



Memorandum

TO: HONORABLE MAYOR AND
CITY COUNCIL

FROM: Councilmember Johnny Khamis
District 10

SUBJECT: PRIVATE ACTIVITY BOND
EXEMPT FACILITIES
FEDERAL POLICY CHANGE
REQUEST

DATE: 06/12/18

APPROVED:

6/14/18

RECOMMENDATION

- 1) Refer, to the full City Council, at the June 26th Council meeting, a support position for requesting a change to the federal policy on Private Activity Bonds to include “community-serving recreation facilities” on the list of Exempt Facilities.
- 2) Direct staff to add this issue to the Legislative Guiding Principles.
- 3) Direct Staff to reach out to Congresswoman Eshoo’s office, the rest of our Congressional Delegation, and our Federal lobbyist, to address this issue.

ANALYSIS

The City of San José is projecting budget shortfalls for the next five years. There are many challenges contributing to this situation, and one of those challenges is a Federal tax regulation.

Community-serving recreation facilities, purchased with Tax Exempt Governmental Bonds, are subject to the Private Business Test and are allowed to be managed by third-party vendors, subject to fixed-fee Management Agreements. The IRS regulation is intended to prohibit revenue sharing agreements for public, bond-funded projects to prevent public funding from being used to support corporate interests. However, this fixed-fee Management Agreement is one factor that is causing our General Fund to subsidize significant losses each year.

Like communities across the United States, the City of San José has a large and growing backlog of infrastructure maintenance needs. Expanding the definition of exempt facilities to include qualified community-serving recreation facilities would allow the management of those facilities to contribute to the City’s General Fund, without significantly impacting the Federal Government’s revenue. If we were allowed to use revenue-sharing agreements for the City’s community-serving recreation facilities we could incentivize private operators to be creative in increasing facility usage and maximizing revenues as they reach for profitability. For San José, that would mean approximately \$2 million or more, per year, that we would not have to spend from our General Fund and approximately \$2 million

or more, per year, that we could earn from revenue sharing. That is \$4 million or more, per year, that could be spent on reducing our infrastructure maintenance backlog.

This request defines “Qualified Community-Serving Recreational Facilities” as those facilities constructed by local municipalities for the purposes of providing active recreational opportunities for the residents of said municipality, and community-based, organized clubs such as Little League, Youth Soccer League, etc. Such facilities include, but are not limited to, sports facilities such as softball, tennis, soccer, and golf; aquatic centers; bike and skateboard parks; community centers; and recreation centers.

Adding qualified community-serving recreational facilities to the Exempt Facilities list would affect municipalities nationwide. This could help struggling cities improve their financial condition, as well as increase tax revenue to the Federal government as third party management companies increase their revenues.

In order to maximize the beneficial effect of such a change, it needs to be applied to existing facilities, with currently outstanding bond debt, as well as those constructed in the future.

Congresswoman Eshoo’s help in securing a tax policy change to expand the types of facilities benefited by Private Activity Bond exemptions to include qualified community-serving recreational facilities, and to define qualified community-serving recreational facilities to include those municipal facilities whose primary purpose is providing access to non-professional organized sports teams/clubs and general public usage, would eliminate a significant budgetary challenge for San José.

BACKGROUND

For almost a decade, the City of San José has been struggling financially. Layoffs and budget cuts have left all departments considerably understaffed. Our remaining staff has adapted, modified, changed, and worked creatively to "do more with less."

Over the past four years, the City of San José has increased the sales tax, approved a library parcel tax, and increased and expanded the business tax. On top of these tax increases, our residents have paid outrageous increases in water rates and seen steady increases in their garbage, sewer, and electricity charges. Further, voters have approved several new sales, parcel, and ad valorem taxes for housing, schools, and transportation, which is on top of the customary increase in property taxes due to the rise in property values.

The high cost of living in our area is a topic often discussed in the press and in our daily conversations, and yet by approving new taxes and increasing service charges, we become part of the problem. Despite our robust economy and tax revenue growth, budget constraints are forecasted to last for many more years, with double-digit deficits projected through 2022 and beyond. The City is currently evaluating the feasibility of placing funding measures on the ballot to increase revenue, however, additional taxes on residents cannot continually be our go-to plan for countering these shortfalls.

To stabilize our General Fund, we must leave no stone unturned and look for ways to reduce costs and increase revenue that do not further burden our residents. This search has highlighted a problem that can only be solved by our Federal legislators.

There have been several situations that arose over this past year that are the result of the bond restrictions placed on our recreation facilities. First, in 2000, voters approved a park bond that included the building of a softball facility and a soccer facility. Finances, staffing shortages, and land purchase negotiations lead to the delay in building both facilities. However, the softball facility is currently under construction, and the soccer facility is in the negotiations phase.

In August 2014, the City completed a Request for Proposals (RFP) for the operation and maintenance of the proposed City-wide softball facility to source an outside operator. Twenty-one in-state operation vendors were contacted to solicit interest. yet only one vendor submitted a proposal. Sportsplex USA was deemed the responsive bidder in late 2014 and the City began negotiations with them. It was required that the selected vendor enter into a Management Agreement in compliance with IRS Procedure 97-13 to manage, promote, operate, and maintain the proposed softball facility.

The Management Agreement required as a stipulation of the tax-exempt bond funding constraint, resulted in a projected net loss in year one to be \$855,000 with an increase to \$993,000 in year five. Because of this constraint, the cost of the proposal from the vendor was much higher than staff had anticipated. Sportsplex USA indicated that they could operate the facility at a much lower cost if the City waived the Management Agreement requirement. After extensive discussions, it was determined that it was not possible for the City to wave the Management Agreement requirement due to the tax code governing tax exempt bond-funded facilities.

Second, In the 1990's, at the height of the roaring dot com era, land for two golf courses was purchased by the City of San José with tax-exempt Governmental Bonds. In September 2015, the City Auditor published the report titled "Golf Courses: Loss of Customers and Revenues Requires A New Strategy." The audit confirmed that bond restrictions were contributing to General Fund subsidies of about \$300,000 per year for each of the golf courses purchased with Governmental Bonds - an amount that has more than doubled since that report was issued. A November 2017 update on the golf courses tells us that because IRS regulations preclude third-party vendors from privately benefiting from the operations of these types of publicly-funded facilities while a debt obligation balance remains outstanding, the City is prevented from contracting with golf course operators using revenue-sharing agreements.

Instead, the City is constrained to providing the operators with fixed compensation via Management Agreements until the outstanding debt obligation for these facilities is extinguished. This is presently the arrangement that the City has with our vendor and it has the effect of shifting all financial risks pertaining to profitability to the City. Thus, as operations and management costs (including staffing costs, water costs, etc.) increase and golf rounds and other revenue-generating products and services remain relatively flat (or decline), the City's General Fund operating subsidies continues to grow. The following table illustrates this effect on just one of the City's two golf courses (the impact on the other course is similar, but was not a part of this November 2017 report):

City of San José Los Lagos Golf Course 3-Year Financial Data with Rounds Played			
	2014-2015	2015-2016	2016-2017
Rounds played	50,078	49,458	47,049
Debt Balance* at Year-End (Millions)	\$26.09	\$24.57	\$23.03
Management Fee**	\$168,289	\$173,491	\$178,279
Net City Loss (Operating Subsidy)	\$386,893	\$483,455	\$621,756

*Funded separately from the operational subsidy and includes principal and interest

** Is included in the operational subsidy amount

When the previously mentioned soccer complex is complete, it is expected that the Management Agreement policy will again result in a poor response to the RFP as well as General Fund subsidies to offset management costs.

On March 12, 2018, Councilmember Khamis submitted a letter to Congresswoman Anna Eshoo requesting her help in making a policy change that would help the City of San Jose better serve our residents and improve our aging infrastructure.

On April 6, 2018, Council District 10 staff received word that Congresswoman Eshoo is amenable to putting forth legislation on our behalf to address our problem, and requests consent from Council in order to move forward.

Congresswoman Eshoo’s sponsorship of legislation to expand the definition of the exemptions to the Private Business Test rules to include qualified community-serving recreational facilities, would eliminate one of the challenges contributing to our budgetary struggles by freeing us from the Management Agreement requirement and benefit the Federal government by generating taxable revenues generated from any income generated by facility operators from tax-exempt, bond-funded facilities that now generate zero taxable revenues.

The Office of the City Clerk will post the item on the City’s Website for the June 20, 2018 Rules Committee Agenda and the June 26, 2018 City Council Agenda.