

Memorandum

TO: HONORABLE MAYOR AND
CITY COUNCIL

FROM: Leslye Krutko
James R. Helmer

**SUBJECT: CONSTRUCTION TAX
SUSPENSION FOR VERY
LOW-INCOME HOUSING**

DATE: April 19, 2006

Approved

Date 4/24/06

COUNCIL DISTRICT: Citywide
SNI: All

RECOMMENDATION

It is recommended that the City Council approve an ordinance amending City of San José Municipal Code Chapters 4.46.039.5, 4.47.092, 4.54.038, and 4.64.035 of Title 4 to extend, through June 30, 2011, the suspension granted to newly-constructed housing restricted to occupancy by very low-income households from the following taxes:

- 1) Building and Structure Construction Tax;
- 2) Construction Portion of the Construction and Conveyance Tax;
- 3) Commercial-Residential Mobilehome Park Building Tax (CRMP); and
- 4) Residential Construction Tax.

OUTCOME

If the construction tax suspension is extended until June 30, 2011, housing restricted to occupancy by very low-income households will receive tax suspensions in the amount of approximately \$2.7 million for an average savings of \$2,651 per unit. If the five-year suspension is adopted, the City's Capital Improvement Program will be impacted by approximately \$2.7 million in foregone revenues in Fiscal Year 2006-07 through Fiscal Year 2010-11. The funds saved from the suspensions will be used to finance additional affordable housing developments.

EXECUTIVE SUMMARY

Since 1992, the City Council has passed an ordinance that suspends construction taxes from newly-constructed very low-income units. The current tax suspension will expire on June 30, 2006 and City staff is recommending an extension of an additional five years through June 30, 2011. The tax suspensions will provide a savings of approximately \$2.7 million for the 1,016 very low-income units that are estimated to be built over the next five years. If the construction tax suspension is extended, the City's Capital Improvement Program will be impacted by

approximately \$2.7 million in foregone revenues in Fiscal Year 2006-07 through Fiscal Year 2010-11.

BACKGROUND

On April 14, 1992 and retroactive to August 1, 1991, the City Council first passed the ordinance that provided a 5-year suspension (through July 1, 1996) for newly-constructed very low-income housing from the following taxes: (1) Building and Structure Construction Tax; (2) Construction Portion of the Construction and Conveyance Tax; (3) Commercial-Residential Mobilehome Park Building Tax (CRMP); and (4) Residential Construction Tax.

The City Council extended the 5-year tax suspension on newly-constructed very low-income housing in 1996 and 2001.

For the purposes of the ordinance, very low-income housing is defined as housing affordable to households whose incomes do not exceed the qualifying limits for very low-income households as established, and occasionally amended, by the California Health and Safety Code. Currently, this is defined as 0-50% of Area Median Income by household size. In addition, only very low-income units that are subject to affordability restrictions are exempt from these taxes. Housing affordable to extremely low-income households falls within the definition of very low-income for purposes of the ordinance.

ANALYSIS

The issue of City construction tax suspensions for certain programs and/or targeted groups, in this case housing affordable to very low-income households, is a difficult policy issue for the City Council. In San José, the issue is a choice between contributing to the affordability of housing and other priorities. On one hand, the four taxes referenced above represent revenue sources which could be used by several City departments to partially defray the costs of capital improvement and maintenance of projects, such as transportation and traffic, public library, fire protection, parks and recreation, and communication facilities. On the other hand, these same taxes have been identified as one of several cost factors that, when combined with other development-related fees and taxes, contribute to making housing unaffordable to many City residents, especially those that earn very low incomes.

1. Cost and Benefits / Impacts Issues

The Mayor's March Budget Message calls for a five-year affordable housing development plan that will add 1,200 affordable homes per year. Currently, the Housing Department estimates that it will build 1,421 units that will be restricted to occupancy by lower-income households over the next five years. Of these units, 1,016 will be restricted to occupancy by very-low income households. Approximately \$2.7 million in cost savings (\$2,651 per very low-income unit) to affordable housing can be realized if the suspensions are extended through the year 2011.

The City relies on construction tax suspensions as a means of demonstrating the City's efforts to remove barriers to affordable housing. The 2005 – 2010 Consolidated Plan, which the City Council approved in May 2005, lists advocating for reasonable development fees as part of the activities the City undertakes to fulfill this objective. The tax suspensions are also listed in the City's Housing Element Report. In addition, in April 2006, the Department of Housing and Urban Development (HUD) announced that government agencies will be eligible to receive additional points on their funding applications if they demonstrate efforts to remove regulatory barriers to affordable housing.

These construction tax suspensions also demonstrate a local match when applying for federal funding, such as the HOME program. In accordance with HUD's requirements, the City of San José provides a 25% match for these funds, primarily in the form of tax and fee waivers and bond proceeds. In Fiscal Years 2001-02 through 2004-05, the City has received \$18,312,000 in HOME funds. It is estimated that we will receive \$4,642,637 for FY 05-06 and \$4,355,567 for FY 06-07.

The tax suspensions also promote the development of affordable housing, thereby providing many benefits to the City's economy. From August 2001 – January 2006, the construction of new affordable housing resulted in an increase of approximately \$9.8 million to the City's budget for units that were not subject to the suspension. The tax suspensions also provide indirect benefits to the City's economy in the form of additional sales taxes and construction jobs created by affordable housing developments. In addition, new affordable housing developments can also facilitate neighborhood revitalization since they are positive additions to neighborhoods, and often provide the incentive for private investment in property improvements in the neighborhood.

Table 1 presents the cost savings very low-income housing units received in Fiscal Years 1991-92 through 2005-06 as a result of the suspensions. From Fiscal Year 2001-02 through the current Fiscal Year, 2,320 very low-income units received suspensions in the amount of \$6,246,568 for an average savings of \$2,692 per unit. The greatest impact of the suspensions fell on the Building and Structure Construction Tax and the Commercial-Residential Mobilehome Park Building Tax. These two particular taxes finance road and traffic capital improvement projects.

2. Housing Needs

The City Council's decision in 1992, 1996, and in 2001 to exempt housing restricted to occupancy by very low-income households from the construction-related taxes was based on the magnitude of the City's housing needs. In addition, the decision was made in recognition of affordable housing production as a critical priority in the City's effort to increase the quality of life for all City residents, especially for those earning very low-incomes. In response, the City embarked on an aggressive and innovative Affordable Housing Production program that will have produced 11,000 affordable units from January 1999 through December 2006. Despite the City's commendable efforts, affordable housing needs, especially for very low-income residents,

remains a critical priority. Today, over 36% of San José's households fall into the very low-income category.

3. Programmatic Needs and Issues

Affordable housing development is financially feasible because local housing funds are used to fill the project's "financing gap." Without the City's financing assistance, it is improbable that affordable housing could be developed. Therefore, the argument that tax suspensions represent foregone revenues to other City programs is hypothetical, at best, because the collection of construction taxes depends on the actual construction of the affordable housing project. The suspensions also serve to stimulate affordable housing production. If the suspensions were eliminated, the construction taxes would be added directly to the project cost, increasing the "financing gap" that the City is required to subsidize.

ALTERNATIVES

- (1) Extend the construction tax suspension through June 30, 2011 for newly constructed very low-income units (current policy).
- (2) Expand the construction tax suspension to include newly constructed low-income units through June 30, 2011 (including very low-income units).
- (3) Do not extend the construction tax suspension for newly constructed very low-income units.

The table below shows the three alternatives available to the City Council, the number of low and very low-income units that the Housing Department estimates it will build over the next five years, and the projected fiscal impact of the construction tax suspensions. Alternative 1 will enable the City to further contribute to the construction of affordable housing by reducing the subsidy required to construct the affordable unit. Although extending the construction taxes will make the development of affordable housing more financially feasible, these suspensions are also foregone revenues to other City departments and programs. The greatest impact would be to road and traffic capital improvement projects. The impact to the City's programs for Alternative 1 and Alternative 2 are listed in Table 2.

Choosing to expand the suspension to include low-income units, Alternative 2, will demonstrate that the City is removing barriers to building affordable housing. Expanding the policy would also provide further incentive for developers to construct lower-income units. However, choosing Alternative 2, would also further decrease the funding available to finance road and traffic capital improvement projects by approximately \$1 million. Staff is not recommending Alternative 2, due to concern for the City's traffic programs and the funding available to finance these projects. However, staff recommends revisiting Alternative 2 if funding becomes available in the future through a state infrastructure bond or state ballot proposition that would secure additional money for road and traffic capital improvement projects.

Alternative 3, choosing to not extend the construction tax suspension will impact the City's efforts to provide decent and affordable housing to its neediest residents by increasing the City's per-unit subsidy, thereby impacting the number of units that could be built. The construction

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taxes would be added to the project cost. In addition, the 2005 – 2010 Consolidated Plan would have to be amended to exclude the tax suspensions that are currently provided. Lastly, this action may also hinder the City’s ability to receive federal funding for its housing programs, since government funding applications frequently provide a preference to jurisdictions that provide evidence of removal of barriers to affordable housing.

	Alternative 1 5- Year Suspension Very Low-Income Units July 2006 - June 2011	Alternative 2 5- Year Suspension Including Low-Income Units July 2006 - June 2011	Alternative 3 No Suspension of Construction Taxes July 2006 - June 2011
Projects and Units			
# of Units	1,016	1,421	1,421
Estimated Tax Suspensions¹			
Building & Structure Tax	982,203	1,373,730	\$0
CRMP Tax	1,543,461	2,158,719	\$0
Construction Tax	76,200	106,575	\$0
Residential Construction Tax	91,440	127,890	\$0
Estimated Total Suspensions	\$2,693,304	\$3,766,915	\$0
Estimated Savings/Low-income	\$2,651	\$2,651	\$0

¹Based on information provided by the Building Division.

COORDINATION

The preparation of this report was coordinated with the City Attorney’s Office, the City Manager’s Budget Office, and the Planning, Building and Code Enforcement (Building Division), Public Works, Fire, General Services, Library Departments, the Development Cabinet, and the Housing Advisory Commission (HAC).

COST IMPLICATIONS

The City’s Capital Improvement Program will be impacted by approximately \$2.7 million in foregone revenues in Fiscal Year 2006-07 through Fiscal Year 2010-11.

CEQA

Not a project.


 LESLYE KRUTKO
 Director of Housing

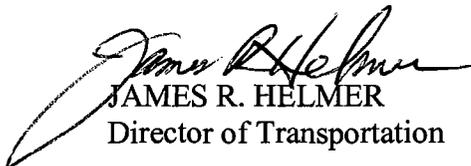

 JAMES R. HELMER
 Director of Transportation

Table 1: Construction Tax Suspensions
Actual Fiscal Impact
FY 1991-92 thru FY 2005-06

	July 1991 - June 1996	July 1996 - June 2001	July 2001 - June 2006
<u>Projects and Units</u>			
# of Units	1,570	2,754	2,320
<u>Tax Suspensions¹</u>			
B&SC Tax	1,255,528	1,982,572	1,843,956
CRMP Tax	1,973,001	3,115,471	3,987,588
Construction Tax	113,230	206,550	187,005
Residential Construction Tax	141,840	247,860	228,020
Total Suspensions	\$3,483,599	\$5,552,453	\$6,246,568
<u>Savings/Low-income Unit</u>	\$2,219	\$2,016	\$2,692

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Table 2: Construction Tax Suspensions
Estimated Fiscal Impact July 2006 - June 2011

	Alternative 1	Alternative 2
	5 - Year Suspension Very Low-Income Units	5 - Year Suspension Including Low- Income Units
CITY PROGRAMS		
Traffic Programs		
Building and Structure Tax ¹	\$982,203	\$1,373,730.00
Construction Excise Tax/CRMP ²	\$1,543,461	\$2,158,719
Residential Construction Tax ³	\$91,440	\$127,890
Subtotal	\$2,617,104	\$3,660,339
% total of Construction Tax		
Parks	64.00%	\$48,768
Park Yards	1.20%	\$914
Fire	8.40%	\$6,401
Library	14.22%	\$10,836
Service Yards	8.78%	\$6,690
Communications	3.40%	\$2,591
Subtotal	\$76,200	\$106,575
TOTAL	\$2,693,304	\$3,766,914

¹Use of funds restricted to capital improvements on major arterials and collectors, including bridges, culverts, lighting and traffic control systems which increase traffic volume.

²Also known as Commercial-Residential-Mobilehome Park Building Tax. The tax may be used for "any usual current expenses" of the City. City Council has historically restricted use to traffic improvements.

³Proceeds from this tax are used to reimburse developers for infrastructure improvements and to construct median island and other street improvements.