



## CITY OF KIRKLAND

Department of Finance & Administration

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### MEMORANDUM

**To:** Kurt Triplett, City Manager

**From:** Tracey Dunlap, Director of Finance & Administration

**Date:** September 24, 2010

**Subject:** Strategies for Phasing Out Reliance on Annexation State Sales Tax Credit

At the July 20 Study Session on annexation finances, a white paper identifying strategies for phasing out reliance on the annexation state sales tax credit when it ceases after 10 years was requested. It is important to note that the actual process for phasing out reliance on the credit will likely be a combination of the strategies below and other actions that may be identified over time. The strategies identified to date include:

- Structure debt service on bonds used to finance facilities to adjust after 10 years to recognize the incremental facilities costs associated with annexation. The annexation area financial analysis assumed that the incremental facilities related to providing service in the potential annexation area would be eligible cost for inclusion in the 10-year annexation sales tax credit calculation. Based on the figures from the June 1 Facilities Study Session, a total of \$20.1 million of the project is allocable to the annexation area, all of which is assumed to be funded with debt. Consistent with the assumptions from the annexation financial analysis, a share of the debt consistent with the per capita debt issued in the existing City will be amortized over the 30-year term, and the amount in excess will be amortized over a 10-year term to coincide with the annexation sales tax credit period. This methodology allows for an equitable allocation of the debt service over the long-term and also matches the annexation area's incremental facilities costs with the anticipated 10-year stream of State sales tax credit.
- As described in recent quarterly annexation updates, the City plans to reimburse costs incurred prior to the annexation effective dates as capacity becomes available in the sales tax credit. It is expected that this reimbursement may take several years and, once these costs have been reimbursed, the amount of the sales tax credit may start to decline.
- In general, departments tend to under-spend their budgeted expenditures, primarily due to the impacts of position vacancies or other savings, as well as good budget management. To the extent that this occurs over time (and once pre-effective date expenses have been reimbursed), it might reduce reliance on the sales tax since the State requires that the reimbursement should not exceed the actual difference between revenues and expenditures.

- The City tends to budget revenues conservatively and hopefully the revenues collected in the annexation area will grow over time. While some of this growth will be needed to pay for increased costs, it will be important to control cost growth to the extent possible to help phase out reliance on the annexation sales tax credit.
- The City has identified the resources needed to provide services in the annexation area over the next biennium, but it is not possible to know with certainty what those service demands will be. As subsequent budgets are developed, additional economies of scale may be identified with the integration of service provision between the existing City and the annexation area.
- A renewed focus by the City on economic development may generate additional sustainable tax revenue prior to the expiration of the sales tax credit. Emphasis will be placed on revitalizing Totem Lake and successfully implementing the Park Place project to create jobs and tax revenue for both the current and new Kirkland.

RCW 82.14.415(9) requires the following annual notifications by the City to the State:

(9) The tax shall cease to be distributed to the city for the remainder of the fiscal year once the threshold amount has been reached. No later than March 1st of each year, the city shall provide the department with a certification of the city's true and actual costs to provide municipal services to the annexed area, a new threshold amount for the next fiscal year, and notice of any applicable tax rate changes. Distributions of tax under this section shall begin again on July 1st of the next fiscal year and continue until the new threshold amount has been reached or June 30th, whichever is sooner. Any revenue generated by the tax in excess of the threshold amount shall belong to the state of Washington. Any amount resulting from the threshold amount less the total fiscal year distributions, as of June 30th, shall not be carried forward to the next fiscal year.

This process of estimating and certifying costs each year will help determine how best to phase out reliance on the annexation sales tax credit. It is the State's intent that the 10-year credit provide the City with time to bring annexation area revenues and expenditures into alignment and the expectation is that the credit amount may not be maximized for the entire 10-year period. The City will make decisions as part of each biennial budget process to balance the budget for the larger City. As part of these deliberations, the process for phasing out reliance on the annexation state sales tax credit at the end of the 10 year period will be an important consideration.