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Georgia Court-Validated Bond Transactions Challenged In Tax Valuation Case Involving Sale-Leaseback Transactions

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Introduction

On November 1, 2010, the Georgia Supreme Court issued its opinion in *Sherman v. Fulton County Board of Assessors*,[1] in which it allowed an individual taxpayer to challenge the Georgia practice of using sale-leaseback bond transactions to encourage real estate development. This longstanding tax abatement mechanism is one of the very few incentives available under Georgia law to attract local development, and cities and counties throughout the state have for decades relied upon the availability of this business development tool.

The trial court initially dismissed Mr. Sherman's challenge for failing to state a viable claim upon which relief could be granted. On appeal, however, the Georgia Supreme Court reversed, holding that the appropriate method for valuing the leasehold estates underlying the sale-leaseback transactions was an issue of fact and the defendants had failed to establish that their proposed valuation methodology was reasonable.

The Sale-Leaseback Bond Transaction

A sale-leaseback bond transaction arises from an agreement between a local development authority, in this case the Development Authority of Fulton County ("DAFC"), and a private developer of real property (the "Developer"). The arrangement is designed to lower property taxes on new developments for a fixed period of years. If set up properly, the transaction leaves DAFC and the Developer in the same substantive positions (other than a reduced tax burden on the Developer) that each was in before entering into the agreement. In other words, DAFC realizes no net change in its revenue or expenses and the Developer enjoys the same use of its property.

Here's how it works. The Developer wants to build commercial improvements on certain real property that he owns. DAFC, in accordance with its redevelopment powers,

[1] No. S10A0924, 2010 WL 4273347 (Ga. November 1, 2010).

buys the property from the Developer and pays for this purchase by issuing revenue bonds to the Developer equal to the purchase price. The Developer then leases back the property from DAFC, which uses the lease payments to pay the principal and interest due on the revenue bonds. As a tax-exempt entity, DAFC does not pay *ad valorem* tax on its fee simple interest in the property.

The Developer, however, is not tax-exempt and therefore remains subject to tax on his leasehold interest in the property. The amount of his tax obligation depends on the assessed value of the lease. As part of the transaction, the parties typically agree that the leasehold interest will be valued at a certain percentage of the fair market value of the property's fee simple estate. The assessed leasehold value then increases by an agreed-upon percentage per year so that, after 10 years, it is valued at 100 percent of the property's fair market value. At the end of the lease, the revenue bonds are paid down or retired and, pursuant to the terms of their agreement, the Developer repurchases the property from DAFC for a nominal sum.

Case Issues and Relief Sought

In the *Sherman* case, DAFC's bond transaction, including its agreement with the Developer, was "validated" by a Fulton County superior court, a statutory procedure used in Georgia to prevent future collateral attacks of bond issuances. Historically, DAFC assumed that the validation process rendered the entire transaction bulletproof. Therefore, the threshold issue in this case was whether allowing a taxpayer to challenge the leasehold valuation method amounted to a prohibited collateral attack on the entire validated bond transaction.

DAFC asserted that, because the leasehold valuation was part of the overall transaction that was validated by the superior court in a public proceeding, it could not be subject to collateral challenge. The superior court agreed and dismissed Mr. Sherman's lawsuit. On appeal, however, a majority of the Georgia Supreme Court justices disagreed, reasoning that while the superior court validated the issuance of the bonds, it did not specifically address and validate the leasehold valuation methodology contained within the sale-leaseback agreement. The majority stated that the valuation formula could be protected from future attack only if the superior court specifically addressed and ruled upon it when it validated the bond transaction.

Mr. Sherman alleged that the agreed-upon valuation methodology was invalid because it was illegal, unconstitutional, *ultra vires*, and constituted a failure of the Fulton County Board of Assessors ("FCBOA") to perform its duty to ensure that property is assessed at fair market value. As a Fulton County resident and taxpayer, he claimed standing to seek the following relief on behalf of himself and all others similarly situated:

- A declaration that the valuation methodology was unconstitutional under, among other sections, Georgia's uniformity of taxation provision (Art. VII, § 1, Para. 3);

- An injunction preventing FCBOA from using the methodology in this transaction; and

- A writ of mandamus ordering FCBOA to accurately determine, for property tax purposes, the values of all past and future leasehold estates.

The Supreme Court only reversed the superior court's dismissal and it remanded the case with direction that the superior court specifically examine and rule upon the validity and reasonableness of the proposed valuation methodology.

The Decision's Implications

While Mr. Sherman purports to seek a tax increase upon real estate developers, his litigation, if successful, may ironically result in a net decrease in tax collections within Fulton County. If the superior courts in Fulton County begin to question and invalidate sale-leaseback bond transactions, one of the only incentives available in Georgia for attracting new businesses, there could be a chilling effect upon future development within Fulton County. Without the property tax abatement incentives that accompany such transactions, developers may look elsewhere to find more tax-friendly jurisdictions in which to invest. Alternatively, Fulton County may have to start paying out of pocket to entice developers to undertake new projects.

While higher leasehold valuations increase tax revenue, at least in theory, and if all other circumstances stand unchanged, development is less likely to occur in the jurisdictions in which the developers face rising property tax costs. All else being equal, development decreases in response to higher tax burdens. If Fulton County winds up losing new development opportunities as a result of the *Sherman* decision, then the resulting lost tax revenue could easily exceed any net tax revenue gained from imposing higher leasehold valuations on current and future developments.

And even if Mr. Sherman is ultimately unsuccessful in getting the proposed methodology invalidated, the Supreme Court's decision may nonetheless have an indirect impact upon Fulton County's future development and tax revenue. Mr. Sherman is the first plaintiff to make a successful attack on the sale-leaseback bond transaction concept. Now that such a challenge has been allowed to proceed, albeit on a narrow issue, there may be an added element of risk to both the developer and the Development Authority in future transactions. Such an increase in risk can increase a project's anticipated cost and may make it less likely to go forward.

On the other hand, the Supreme Court's ruling provides that parties may protect themselves from such challenges by ensuring that future bond validation proceedings include a request for a ruling specifically on the methodology used to value the leasehold estates. Since the *Sherman* opinion, the DAFC has sought such specific rulings in order to insulate new sale-leaseback transactions from future attack. It has requested express findings in the bond validation orders that the formulas used to value leasehold estates are reasonable and nonarbitrary. So, while the *Sherman* ruling allowed a challenge to past transactions, its language may ultimately afford a means of increased security for future agreements between the DAFC and private developers.

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