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Arizona Supreme Court Clarifies "Gift Clause" Requirements for Tax Incentives in Economic Development Agreements

In a significant new decision, the Arizona Supreme Court has held that indirect benefits, such as projected sales tax revenues, may not be considered in determining the adequacy for Gift Clause purposes of the consideration received by a governmental entity in a transaction with a private party. The only benefits that may be considered are those that flow directly from the contractual provisions and the counterparty. In [Turken v. Gordon](#), Case No. CV-09-0042-PR, decided January 25, 2010, the court clarified the legal requirements for compliance with the Gift Clause in the Arizona Constitution, and applied this clarification prospectively only.

Article 9, §7 of the Arizona Constitution, commonly referred to as the Gift Clause, provides:

Neither the state, nor any county, city, town, municipality, or other subdivision of the state shall ever give or loan its credit in the aid of, or make any donation or grant, by subsidy or otherwise, to any individual, association, or corporation[.]

The Arizona Supreme Court set forth a two-prong test for Gift Clause compliance in *Wistuber v. Paradise Valley Unified School District*, 141 Ariz. 346, 687 P.2d 354 (1984). It held that an expenditure by a governmental entity does not violate the Gift Clause if both (a) the expenditure has a public purpose and (b) the

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consideration received by the governmental entity "is not so inequitable and unreasonable that it amounts to an abuse of discretion, thus providing a subsidy to the private entity." *Id.* at 349, 687 P.2d at 357 (internal quotations and citations omitted).

In *Turken*, several taxpayers and business owners sued the City of Phoenix to prevent payments to the developer, NPP CityNorth, LLC (NPP) of the CityNorth project. The City had agreed to pay NPP a portion of certain transaction privilege taxes (sales taxes) generated at the CityNorth development, up to a maximum of \$97.4 million. In exchange, NPP agreed to provide 3,180 parking spaces for free public use, 200 of which would be exclusively for commuters. Plaintiffs alleged that this agreement and the ordinance approving it violated the Gift Clause and several other provisions of the Arizona Constitution.

The trial court upheld the agreement, finding a public purpose, and including projected CityNorth sales tax revenues and other indirect benefits as consideration to be received by the city. Reversing on the Gift Clause claim, the court of appeals found that the agreement unduly promotes private interests, which the court believed is an additional test based on *Kromko v. Arizona Board of Regents*, 149 Ariz. 319, 718 P.2d 478 (1986). The appellate court, unlike the trial court, declined to consider indirect public benefits including the projected sales taxes.

Stating that *Kromko* did not add an additional element, the Arizona Supreme Court confirmed that the two-part analysis of *Wistuber* remains the law of Arizona. Initially, the court reviewed the public purpose requirement, found that public purpose is an expansive and inclusive term, and confirmed that courts must give proper deference to the public purpose findings of a governmental body. The court had little difficulty concluding that public parking is a legitimate public purpose, and also found that indirect benefits – such as increasing the tax base, decreasing pollution, creating jobs and producing denser development – can also satisfy the public purpose requirement in appropriate situations.

Turning to the consideration question, the court rejected the third element of not "unduly promoting private interests," which had been espoused by Justice Cameron in his dissent in *Wistuber*. Viewing the *Wistuber* test as "simpler" and "straightforward," the court set forth the relevant inquiry:

When a public entity purchases something from a

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private entity, the most objective and reliable way to determine whether the private party has received a forbidden subsidy is to compare the public expenditure to what the government receives under the contract. When government payment is grossly disproportionate to what is received in return, the payment violates the Gift Clause.

Opinion at 16, ¶22.

The court found that indirect benefits such as potential sales tax revenues cannot be part of the computation of what the government receives. On the contrary, the only consideration that can be considered "focuses instead on the objective fair-market value of what the private party has promised to provide in return for the public entity's payment." Opinion at 21, ¶33. The court focused solely upon the consideration NPP is obligated to provide under the contract. Increased sales taxes arise not from the NPP agreement, but rather from the obligations of CityNorth and its tenants under the tax laws. NPP's only obligation under the contract was to provide use of the parking spaces, and the issue was thus whether the potential \$97.4 million payment "far exceeds the value of the parking places promised in return." Opinion at 24, ¶42. The court found that the agreement with NPP "therefore quite likely violates the Gift Clause." Opinion at 25, ¶43. However, it was not necessary to decide that issue because the decision will be applied only prospectively.

The court also rejected the argument that compliance with A.R.S. §9-500.11 satisfies the Gift Clause. That statute requires certification by a public body that projected tax revenues will exceed tax incentives in an economic development agreement. Viewing the statute as imposing an additional and separate requirement, the court found that satisfaction of this statutory requirement does not by itself satisfy the *Wistuber* consideration requirement.

Recognizing that confusion may have arisen from prior cases, the court limited its opinion to transactions occurring after the date of the decision. The Arizona Supreme Court thus vacated the appellate decision, affirmed the trial court's dismissal of plaintiffs' Gift Clause claim and remanded the case to the court of appeals to consider plaintiffs' other claims (equal protection and special laws clauses).

Several conclusions can be drawn. First, the decision does not affect agreements pre-dating January 25, 2010, although there may be issues as to when an

agreement is entered into or the effect of amendments to agreements. Second, indirect benefits such as increased excise taxes will not satisfy the Gift Clause "consideration" requirement. The benefit to the governmental entity must flow directly from, and be set forth in, the contract. Third, the value of direct benefits to the city, and its relationship to payments by the governmental entity, may require expert analysis and specific findings in the agreement and authorizing legislative action.

Drafting economic development and other agreements between public and private parties requires a thorough and sophisticated understanding of applicable Arizona statutory and constitutional provisions including the Gift Clause. Contact one of the public finance lawyers in the Squire Sanders Phoenix office to discuss these issues.

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