Who Foots the Bill for Local Capital Improvements Projects?

by Michelle DeLappe

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This installment of Skookum Tax News focuses on special benefit assessments, particularly regarding Seattle's waterfront development project. No matter where they occur or what improvements they are funding, controversies around special benefit assessments often arise. This article explores many of the related issues, including recent court decisions.

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Whenever a local government undertakes a special capital improvement — whether a new well, a sewer system, sidewalks, or whatever the project — someone, of course, must pay for it. Many states allow local governments to fund such projects with special benefit assessments. These assessments are levied on property owners who are deemed to receive some special benefit from the new improvements. Is the assessment a tax? A fee? Some other governmental charge? Whatever it is, local governments must be careful to ensure that they comply with legal requirements. As with anything involving significant sums of money, special assessments are often rife with controversy. Property owners may protest the very formation of the improvement district used to finance the public improvements. Individual owners may contest the amount of their assessments. Disputes may also arise as landlords try to pass the assessment through to tenants, requiring careful examination of lease terms. In the meantime, buyers and sellers may have to negotiate what effect the assessments have on sales of properties in the improvement district.

Seattle's waterfront development project illustrates the challenges associated with special benefit assessments. Since the 1950s, a double-decker elevated highway — known locally as "the viaduct" — has run alongside Seattle's entire downtown waterfront. After a similar structure in Oakland collapsed in a 1989 earthquake, resulting in 42 deaths, Seattle has been considering how to replace its viaduct while it awaits "the big one" — a massive earthquake expected in the Cascadia subduction zone.[1] Starting in 2013, work finally commenced on a tunnel to replace it. After the tunnel opens, demolition of the unsightly viaduct should occur in 2019. And then, the final phase: The Waterfront Seattle Program will launch, creating 20 acres of parks and public spaces connecting the waterfront to downtown.

The city council plans to raise $200 million in a one-time special benefit assessment to help pay the anticipated $688 million cost for the Waterfront Seattle Program. (The city expects to pay for the remainder with state and city funds and philanthropic donations.) One of the first steps in the local improvement district (LID) process was to identify the properties that will receive a special benefit from the project. The city has identified an area containing approximately 6,000 tax parcels as benefiting from the long, linear park and pedestrian improvements. The area containing those properties constitutes the city's proposed LID. As part of this process, the city

[1] Kathryn Schulz, "The Really Big One," *The New Yorker* (July 20, 2015).

hired an independent appraiser, Robert J. Macaulay of Valbridge Property Advisors, to provide a preliminary estimate of how much each property will benefit in terms of the expected increase in each property's market value because of the Waterfront Seattle Program. This is crucial for two reasons: The assessment must not exceed the value of the property's total special benefit from the improvements, and the apportionment of the total LID funding is proportionate to the special benefit received by each property in the LID. The city estimates that each owner will pay approximately 48 percent of the special benefit received by their property. The reported median preliminary assessment is approximately $2,400. Opponents point out that this is deceptively low, as the average payment will be more than $33,000. Many owners of condominiums close to the improvements will pay closer to $100,000, and many owners of commercial properties will pay upwards of $1 million.

A Difficult Appraisal Project

Macaulay faced a particularly difficult project in forming a preliminary estimate of the expected increase in value, that is, the difference between the values before and after the waterfront project, without including normal market appreciation or the influence of any other factors. Under Washington law, the benefit must be "actual, physical and material and not merely speculative or conjectural."[2] But the facts here make it very difficult to achieve this. As Macaulay explains in his preliminary report for the city, for the "before" value scenario, he had to first assume the completion of several ongoing projects, including the replacement of the viaduct and the improved views of many properties thanks to that change.[3] To consider the effect on market value due solely to the proposed improvements, he analyzed data and studies from many other cities that have created parks and street beautification projects over the course of decades. Some overarching observations emerged from his analysis. For example, not all parks increase the value of the surrounding properties: Poor maintenance of the amenities or traffic and congestion caused by amenities that draw people from outside the neighborhood can even have a detrimental effect on values. But the study anticipates that the proposed amenities in Seattle's waterfront and downtown area will have a positive effect on values of properties depending on their proximity to the amenities. The study also had to determine this effect on many different types of properties: condominiums and apartments, retail stores, hotels, office buildings, and even stadiums.

How to Challenge the LID and the Assessments

Property owners that wish to protest the waterfront program LID must file their written protest with the city clerk within 30 days of passage of the ordinance forming the LID, which the council will likely consider this fall. If owners representing at least 60 percent of the assessed value of the LID have submitted a written protest, the city may not form the LID. A group of property owners, the No Waterfront LID Coalition, has organized to encourage protesting the LID, including with a website (nowaterfrontlid.org). Many homeowners in the proposed LID object to a special benefit assessment on a small portion of the city's denizens for parks and facilities that will benefit the city as a whole or that may prove to be no benefit at all to local residents facing increased traffic and congestion.[4] The LID has prominent advocates, too, such as the hospitality industry's interest in Seattle's becoming a "world-class city."[5]

After adopting the final ordinance, assuming the LID survives the 60 percent test, the city's appraiser will complete a final special benefit analysis with final assessment amounts for each property. After that point, public hearings will occur at which individual property owners may contest their assessment amounts. Any owner that fails to file an objection before the hearing

[2] *Heavens v. King County Rural Library District*, 66 Wn.2d 558, 563, 404 P.2d 453, 456 (1965).

[3] Robert Macaulay, "Summary of Waterfront Seattle Project Formation Special Benefit/Proportional Study for LID" (May 9, 2018).

[4] Steve Danishek, "Opinion: Seattle's Waterfront LID Is Not Local and Not Fair," *Puget Sound Bus. J.* (July 6, 2018); Kirk Greene, "Opinion: Waterfront LID a Backdoor Approach to Taxation," *Puget Sound Bus. J.* (June 29, 2018); and Karen Gielen, "Seattle's Assessment for Waterfront Park Is Unfair, Unaffordable," *The Seattle Times*, Apr. 2, 2018.

[5] Howard Wright, "Wright on Center: Waterfront Improvement District a Fair Way to Fund Necessary Upgrades," *Puget Sound Bus. J.* (June 22, 2018).

date loses any right to challenge the assessment. But owners that timely challenge their assessments, if not satisfied with the outcome of the hearing, may then appeal to superior court.[6]

To prevail in court, an owner would need to prove that its assessment is premised on a fundamentally wrong basis or that the council decision setting the assessment roll was arbitrary and capricious.[7] These are difficult standards to meet. To prove the former, the city's method of assessment or procedures must be shown to have erred so fundamentally that the only remedy would be to nullify the entire LID, not merely to modify a property's assessment.[8] Even if the court finds this standard met, it will nullify or modify only the assessment of the properties of the plaintiffs in the case; other owners would still have to pay their assessments.[9] And even an erroneous decision can still survive the arbitrary-and-capricious standard.[10] To meet this standard, the owners must prove the council took "willful and unreasoning action, taken without regard to or consideration of the facts and circumstances surrounding the action."[11]

Collections and Caveats After the Fact

Finally, collections of the assessments would commence, likely in 2020. The city will allow property owners a choice on payment: to "prepay" the assessment in one lump sum or to pay it over a period of 20 years at a modest rate of interest. Those that opt for the lump sum may want to consider the fate of owners in Indianapolis that made a similar election to pay for sewer improvement projects until that city adopted a new mechanism to finance projects in 2005. The new mechanism meant that those owners that had opted for installment plans received a windfall as the city forgave all installments that had not yet been paid. The owners that had made upfront payments sued for refunds so that they would receive equal treatment, but to no avail: The U.S. Supreme Court concluded that the disparate treatment was for a legitimate governmental purpose, and that the administrative burden of trying to make things equal would have been too great.[12] Though it is unlikely that Seattle would make any sort of change after the fact that would result in forgiving outstanding assessments for those that opt for the 20-year payment plan, if it does occur, it would have no obligation to provide refunds to those that prepay the assessment.

Those faced with the prospect of paying these assessments have also been wondering whether the city will ask for a supplemental assessment later if other funding falls through or if cost overruns occur. The city has stated that it will not do so. But there is nothing legally to prohibit it from doing so. Nor do owners have any recourse if the anticipated benefits fail to materialize. In a recent appellate decision, a property owner in another part of Washington unsuccessfully challenged LID assessments that were to include a new well.[13] The well water was not ultimately deemed suitable for drinking. Thus, an important benefit that had been the basis for the LID assessments failed to materialize. Nevertheless, the court upheld the assessment. Regarding Seattle's waterfront, this means owners have no real recourse if the project falls short of what is planned or the increase in market values does not occur (which would be difficult to prove given the many factors affecting value).

Who Pays: Landlords or Tenants?

To the extent their leases allow for it, landlords will likely pass the assessments through to their tenants. Tenants in the LID should review their lease provisions carefully. Some leases may make the tenant liable for all taxes and assessments, but others may apply only to property taxes and typical annual assessments. Those tenants would have strong grounds to refuse to pay this one-time special benefit assessment. Moreover, a tenant could argue that

[6] Wash Rev. Code 35.44.200.

[7] Wash. Rev. Code 35.44.250.

[8] *Abbenhaus v. City of Yakima*, 89 Wn.2d 855, 858, 576 P.2d 888, 890 (1978).

[9] *Id.*

[10] *Id.*

[11] *Id.*

[12] *Armour v. City of Indianapolis*, 566 U.S. 673 (2012).

[13] *Hamilton Corner I LLC v. City of Napavine*, 200 Wn. App. 258, 402 P.3d 368 (2017), *as amended* (Sept. 12, 2017).

the benefit is received by the landlord more than by the tenant because the assessment is based on the premise that the landlord will receive more than twice the amount of the assessment on sale of the property. The tenant, in contrast, would receive only the benefit that would accrue to it by virtue of its proximity to the improvements when complete. Given that the improvements will take several years to complete, the lease term may expire before any benefit accrues to the tenant (not to mention that in the interim, the tenant must suffer instead its proximity to a major construction zone).

What About Sales of Properties in the LID?

Buyers and sellers of properties in the LID will also have to take the assessment into account. The prospect of the LID before it is formed poses an interesting valuation quandary for market participants. At this point, the factors to consider are a likely future expense that can be approximated, and an increase in market value more than twice the expense amount, though that increase in the property's value is more remote and much less certain than the expense. Appraisers may reflect these factors in a discounted cash flow and with a capitalization rate that includes the degree of uncertainty about these factors as of the valuation date.

Once collection of the assessment begins, the dynamic between buyers and sellers changes. If a seller prepays the assessment, this should increase the purchase price since the buyer will have been relieved of this responsibility. Since Washington imposes a real estate excise tax on the value of the real estate sold, one tax issue that could arise is whether the increase based on prepayment should be reported as part of the value of the real estate. Arguably, the portion of the value attributable to the prepayment is nontaxable intangible value, not unlike value flowing from contractual rights, but it is unclear whether the Department of Revenue would agree. On the other hand, buyers that will assume a seller's election to pay the assessment over the course of 20 years will need to incorporate that expense in the valuation analysis; they should pay a lower price in light of that ongoing obligation.

Conclusion

The controversy around local improvements in Seattle is far from unique; nearly every local community faces similar decisions at some point. Seattle's waterfront improvement proposal puts the issues in high relief, however, because of the large area affected and the unusually high amount to be collected. Businesses and homeowners in Seattle's proposed LID are considering whether to challenge or embrace this project and who will foot the bill when it comes. It remains to be seen whether the inevitable controversies that ensue will generate new court decisions in the area of special benefit assessments. ■