FISCAL FACT

April 6, 2009
No. 167

From the House That Ruth Built to the House the IRS Built

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New York City and New York Yankees Abuse PILOTs to Finance New Stadium

Executive Summary
Baseball season is finally here, and thousands of baseball fans are heading to the ballpark to cheer on their teams and enjoy America's national pastime. One baseball club that is always discussed during this time of year (for better or for worse) is the New York Yankees. The Yankees are widely known for spending large sums of money to attract top baseball players. It was thus no surprise when it became known that the new Yankee Stadium would be expensive; priced at approximately $1.3 billion,[1] it will in fact be the most expensive stadium ever built. Tickets will also be pricey, with seats behind home plate selling for $2,500 per game.[2]

The stadium's construction costs have been publicly subsidized in the form of $942 million in tax-exempt bonds issued by New York City.[3] Seeking tax-free status for the bonds to ensure a lower interest rate, New York structured the deal to ensure it didn't run afoul of a federal tax code provision which requires that such bonds not be "private activity bonds." This serves as a huge benefit because the bonds are exempt from city, state, and federal taxes, and have an interest rate about 25 percent below that of taxable bonds.

There are two parts to this financing scheme which seem "foul." First, the new Yankee Stadium will be city-owned and thus exempt from property taxes. Meanwhile its primary tenant, the Yankees, will pay no rent. This clearly brings up the issue of whether such tax-exempt bonds should have been issued at all, and especially when the city is so far in the red.

Secondly, to pay off the bonds over time, New York City will receive payments theoretically equivalent to the property taxes that Yankee Stadium would otherwise pay. The city claims that these payments in lieu of taxes (PILOTs) equal taxes that would otherwise be owed. In reality, these payments are inflated by overvaluing the stadium property by three times that of

comparable property. By inflating the payments in lieu of taxes, the City can say to taxpayers that the Yankees are paying a significant part of the stadium's cost, while telling the IRS that the City is paying for almost all of it.

While the IRS signed off on the deal, it has subsequently approved a regulation prohibiting such shell games in the future. The regulation applies only to bonds sold on or after October 24, 2008, leaving previously issued bonds for the Yankees project and even newly issued bonds to pay for cost overruns in the clear. (However, the project's alleged use of inflated assessments remains the subject of public debate and congressional hearings.) Going forward, local governments will still be able to use tax-free status for private projects, but only if public benefit is convincingly demonstrated by meeting a more rigorous standard.

Tax-Exempt Financing Is Extensively Used, Increasingly Abused

In order to completely understand how the City of New York and the Yankee organization have truly taken advantage of the tax code and taxpayers, it is essential to have a basic understanding of tax-exempt financing. Tax-exempt bonds are an important source of financing for state and local governments. Interest earned on bonds issued to support projects determined to benefit the public as a whole is exempt from federal income tax.[4] However, interest earned on bonds issued to fund projects partly or wholly benefiting only private parties (known as private activity bonds) are generally subject to federal income tax.[5]

A private activity bond will be taxed if it meets *both* the "private business use" test and a "private payment" test in the Internal Revenue Code.[6] The "private business use" test considers whether a private business uses more than 10 percent of the proceeds of an issue. Private business use generally arises when a private business has a legal right to use the bond-financed property. The "private payment" test considers the source of payment on the debt service in issue, taking into account whether the payments are directly or indirectly derived from property used by a private business. If 10 percent or more of the proceeds of the bond issuance are used for any private business use *and* if repayment is secured by private property or payments made on private property, the bonds cannot qualify for tax-free treatment.

Because Yankee Stadium and its associated projects are indisputably designed for private use by the Yankees organization, and because a private business will be paying rent for use of the bond financed property, they would ordinarily be classified as "private activity bonds" and not receive tax-free status under the Internal Revenue Code. However, due to the structure used to finance the stadium, such bonds were considered tax-exempt.

New York Relied on Tax-Exempt Financing to Sell the Stadium Project

In 2006, the City of New York and the New York Yankees' organization announced plans to build a new Yankee Stadium in the South Bronx. The financing of the stadium was meticulously structured in order to allow the Yankees to use tax-exempt bonds. The City agreed to own the land (thus exempting it from property taxes) and lease it to the New York City Industrial Development Agency (NYCIDA).[7] NYCIDA, a government entity with taxing and eminent domain power, would then lease both the land and the stadium to a special purpose entity created as an affiliate of the Yankees, which would, in turn, lease both to the baseball team. Rather than paying property taxes, the Yankees would make payments in lieu of taxes (PILOTs) to NYCIDA which would pay off the tax-exempt bonds. In addition, the initiative qualified for tax-exempt bond status since taxpayers, not the Yankees, would be paying for the project.

The cost savings provided by tax-exempt bond financing is immense. For the Yankees project, $942 million in tax-exempt bonds have been issued.[8] It is estimated that the tax-exempt status results in annual interest savings of approximately $7.7 million to $15.7 million for a period of thirty (30) years, totaling between $231 million and $471 million.[9] Without this generous subsidy, it is unlikely that such an expensive stadium could have been built.

It is, at the very least, debatable whether a new stadium for the Yankees benefits the public and serves a sufficiently broad public purpose to justify public subsidies. While financing with government bonds remains popular and attractive, studies have shown that publicly funded stadiums have no effect on the growth rate of real per capita income and may, in fact, reduce the level of real per capita income in cities that build them.[10] Congressman Dennis Kucinich, who chaired several congressional hearings held on publicly financed stadiums, warned, "Not only are other more important public safety projects ignored, such as repairing structurally deficient bridges and aging water distribution and treatment systems, but granting a federal tax exemption to bonds issued to build these stadiums means more and more expensive stadiums are being built than if there were no federal subsidy."[11] Kucinich also argues that the subsidy is a "transfer from the many to the wealthy."[12]

City officials, however, argue that the stadium will greatly benefit the community. Mayor Michael Bloomberg predicts that the stadium will "revitalize the South Bronx with thousands of jobs,"[13] including nearly 6,500 construction jobs and approximately 1,000 permanent jobs.[14] These projections have been criticized as overly optimistic.[15] With the projected ticket prices being out of reach for many people, some members of the community have likened the project to the creation of "a playground for Manhattanites." To assuage some of these concerns, the city has promised other development projects in the area, such as a new park, tennis courts, and other recreational facilities. However, these projects are far behind schedule and will probably not be ready until at least 2011.[16]

It is indisputable that the stadium and its associated projects are designed for private use by the Yankees' organization and that a private business will be paying rent for the use of the bond-financed property. Therefore, the issued bonds would ordinarily be classified as "private activity bonds" and be denied tax-free status under the Internal Revenue Code. However, the Yankees and the City of New York requested a Private Letter Ruling (PLR) from the IRS, seeking an exception to the private payments test.[17] They argued that because the rent payments are equivalent to generally applicable taxes, they are not private payments but rather payments in lieu of taxes and should qualify as a regulatory exception.

The city's claim that the Yankees' payments are akin to tax payments rather than debt service payments rests on the fact that the PILOTs are based on property tax assessments. A PILOT arguably satisfies the definition of "generally applicable tax" if the payment is not greater than the amount imposed for a tax of general application and the payment is designated for a public purpose.[18] For example, if $50 million was needed annually to pay off the bonds, but actual property taxes would amount to only $30 million, a PILOT that would qualify for tax-free status could not exceed $30 million.

The city was determined to ensure that the payments would cover all bond costs, and equally determined to receive tax-exempt status on the bonds. Consequently, it was important that the stadium property be assessed at a value greater than the bonds in order for the payments to equal the debt service and be at a value which would produce property taxes equal to or less than what the taxes on the actual property would have otherwise been. Three appraisals were conducted, each purportedly using comparable land and taking into account the size, location, and appreciation in value from the development.

Using Manhattan Land to Value a Bronx Stadium

The first land assessment was performed by the New York Department of Finance (DOF). The DOF chose eight parcels of land located in Manhattan as comparables for the assessment, rather than in the Bronx where the stadium was to be located. The Bronx is the poorest district in the country,[19] compared to Manhattan which has some of the highest real estate values in the world. The Manhattan-based appraisal was also calculated using 17 acres, compared to the 14.5 acres upon which the stadium is located. These two dubious assessment methods used by the DOF resulted in an inflated assessed value of $204 million.[20]

Two independent assessments provided significantly lower figures than the DOF appraisal.[21] ne estimated the amount of money which would be required to replace park land lost by the stadium's construction. This appraisal evaluated comparable property in the Bronx and determined the land was worth $26.8 million. The third appraisal, performed by a private firm at the request of the New York City Industrial Development Agency (NYCIDA), assessed the land at $40 million. Not surprisingly, only the DOF appraisal for $204 million was submitted to the IRS.

In addition to the valuation of the land, DOF did an assessment of the stadium itself and, working with Goldman Sachs, valued the stadium at $1.025 billion.[22] The final dollar value of the assessment was $1.129 billion.[23] Typically, a project engineer will verify the assessment numbers in a certified cost schedule; however, no verification was provided in this case, which raised serious questions concerning a number of project costs which appeared to be overstated or counted twice.

Despite obvious concerns over these assessments, NYCIDA approved the issuance of $920 million in tax-exempt bonds and $25 million in taxable bonds, both to be repaid by the Yankees by PILOTs. City officials further contended that funding for the $800 million in construction would be fully provided by the Yankees.

The IRS Approved the Tax-Exempt Bonds But Has Moved to Tighten Standards

NYCIDA submitted only the DOF valuation when it presented its request for a PLR. These valuations indicated that the PILOTs would be sufficient to cover the debt service requirements of the bonds. City officials argued that the financing plan complied with IRS rules and that the Yankees did not receive special treatment beyond that which any other taxpayer would have received. In considering similar requests, the IRS does typically give great deference to state and local governments in determining if sufficient public benefits exist to justify tax-exempt financing for projects. In this case, the IRS deferred to the city's assertion that the PILOT payments and the property taxes were closely linked, and approved the stadium project bonds for tax-exempt financing. However, the IRS further stated in its private letter ruling that its opinion was strictly based on the figures provided by the

NYCIDA, and any deviation from those facts and representations could cause the PLR to become inapplicable.[24]

The use of PILOTs approved by this private letter ruling issued by the IRS appears to be prohibited by two separate Treasury Department regulations. First, a PILOT should be treated as a special charge if it is "made in consideration for the use of property financed with tax-exempt bonds."[25] In the present case, the Yankees' PILOTs appear to be designed to be "made in consideration" for the construction and "use of property" (i.e. the stadium) "financed with tax-exempt bonds."

Secondly, the PLR explained that these PILOTs are not rightly characterized as "payments for a special privilege granted or service rendered"[26] because they "do not create a new charge separate and apart from the system of real property taxes that are due for use of the stadium."[27] Thus, the defenders of the Yankees' PILOT are trying to analogize PILOTs to tax abatements. By this reasoning, it would be difficult to imagine any application for a PILOT being denied because PILOTs are typically derived from "the system of real property taxes"—they are, after all, payments in lieu of taxes. The IRS fell short in this PLR of correctly applying the PILOT rule and other Treasury Department regulations and failed to demonstrate that the IRS was obligated by the regulations to allow the use of the Yankees' PILOTs.

It comes as no surprise that after issuing the ruling, the IRS proposed and finalized a new regulation narrowing the use of PILOTs. The new regulation applies to bonds sold after October 24, 2008, and therefore does not apply to Yankee stadium since all the bonds for that project had been sold prior to this date.

There is no doubt that the Yankees hit a home run to win the tax-exempt game in the final inning. For others not so fortunate, the new regulation requires that an eligible PILOT must represent "a fixed percentage of, or reflect a fixed adjustment to, the amount of generally applicable taxes in each year, based on comparable current valuation assessments."[28] This eliminates the ability of state or local governments to set PILOTs at fixed annual amounts that do not fluctuate with changes in the generally applicable taxes on which the PILOT is based. The regulation also requires periodic recalculation of any PILOTs based on current assessed value and provides a standard to determine whether a PILOT payment is "commensurate" with generally applicable taxes, as such term is used in section 1.141-4(e)(5). Clarifying the "commensurate" standard provides more certainty to issuers with respect to the application of PILOTs.

Conclusion

It is doubtful the city would have foregone the property tax revenue to build a new baseball stadium given the current state of its budget, which is looking at an approximate $4 billion shortfall for FY 2009-2010. However, putting aside the turbulence of economic conditions and whether $2,500 seats are likely to be sold, it is still debatable whether a new Yankee Stadium built with tax funds could be a benefit for the public. But because of the way the project is being financed, it is difficult to know what the actual cost to the taxpayer is, let alone whether it is the best use of scarce taxpayer dollars.

Here, New York City has tapped into taxpayer funds by shifting the financing through different layers of local government while essentially claiming that the stadium will pay for itself.

If there are justifiable uses for PILOTs, the Yankee Stadium project does not appear to be one of them. When taxpayers elsewhere hear that any project is being funded by PILOTs, they should remember the cautionary tale of the Yankee PILOTs and insist on strict transparency and accountability so that their taxpayers do not end up subsidizing private uses with public funds.

Notes

1."New Yankee Stadium to Cost $1.3 billion," *Forbes* (Feb. 7, 2008).

2."Seats Behind Home-Plate at Yankee Stadium to Cost Between $500- $2500," ESPN.com (Mar. 21, 2008) (accessed on November 18, 2008) http://sports.espn.go.com/mlb/news/story?id=3305979.

3. Mark Giannotto, "Yankee Stadium Bonds Request Defended as Good for the Bronx," *The New York Sun* (Jul. 3, 2008).

4. *See* 26 U.S.C. § 103 (a). Gains realized from the sale of exempt bonds are taxed.

5. *See* 26 U.S.C. § 103(b)(1); 26 U.S.C. § 141. Even private-activity bonds which qualify for exclusion from federal income tax are taxed under the Alternative Minimum Tax (AMT), which denies tax preferences to many high-income taxpayers. *See* 26 U.S.C. § 7(a)(5)(C).

6. 26 U.S.C. § 141(a).

7. *The House That You Built: Hearing Before the NY State Comm. on Corp., Authorities, and Comm*. (2008) (testimony of Assemblyman Richard L. Brodsky).

8. Gary Thorne, "Tax-exempt Bonds Part of Baseball's Growth Plan," *USA Today* (Nov. 4, 2008).

9. *See supra* note 7.

10. Dennis Coates and Brad R. Humphreys, "The Growth Effects of Sport Franchises, Stadia, and Arenas," UMBC Dept. of Economics Working Paper #97-02 (Sep. 27, 1997).

11. *Gaming the Tax Code: Public Subsidies, Private Profits, and Big League Sports in New York: Oversight and Gov. Reform Comm.*, 110th Cong. (2008) (statements by Rep. Dennis J. Kucinich).

12. *Id.*

13. August 16, 2006, NYC Press Release.

14. *Id*.

15. *See supra* note 7.

16. *See* Tom Ferrey, "South Bronx Neighborhood Taking Hit From New Stadium," ESPN.com (Sept. 19, 2008), http://sports.espn.go.com/mlb/news/story?id=3598021 (last visited on Nov. 18, 2008).

17. *See supra* note 7.

18. Treasury Reg. section 1.141-4(e)(5).

19. *See supra* note 16.

20. *See supra* note 7.

21. *Id.*

22. *Id.*

23. *Id.*

24. *Id.*

25. Treas. Reg. § 1.141-4(e)(5).

26. Treas. Reg. § 1.141-4(e)(3).

27. *See supra* note 7.

28. Treasury Reg § 1.141-4(e)(3).