so that a State grant under the IFIP program (Act 23) may be received by RACL to assist in funding the construction of the common elements of the hotel and convention center.

RACL will issue hotel revenue bonds in the amount of $24 million backed by a Letter of Credit issued by regional and local banks, which will be secured by PSP lease payments and a mortgage on the hotel unit. PSP will make lease payment equal to the debt service on the bonds and pay all operating expenses and RACL expenses in connection with the bond issue and the hotel, except PSP will not be responsible for any real property taxes which may become due as a result of RACL's loss of tax immunity.

As a result of the ownership by RACL, the hotel will be immune from real property tax. This immunity is an integral part of the financial feasibility of the hotel project. In order to solidify the economics of the transaction as a results from RACL's tax immunity and memorialized the PILOT payments, RACL requested that the City create a Tax Increment Financing (TIF) District and that the School District and the County opt into the TIF District. The School District rejected the PSP offer and presented its own proposal, which was unacceptable.

The hotel and convention center project, in the opinion of RACL, is the keystone to continued revitalization of downtown Lancaster City and is within RACL's mission. Therefore, RACL proposes to utilize its tax immunity which would mean that RACL would not pay real property taxes during their ownership. At the end of 20 years, PSP will have a purchase option to acquire the hotel for a minimum price of $2.25 million.

It is possible that the tax immune status of the project could be challenged which would threaten the feasibility of the entire project. In that case, RACL will pay all real estate taxes to the County and School District which would result if the tax immunity of RACL is not sustained. PSP will make a voluntary contribution to the City of $200,000 per year plus 30% of annual cash flow generated by the project above a 12% cash on cash return to PSP to offset this risk.

For the project to proceed, RACL is hereby requesting that the City authorize a Limited Guaranty which will cover any shortfalls in debt service as a result of RACL payments of real estate taxes which may be imposed as a result of a successful challenge to the tax immune status of RACL. These payments will be offset to some degree by the voluntary payments to be made by PSP to the City. A separate analysis of projected risk and exposure to the City is provided as an attachment to this request.

If this project which is so vital to the success of the efforts to remake the downtown of Lancaster is to go forward, it is necessary for the City to undertake the requested guarantee.

City of Lancaster
Limited Hotel Revenue Bond Guarantee

Year	SDoL/County Estimated Taxes Due	PSP Guaranteed Payments	PSP 30% Participation Payments	Projected Amount of Guarantee
2005	34,641	46,960		(12,319)
2006	35,507	48,134		(12,627)
2007	590,354	200,000	-	390,354
2008	605,113	200,000	-	405,113
2009	620,240	200,000	-	420,240
2010	635,746	200,000	194,731	241,016
2011	651,640	200,000	238,252	213,388
2012	667,931	200,000	277,468	190,463
2013	684,629	200,000	317,832	166,797
2014	701,745	200,000	359,378	142,367
2015	719,289	200,000	402,138	117,151
2016	737,271	200,000	446,146	91,125
2017	755,703	200,000	491,438	64,264
2018	774,595	200,000	538,050	36,546
2019	793,960	200,000	586,018	7,942
2020	813,809	200,000	635,380	(21,571)
2021	834,154	200,000	686,175	(52,021)
2022	855,008	200,000	738,444	(83,435)
2023	876,384	200,000	792,226	(115,842)
2024	898,293	200,000	847,563	(149,270)
	13,286,014	3,695,094	7,551,239	2,039,680

Assumptions

Projected Market @ Stabilization (2009/2010)	28,300,000
City Millage Rate	0.824%
County Millage rate	0.285%
School Millage rate	2.032%
Total Millage	3.141%
Inflation Factor	2.50%

Projected Debt Service	($2,232,861)
Loan Amount	24,000,000
Interest Rate	7.00%
Amortization	90

Assessed value required for full debt service 96,368,620

All information contained herein are estimates and are subject to change based on actual results.