# EXECUTIVE REPORT

## MULTIFAMILY
## PROPERTY TAX EXEMPTION

## PROGRAM REVIEW:
## 1999 Program Year

*RECOMMENDATIONS FOR PROGRAM AMENDMENT*

*And*

*SPECIAL ISSUES FOR COUNCIL CONSIDERATION*


Submitted by:

| | |
|---|---|
| Office of Housing | Strategic Planning Office |
| Cynthia A. Parker, Director | Denna Cline, Director |

# CONTENTS

# EXECUTIVE SUMMARY

## Key Results and Conclusions

- Eleven Projects (673 total units) applied for and were approved to receive a property tax exemption in 1999, exceeding the first-year goal for the program that ten projects seek to participate in the program.
- Commitments were made in 1999, under this program, for 189 affordable units.
- Studios are 64% of all first-year affordable units – for all program neighborhoods; 25% are one-bedroom units.
- Private developers were not interested in the tax exemption program for home ownership projects in 1999. A potential disincentive may exist for private developers to use the program for home ownership projects.
- Input received from developer interviews and applications (see Attachment B) has been mostly favorable. Input has included:
    1. The Program can make a difference where the market is marginal or project feasibility is questionable; and
    2. In stronger market areas, the Program has little affect on the decision to develop, but helps produce affordability.

<u>Stimulating Housing Production</u>

- In stronger markets, like Pike/Pine, developers have indicated that the property tax incentive is not a significant factor in the decision to undertake a project.
- Where housing markets are weak, and market rents are low, a 10-year exemption from property taxes, alone, is not enough to sustain new development and "jump start" the local market.
- The tax exemption program may be most effective in stimulating housing production in "swing" markets where at least moderate rents are attainable, and where other incentives or investor interest exists (e.g., the International District and 23rd @ Jackson-Union).

<u>Creating Affordable Housing</u>

- In program neighborhoods where market rents are low, an 80% affordability requirement will not achieve a significant affordable housing benefit since market rents are already below 80% for most unit types. This lack of affordable housing benefit at the 80% level is most likely to occur in the North Rainier, Columbia City, MLK @ Holly, and South Park program neighborhoods.
- The 80% requirement in these areas is effective only for larger units, where "affordable" rents at the 80% level are consistently below market rents.
- Regardless of the level of the requirement, affordability requirements are most effective where housing markets are strong, market rents are relatively high, and the project would probably have proceeded even without a tax exemption.

## Proposed program amendments

One purpose of the Annual Review is to propose program amendments. Because the tax exemption program is still so young, and experience with it so limited, the Executive has deliberately chosen not to propose numerous amendments nor any sweeping changes to the program. The two amendments being proposed at this time are:

<u>1. Ensure Affordable Unit Comparability.</u>
Although studio units made up 27% of total units in the eleven projects approved in 1999, studios comprised 64% of all affordable units. To ensure that affordable units are comparable to market-rate units, the Executive recommends that the tax exemption program be amended to require that affordable units be comparable to market-rate units – in unit type, number of bedrooms, and interior specifications.

<u>2. Add Program Neighborhoods.</u>
Two neighborhoods, not currently included in the tax exemption program, meet the criteria of Chapter 5.72 SMC for being included as "target" or program neighborhoods. The Executive recommends that the Rainier Beach and Capitol Hill urban villages be added to the tax exemption program. The recommended affordability requirement for Capitol Hill is that 40% of project units be affordable at 60% of median income. No recommendation is made at this time regarding affordability requirements for Rainier Beach.

<u>Homeownership Resale</u>
In order to address the lack of predictability resulting from affordability requirements on homeownership projects, the Executive also recommends that the City pursue an amendment to RCW 84.14 that would enable the City to implement affordable housing resale provisions for homeownership that do not discourage private developers from using the program to support home ownership projects.

## Special Issues for Council Consideration

In its review of the tax exemption program, the Executive has identified four special issues that do not call for program amendment at this time. However, these issues are significant enough to warrant Council attention. As part of subsequent annual reviews of the tax exemption program, the Executive may follow-up on these issues with appropriate program amendment proposals. These four issues are:

1. Land appreciation under tax exemption,
2. The potential impact of rent restructuring upon the expiration of the tax exemption benefit,
3. Issues associated with the recently created DCTED tax exemption for low-income housing,
4. The effectiveness of affordability requirements.

# BACKGROUND

## A. Annual Review Requirements

The Multifamily Tax Exemption Ordinance requires an annual review of the program to assess how it is working and determine whether any changes are needed to improve the program. The Office of Housing, Strategic Planning Office, and a review committee including City staff from Design, Construction and Land Use, City Budget Office, Law Department, Office of Economic Development, and Council Central Staff worked together to review the first year of program operation and recommend needed program refinements.

The ordinance specifically requires a review of:

- Development activity;
- Types, numbers, location, rents and sales prices of units produced;
- Information regarding low- and moderate-income households benefiting by the program;
- Tax revenue implications of the program; and
- Other appropriate factors.

The Ordinance also specifies that recommendations may include:

- Whether neighborhoods should be added or removed;
- Whether affordability limits should be changed in certain areas;
- Analysis of issues related to the use of the program for home ownership units; and,
- Any needed changes in the ordinance regarding program operation.

## B. Program Authorized by City Council

Seattle's program for granting ten-year property tax exemptions for multifamily housing was adopted by the City Council on December 2, 1998. The implementing ordinance, codified as Chapter 5.72 of the Seattle Municipal Code, became effective on January 4, 1999.

The Multifamily Property Tax Exemption Program allows for a partial property tax exemption for up to ten years for new or rehabilitated multifamily projects (apartments and condominiums). The program is authorized and regulated by State Law (RCW 84.14) and was modified by the City (to add an affordability requirement) and adopted by ordinance. It is intended to provide an incentive for the production of additional housing units, to further the goals of the Growth Management Act, within urban centers and villages particularly where such development is not occurring through the market at a desirable rate. The Seattle program is also intended to promote affordable housing, community development and revitalization in targeted neighborhoods. Affordability is promoted through restrictions on household income levels for a percentage share of new units within each development.

Ordinance 119237 identified nine geographic areas where housing would be eligible under the new program. Eight neighborhoods were included in the Seattle program with the requirement that 25% of the units be affordable to people with income at or below 80% of median income:

- Westlake/Denny Triangle
- 23rd at Jackson
- Pioneer Square
- International District
- Rainier at I-90
- Columbia City
- Martin Luther King at Holly
- South Park

The ninth area, Pike-Pine, was included with a requirement to provide more affordable housing (40% of units affordable to people with income at or below 60% of median), since the primary concern of the City and the neighborhood was the affordability of new housing development. A map showing boundaries of the nine areas is attached (Attachment A).

# PROGRAM EFFECTIVENESS

This section evaluates the effectiveness of the Multifamily Tax Exemption Program in terms of its ability to achieve the two primary goals of the program: (1) stimulating housing production in the nine program neighborhoods; and, (2) creating affordable housing in those neighborhoods. In addition, use of the tax exemption for home ownership is evaluated. Developer input on the program from applications and interviews is also discussed.

## A. STIMULATING HOUSING PRODUCTION

**Summary of Development Activity**

Overall residential development activity in the nine program neighborhoods is summarized below in Table 1.

Table 1 Units Completed by Program Neighborhood (net of demolition), 1997 – 1999

| Neighborhood | 1997 | 1998 | 1999 | Active Permits (as of 03/00) | Tax Exempt. Program Active Permits |
|---|---|---|---|---|---|
| Denny Triangle | 0 | 1 | 0 | -81 | 0 |
| Pike/Pine | -25 | 68 | 75 | 109 | 0 |
| Pioneer Square | 15 | 6 | 10 | 69 | 20 |
| International District | -48 | 98 | 0 | 324 | 264 |
| 23rd @ Jackson-Union | 40 | 33 | 39 | 57 | 57 |
| North Rainier | 32 | 41 | 5 | 20 | 0 |
| Columbia City | 3 | 6 | 2 | 11 | 0 |
| MLK @ Holly St. | 5 | -370 | 212 | -144 | 0 |
| South Park | -1 | 6 | 15 | 9 | 0 |
| TOTAL | 21 | -111 | 358 | 374 | 341 |

Table 2 provides an update on how program neighborhoods have progressed toward meeting their Comprehensive Plan goals for housing.

Table 2 Progress Toward Housing Goals by Program Neighborhood

| Neighborhood | Units Built 1994 – 1999 | 20-Year Growth Goal | % Progress Toward Goal as of 1999 |
|---|---|---|---|
| Denny Triangle | 1 | 3,500 | 0% |
| Pike/Pine | 146 | 620 | 26% |
| Pioneer Square | 31 | 2,100 | 0% |
| International District | 12 | 1,300 | 0% |
| 23rd @ Jackson-Union | 174 | 900 | 19% |
| North Rainier | 88 | 1,200 | 7% |
| Columbia City | 17 | 740 | 2% |
| MLK @ Holly St. | -174 | 800 | -22% |
| South Park | 40 | 350 | 11% |

## Summary of Tax Exemption Activity (1999)

When the Tax Exemption Program was first created by the City Council in 1998, a goal of ten tax exemption projects was established for 1999, the first year of the program. This goal was exceeded. During 1999, the first year of program implementation:

- A total of 673 units within 11 projects were approved by the City Council for the tax exemption.
- Within this total, commitments were made for 189 affordable units (28% of all units).
- All projects are new construction – to date no rehabilitation projects have applied for the exemption.
- Two projects, the Noji Gardens townhome project being developed by HomeSight and Kauri's 7th Avenue South project, were approved as homeownership projects.
- Six of the eleven approved applications (71% of total 1999 tax exemption units) were already in some stage of the permitting process at the time the tax exemption program was adopted.
- Three of these six projects were under construction as of April 2000 and only these three had received building permits.
- All approved projects are projected to be complete by the fall of 2001.

Attachment A provides a detailed description of the 11 tax exemption projects approved in 1999.

Table 3 Tax Exemption Projects approved in 1999 by Neighborhood.

| Neighborhood | #Projects | #Units | #Affordable |
|---|---|---|---|
| 23rd @ Jackson-Union | 5 | 197 | 53 |
| International District | 3 | 340 | 87 |
| Pike/Pine | 1 | 62 | 25 |
| MLK @ Holly | 1 | 54 | 14 |
| Pioneer Square | 1 | 20 | 10 |
| **TOTAL** | **11** | **673** | **189** |

Neighborhoods with no tax exemption activity in 1999 (and very little housing activity generally) were Columbia City, South Park, North Rainier, and the Denny Triangle.

## Stimulating Housing Production –Results by Program Neighborhood

**Denny Triangle.** Only one unit of housing has been produced in the Denny Triangle in the past five years (net of demolitions), representing no progress toward the neighborhood's very aggressive production goal of 560 units over this time period (3,500 over 20 years). No tax exemption applications were made for the Denny Triangle in 1999.

- It was expected when the tax exemption program was created that, with proformas showing marginal returns, the property tax benefit would be sufficient to move some projects forward in this neighborhood.
- Uncertainty with major public projects in the neighborhood (e.g., Convention Center, Sound Transit) may have contributed to the weak performance of the Denny Triangle housing

market during 1999, and the inability of the tax exemption incentive to stimulate housing production.

**Pike/Pine.** 118 units have been completed in Pike/Pine (including demolitions) over the past three years; active building permits total 109 as of earlier this year. Pike/Pine is a strong housing market and has well exceeded its 5-year production goal. One project (62 units) in Pike/Pine applied for the tax exemption in 1999.

- In stronger markets, like Pike/Pine, developers have indicated that the property tax incentive is not a significant factor in the decision to undertake a project.

**Pioneer Square.** One Pioneer Square project (20 units) applied for and was approved to receive the tax exemption in 1999. Only 9% of the neighborhood's 5-year expectation for housing growth has been achieved.

- Even the combination of TDR/Bonus and property tax exemption programs available in Pioneer Square did not succeed in stimulating housing production in 1999.

**International District.** With building permits for 324 units currently active and 38% of its 5-year housing goal achieved, the housing market in the International District has been operating at a moderate level and appears to be gaining strength. Three projects (340 units) applied for the tax exemption in 1999.

- Developers for the two rental projects to receive the tax exemption in the International District indicate that that the program did make a difference in their decision to proceed with the projects; the developer of the ownership project in the neighborhood indicated that the tax exemption was not a factor.

**23rd @ Jackson-Union.** With increased development activity in the past three years, 23rd @ Jackson-Union has just met its 5-year housing growth goal. With 5 projects (197 units) in 1999, there was more interest in the tax exemption program in this neighborhood than in any of the other eight program neighborhoods.

- Detailed discussions with developers, while the tax exemption program was being developed, indicated that some inactive projects in the neighborhood would move forward if a property tax exemption were available.
- Three of the four tax exemption developers at 23rd @ Jackson-Union have indicated that the tax exemption incentive was persuasive in their decision to move forward with their projects.

**North Rainier/Columbia City/MLK @ Holly.** These three Southeast neighborhoods have seen very little private housing development over the last five years. Eighty-nine units at North Rainier has brought the neighborhood to 46% of its 5-year growth goal. In contrast, only 21 units in Columbia City represent 18% of its 5-year goal. In all three neighborhoods, only one project (54 units) in MLK @ Holly received the tax exemption in 1999.

- Developer interviews and proforma work conducted prior to the adoption of the program clearly indicated that, even with the tax exemption incentive, market rate rents in these neighborhoods were too low to support the capital and operating costs of new development.
- Consistent with this concern and the belief that the tax exemption program alone could not stimulate development in these areas, housing production remains at low levels.

**South Park.** South Park achieved 70% of its 5-year growth goal for housing, with 39 units built, 1995 – 1999; however, active permits for only 9 units are currently in place. No applications to the program were made for South Park during 1999.

- As with the Southeast communities, market rents in South Park may be too low to sustain new development, even with the tax exemption incentive.

**Stimulating Housing Production – Conclusions**

- In stronger markets, like Pike/Pine, developers have indicated that the property tax incentive is not a significant factor in the decision to undertake a project.
- The tax exemption program may be most effective in stimulating housing production in "swing" markets where at least moderate rents are attainable, and where other incentives or investor interest exists (e.g., the International District and 23rd @ Jackson-Union).
- Uncertainty with major commercial or public projects in neighborhoods (e.g., stadiums, Convention Center, Sound Transit) may weaken local housing markets to a level where the tax exemption program or other available incentives are insufficient to stimulate production.
- Where housing markets are weak, and market rents are low, a 10-year exemption from property taxes, alone, is not enough to sustain new development and "jump start" the local market.

## B. CREATING AFFORDABLE HOUSING

Projects in the Pike/Pine target area are required to provide at least 40% of the units to households with income at or below 60% of median. All other target areas require projects to provide at least 25% of the units to households with income at or below 80% of median.

The 11 projects approved by City Council in 1999 will include 189 affordable units, as shown in Attachment A and Table 4.

Table 4 Planned Affordable Units (1999 Program Year) by Unit Type

| Type | | Affordable Units | All Units |
|---|---|---|---|
| Studios | ---- | 121 units (19 affordable at 60% of median) | 185 |
| 1 Br | ---- | 47 units (6 affordable at 60% of median) | 266 |
| 2 Br | ---- | 14 units | 170 |
| 3 Br | ---- | 7 units | 30 |
| Other | | 0 units | 22 |
| TOTAL: | | 189 units (25 affordable at 60% of median) | 673 |

It should be noted that "affordable" is defined in the tax exemption program not by the rent that is charged, but through occupancy of the unit by an income-eligible household. Information about actual rents and the households served will not be available until these projects are completed and occupied.

It was recognized before the program was adopted that affordability requirements, particularly at the 80% level, would have little effect on rent levels in neighborhoods with weaker markets where market rents are already "affordable."

Attachment C compares Spring 2000 market rents in program neighborhoods with rents considered affordable (30% of monthly income) to households making the maximum household income allowed under the program in each neighborhood. It confirms that "affordable" rents are often above market, particularly for studio units, and for units of all sizes in southeast Seattle and South Park. For example:

- "Affordable" rents for studio units at 23rd @ Jackson-Union could be as high as $921, whereas the median market rent for a studio is $500, and rent for a studio in a newer building is $764.
- "Affordable" rents for 2- bedroom units in South Park could be as high as $1,184, while market-rate rents for 2-bedroom units average $625, and the median market rent in newer buildings in the South Park area is $728.

"Affordable" rents are at or below-market primarily in Pike/Pine (where affordable units must reach households with incomes at or below 60% of median); in downtown neighborhoods, and in larger units. Affordability requirements at the 80% level seem most likely to make a difference in the Denny Triangle, Pioneer Square, International District, and 23rd @ Jackson-Union program neighborhoods. In both the Downtown and the Central Area housing markets, Dupre + Scott data show median rents increasing by double digits between 1998 and 1999. Affordability requirements at the 80% level provide some assurance for moderate-income tenants in neighborhoods where rents are increasing faster than incomes, even if current market rents are "affordable."

Affordability requirements at the 80% level may make more of a difference for ownership housing, as market-rate housing is out of the reach of many prospective home buyers, even those with incomes above 80% of median. HomeSight considers the exemption critical to reaching moderate-income buyers in the Noji Gardens project.

There were concerns when the program was adopted that the stricter affordability standard (40% of units at 60% of median) in the Pike/Pine neighborhood would make it too costly for private developers to make use of the program. However, the sponsors of a 62-unit apartment building in the Pike/Pine neighborhood actively sought the tax exemption in 1999, despite the stricter affordability standard (see developer statement in Attachment B).

The multifamily property tax exemption program appears effective as a tool for increasing the supply of affordable housing primarily in stronger markets, and for larger units. Affordability issues should continue to be monitored carefully as projects are completed and more data becomes available.

**<u>Creating Affordable Housing -- Results by Program Neighborhoods</u>**

<u>25% of project units @ 80% of median income</u>
**Pioneer Square/International District/23rd @ Jackson-Union.**
**North Rainier/Columbia City/ Denny Triangle/South Park.**

- The Welch Plaza (23rd @ Jackson-Union) developers indicate that the 80% affordability requirement will not result in any below market-rate units since market rents in the area are below 80%.
- 50% of the Pioneer Square units approved in 1999 will be affordable below 80%; all are studio units.
- Noji Gardens in MLK @ Holly will result in the development of 14 owned units affordable at or below 80%.

<u>40% of project units @ 60% of median income</u>
**Pike/Pine.**

- The single project approved for Pike/Pine in 1999 will result in the creation of 25 affordable units, affordable at or below 60%, mostly studio units.
- For all unit types, market rents in Pike/Pine are near to or substantially higher than the 60% allowed.

**<u>Other Results on Affordable Housing</u>**

- Studios are 64% of all first-year affordable units – for all program neighborhoods; 25% are one-bedroom units.

**<u>Creating Affordable Housing – Conclusions</u>**

- In program neighborhoods where market rents are low, an 80% affordability requirement will not achieve a significant affordable housing benefit since market rents are already below 80% for most unit types. This lack of affordable housing benefit at the 80% level is most likely to occur in the North Rainier, Columbia City, MLK @ Holly, and South Park program neighborhoods.
- The 80% requirement in these areas is effective only for larger units, where "affordable" rents at the 80% level are consistently below market rents.
- Regardless of the level of the requirement, affordability requirements are most effective where housing markets are strong, market rents are relatively high, and the project would probably have proceeded even without a tax exemption.

## C. HOMEOWNERSHIP

There was little interest in use of the tax exemption program for home ownership in 1999. For-profit developers have been skeptical about the benefits of the program for ownership housing, both because it has been uncertain how the affordable housing requirements would be applied in ownership projects, and because the tax savings accrue to individual home buyers, not the developer. Only HomeSight, a nonprofit dedicated to affordable home ownership, welcomed the program as a much-needed tool to assist homebuyers with incomes over 80% of median as well as lower-income buyers. However, interest in the tax exemption for ownership projects has been growing, and all three of the applications received in January 2000 were for ownership projects.

The most critical issues affecting use of the tax exemption program for home ownership stem from the affordability requirements of the City's program. Only a portion of the units in a project is required to be affordable, but all owners in the project receive the benefit of the exemption, and are vulnerable to the resumption of property taxes (and, potentially, penalties and interest) if the exemption is cancelled because of resale of an affordable unit to an ineligible buyer.

Affordable units in an ownership project are subject to a right of first refusal, whereby the City or its assignee is entitled to match any *bona fide* offer by a prospective purchaser whose household income is above the applicable limits. However, the right of first refusal (which is the only mechanism provided in Chapter 5.72 SMC for preserving affordability upon resale of ownership units) is not sufficient to assure continued compliance with affordability requirements. The City has no obligation to exercise the right of first refusal, and has not identified any resources for purchasing such units and assuring that they are affordable to new buyers.

To date, we have addressed this dilemma by contract language that requires the applicant for the tax exemption to take continuing responsibility for compliance and/or to assure that the responsibility is assumed by the condominium homeowners' association. Provisions with respect to the tax exemption are required to be included in the offering statement and condominium declaration (or covenant, if the form of ownership is not a condominium), subject to the approval of the Housing Director. While this is workable in theory, it may actually work only for nonprofits such as HomeSight, who have other tools for maintaining affordability and are prepared to play a long-term role in the projects they develop. Lack of predictability about the continuation of the exemption is a major issue for buyers and lenders, and could greatly diminish the value of the tax exemption program as an incentive for home ownership.

## D. DEVELOPER INPUT

As part of the review of the Tax Exemption Program, OH and SPO staff conducted interviews with three private developers who applied to use the program in 1999. Common points made by these developers include:

- In target areas where the market for new multifamily housing is weak or uncertain, and feasibility is questionable, the program can make a major difference in project feasibility.
- Affordability requirements don't necessarily result in lower rents in weak markets, where market-rate rents are already "affordable."
- In neighborhoods with stronger markets, e.g., Pike/Pine, the program helps produce affordable units.
- In general, the stronger the market, the less difference the program makes in the decision to undertake the project.

- Nine of the eleven applicants have indicated in participant interviews that the program is helpful in improving project feasibility, compensating for increased costs, allowing increased quality of construction, and/or providing more affordable housing.

Attachment B includes both a summary of comments from these interviews and developer responses to a program assessment question included in the tax exemption application. Attachment E is a letter from the Fortune Group outlining additional thoughts on the program.

## E. SUMMARY OF CONCLUSIONS ON PROGRAM EFFECTIVENESS

After only one year, eleven tax exemption projects and no occupied units, all conclusions and results included in this report run the risk of being premature. A more extended period of availability, use, and input could be useful in evaluating the effectiveness of the tax exemption program.

Conclusions regarding the ability of the program to achieve its primary goals in its first year can be best summarized by considering the likely effectiveness of the tax exemption program according to the condition of the local housing market:

**WEAK HOUSING MARKET**

- The tax exemption alone is not sufficient to result in significant increases in housing development.
- Little to no benefit from affordability requirements.

**"SWING" HOUSING MARKET**

- In these areas, where market rents are moderate-to-high, where developer interest is high, project feasibility is questionable and other incentives or programs exist to stimulate development, the tax exemption can be most advantageous and effective at encouraging housing growth.
- Affordable housing benefits from program requirements are possible in these areas, especially for larger units and where required affordability levels are crafted to be lower than market rents.

**STRONG HOUSING MARKET**

- A tax exemption is not likely to be a significant factor in the decision to develop.
- Affordability benefits from program requirements are highest.

In addition to the results and conclusions reported earlier in this section on the ability of the tax exemption program to stimulate housing production and create affordable housing, important issues regarding program effectiveness include:

- Private developers were not interested in the tax exemption program for home ownership projects in 1999.
- A potential disincentive may exist for private developers to use the program for home ownership projects.
- Input received from Developer interviews and applications (see Attachment B) has been mostly favorable, substantiating conclusions reached earlier that:
   3. The Program can make a difference where the market is marginal or project feasibility is questionable; and

4. In stronger market areas, the Program has little affect on the decision to develop, but helps produce affordability.

# FISCAL ASSESSMENT

**1. General Process of property tax exemption**

Owners of approved projects/units do not pay property taxes on eligible residential improvements for up to ten years following completion of a project. However, the City may, or may not, lose the tax revenue:

- Taxes are either forgone or shifted to other taxpayers, depending on whether or not a project is included as new construction by the county assessor on final tax rolls for the coming tax year.
- The period for which new construction is counted is from August 1 – July 31. For example, projects under construction during August 1, 1999 through July 31, 2000 will be included as new construction for the 2001 tax year. Uncompleted projects will be given partial new construction value to its level of completion as of July 31. An eligible project under the 84.14 program is not exempted from property tax until it is completed and issued the Final Certificate of Tax Exemption by the City. If a newly constructed project is included on the final tax rolls before the exemption is granted, the City receives the new construction tax revenue from that project and the tax burden is subsequently shifted to existing tax payers. If the exemption is granted before it is counted, then the City does not receive the new construction revenue and the tax burden is not shifted.

The City can influence whether taxes are shifted or foregone by issuing exemptions after the new construction is included on the tax rolls by the assessor in the late Fall. Under this circumstance, taxes would largely be shifted and relatively little tax revenue would be lost. However, because State law requires exemption certificates to be issued within 40 days of receipt of a completed application, only those projects completed in late Summer would likely be granted the exemption in the late Fall.

**2. Revenue Analysis**

The greatest impact to City revenues is the potential loss in new construction property tax revenue. The amount of the property tax levy that the City requests each year is restricted to 106% above the previous year's levy. However, a provision allowing the City to collect tax revenue for new construction is not restricted by the 106% limitation.

As stated above, it is not clear whether the tax would be shifted to other taxpayers or foregone. If shifted, then for every $1 million of tax liability, the effective tax rate would go up less than $.02 per $1,000 of assessed value, or about $5.00 per year for a Seattle house valued at $250,000.

Tax impacts of the 11 projects approved in 1999 will begin to be felt in 2001. Seattle revenues foregone or shifted are estimated to be about $152,600 in 2001, increasing to $260,000 in 2002. This represents approximately 10% of annual new construction revenue. Over the maximum ten-year life of the exemptions for these projects, Seattle revenues foregone or shifted are estimated to have a value of $2.15 million in today's dollars (present value).

Tax costs to the City are estimates based on figures provided by project developers, and may not reflect actual assessed value upon completion. Some approved projects may still opt out of the program later. Future annual program reports will track these issues, as well as the proportion of tax revenues foregone or shifted. More reliable projections will be possible over time.

## PROGRAM ADMINISTRATION

The Multifamily Property Tax Exemption Program is administered by the Office of Housing. As 1999 was the first year of operation, creating forms, procedures, and model agreements required staff time in addition to the time spent processing applications. Applicants appreciate the simplicity of the program; developers have often commented on how easy the application process is. Statutory time limits (90 days from receipt of a complete application to City Council approval) were consistently met. Developers had few recommendations for improvements except for resolution of issues related to home ownership. Overall, the program has been very well received and is well liked by developers.

Staffing. When first proposed by the Executive, it was expected that the Tax Exemption Program would be self-sustaining, assuming a City application fee of $500 per project was assessed. It was also expected that administration of the program would require 0.25 FTE. Actual experience, however, has been that 0.5 FTE has been needed to administer the program during its first year primarily due to the staff time necessary to perform program startup activities (e.g., program approval documents).

Program Administration Changes. The Office of Housing is considering minor changes to the information requested on applications for tax exemption, both for clarification and to facilitate the assessment of program effectiveness. Such changes may be implemented through adoption of Director's Rules.

The only ordinance change recommended with respect to program administration is the addition of a fee for contract amendments requested by property owners, when such amendments require City Council approval.

# PROGRAM AMENDMENTS

Because the tax exemption program is still so young, and experience with it limited, the Executive has deliberately chosen not to propose numerous amendments nor any sweeping changes to the program. Two subjects are presented in this section as issues that warrant program amendment at this time: (1) units designated as affordable in tax exemption projects are not likely to be comparable to other units within a project; and (2) adding urban villages to the nine neighborhoods that are currently included in the Multifamily Tax Exemption Program.

## 1. Ensuring Unit Comparability

The 11 tax exemption projects approved by the City Council in 1999 will provide 189 affordable units (see Attachment A for more detail):

| Type | | Affordable Units | All Units |
|---|---|---|---|
| Studios | ---- | 121 units (19 affordable at 60% of median) | 185 |
| 1 Br | ---- | 47 units (6 affordable at 60% of median) | 266 |
| 2 Br | ---- | 14 units | 170 |
| 3 Br | ---- | 7 units | 30 |
| Other | | 0 units | 22 |
| TOTAL: | | 189 units (25 affordable at 60% of median) | 673 |

**Problem**
Although studio units make up 27% of total units in the 11 approved projects, they comprise 64% of the affordable units. Private developers report that studio units are easiest to produce, and smaller units are more financially feasible in urban markets.

**Options**
To ensure a broader distribution of affordable unit types and also ensure that affordable unit types are consistent with market-rate unit types, four options are presented for Council consideration:

1. Limit Affordable Studios. Amend program rules to impose a limit on the use of studios for satisfying the affordability requirement. Under this option, no more than a fixed percentage of affordable units could be studio units.
2. Require Comparability. Amend program rules to require that affordable units be comparable in size and type to market-rate units.
3. Measure Affordability Compliance by Square Footage (rather than by units). Amend program rules so that a fixed percentage of total livable area (rather than a fixed percentage of total units) is affordable at specified income levels.
4. No Change. Do not amend the program to address the distribution of affordable unit types at his time. Reconsider the issue as part of future program reviews.

**Analysis**

Option #1 Limit Affordable Studios

Studios may make up no more than X% of the affordable units in any project. This requirement would have no affect on projects where studio affordable units are already proposed below the fixed percentage.

**Pros**

- For most projects, this requirement would ensure that affordable units include studio units.
- More flexibility to developer than with strict comparability option.

**Cons**

- No protection against downgrading the quality of affordable units to help reduce costs.
- Maximizing the number of affordable studio units may in some areas and for some projects, be desirable.
- May serve as a disincentive to include larger units in a project, resulting in a project mix of mostly studios and one-bedroom units.

Option #2 Require Comparability

Affordable units must be comparable to market-rate units – in unit type, number of bedrooms, and interior specifications. The Affordable unit mix must be comparable to the project unit mix. OH staff would be responsible for ensuring compliance with this requirement.

**Pros**

- Ensures that affordable units are indistinguishable from market-rate units.
- Larger units (2+ bedrooms) could be combined into a single category to simplify compliance.
- The Washington State Housing Finance Commission uses a similar approach to ensuring unit comparability in tax credit projects.

**Cons**

- Potential for greater financial burden on developer (depending on the proposed mix of larger units).
- The added cost of supplying larger affordable units could be offset by reductions in standards (e.g., parking requirements) for those larger units.

Option #3 Measure Affordability Compliance by Square Footage

Program rules are amended so that a fixed percentage of "total livable area" in a project is set-aside as affordable housing. For example, instead of requiring that 20% of total units be affordable at 80% of AMI, the new rule would require that 20% of total livable area (in square feet) consist of units affordable at 80% of AMI. OH staff would be responsible for ensuring compliance with this requirement.

**Pros**

- Provides most flexibility to developers in terms of unit mixing.
- May serve as an incentive to build larger units. Because larger units will consume more of the required affordable livable area than will smaller units, developers may be inclined to build larger affordable units.

**Cons**

- With an emphasis switched to affordable "livable area", fewer total affordable units may result.
- Careful attention to the definition of and monitoring of "livable area" would need to be part of tax exemption administration.

Option #4 No Change
Reconsider the unit mix issue as part of future program reviews, when more information is available.

**Pros**

- Sufficient information on first-year projects (rents, sizes, types, locations within buildings, interior specifications) is not yet available.

**Cons**

- Despite lack of information on first year units, developers indicate a strong interest in favoring studios as affordable units.

**Recommendation**
*Option #2 – Require Comparability*. Amend Chapter 5.72 SMC to require that affordable units be comparable to market-rate units – in unit type, number of bedrooms, and interior specifications.

**Rationale**
Program rules that require unit comparability will help ensure that a tax exemption applicant is aware of the need to structure a project so that the affordable unit mix is similar to the market-rate unit mix. Random inspections may be relied upon by Office of Housing staff to ensure compliance with this requirement.

## 2. Adding Program Neighborhoods

**Issue**
Several neigborhoods, not currently included in the tax exemption program meet the criteria of Chapter 5.72 SMC for being included as a "target" or program neighborhood.

**Analysis**
Under current criteria listed in Chapter 5.72 SMC, all areas targeted for tax exemption must be within an urban village. In initially determining target neighborhoods, City Council considered urban villages:

- Where housing development has been minimal;
- Where Comprehensive Plan targets were ambitious;
- Considered distressed;
- With neighborhood support for the new program; and/or
- Where housing affordability is an issue.

In 1998, when the current target neighborhoods were chosen, not all urban villages had completed or adopted Neighborhood Plans. Consideration of proximity to light rail stations was not emphasized, although it is among the factors listed in SMC Section 5.72.030.

Neighborhood plans for the following areas request being included in the tax exemption program: Belltown, Commercial Core, Eastlake, Capitol Hill, and Rainier Beach.

Housing development activity as compared to Comprehensive Plan goals for these urban villages is shown in the following table:

| **Neighborhood** | Units Built '94 – '99 | Units Built as % of 20-year Growth Goal | Active building permits |
|---|---|---|---|
| Belltown | 480 units | 7% | 1,136 units |
| Downtown Commercial Core | 624 units | 48% | 345 units |
| Eastlake | 242 units | 64% | 32 units |
| Capitol Hill | 242 units | 12% | 75 units |
| Rainier Beach | 54 units* | 7% | 8 units |

* 43 of this total is Villa Park, owned by the Seattle Housing Authority.

**Options**

Based upon the information provided above and the criteria for neighborhood selection in Chapter 5.72 SMC, the Council may elect either to: (1) not add neighborhoods to the tax exemption program at this time, or (2) add neighborhoods that meet the established criteria.

<u>Option #1 Do Not Add Neighborhoods</u>

**Pros**

- More information on the effectiveness of the program in existing program neighborhoods is needed before neighborhoods are added;

**Cons**

- Several neighborhoods could clearly benefit from and are in need of either the production stimulus affects of the tax exemption or from the affordability provisions of the program.

<u>Option #2 Add Neighborhoods</u>

**Pros**

- Neighborhood Plans for five neighborhoods have requested inclusion in the tax exemption program.
- Neither Capitol Hill nor Rainier Beach have made significant progress toward their housing growth goals included by the Comprehensive Plan.
- Affordable housing, and the tax exemption program as an affordable housing tool, are favored by the Capitol Hill, Downtown, Eastlake and Rainier Beach plans and planning groups.

**Cons**

- Other tools for encouraging affordable housing development are available in downtown neighborhoods.

**Recommendation**

- Add the Rainier Beach and Capitol Hill urban villages as tax exemption program neighborhoods.
- Establish an affordability requirement for Capitol Hill that is identical to that currently in place for Pike/Pine (i.e., 40% of project units affordable at 60% of median income).
- No recommendation is made at this time regarding affordability requirements for Rainier Beach.

**Rationale**
Since they have already made significant progress toward their 20-year housing production goals, it does not appear that the tax exemption incentive is needed in the Belltown, Commercial Core and Eastlake urban villages.

Capitol Hill
Capitol Hill is also experiencing a considerable amount of housing development, although short of its 5-year growth goal. Affordability, however, is a significant concern for the neighborhood. A letter from the Capitol Hill Stewardship Committee (see Attachment D) requests that the tax exemption program be expanded to include Capitol Hill with affordability requirements similar to those in place for the Pike/Pine neighborhood. Adding Capitol Hill to the Tax Exemption Program is warranted in terms of gaining experience with how well the program works as a tool for increasing the supply of affordable housing. It would also make the program available as an incentive in the vicinity of the Capitol Hill light rail station.
- Rent for a Capitol Hill studio, at 60 % of median income would be $691, $57 below market rent for a studio in a newer building; for 2-bedroom/2-bath units, rents for affordable units would be $324 below market rents in a newer building.

Rainier Beach
Henderson/Rainier Beach has experienced extremely low development activity – only 15 units of market rate development has taken place in the last five years, with building permit applications on file for an additional eight units. Additional housing development is desired by the community and was a theme in the neighborhood plan. So little development activity has occurred in this neighborhood that there is no market information available for rents in newer buildings. Average rents in the Rainier Valley actually declined from 1998 to 1999.

## 3. Homeownership Resale

The executive has considered three alternatives for addressing the lack of predictability resulting from affordability requirements as applied to homeownership projects. These alternatives include:

1. Eliminating affordability as a requirement in ownership projects.
2. Making affordability requirements for ownership projects applicable only to the initial sale, with no restriction on resale.
3. Granting the exemption only for affordable units.

Either of the first two alternatives can be implemented by the City by amending Chapter 5.72 RCW, if the approach is acceptable on a policy level. These alternatives would weaken the property tax exemption program as a tool for achieving and maintaining housing affordability, but enhance it as an incentive for investment by lenders and individual home buyers in Seattle's distressed communities, consistent with growth management goals.

We find the third alternative attractive, based on the experience with a similar approach in Portland, Oregon, but may not be able to implement it without changes to state law.

Chapter 84.14 RCW treats a building or project as a single entity for the purposes of granting a tax exemption, and treats it as a single entity when the exemption is cancelled for non-compliance. It does not appear to provide for the situation where units are owned separately, as in a condominium, and only some of the units receive the exemption. The Law Department has advised that the structure of the Portland program, which provides for grant of the exemption to individual units in a multifamily structure, is inconsistent with Chapter 84.14 RCW, and that a change in State law would be necessary to implement ownership provisions similar to those in Portland.

In Portland, an ownership unit is considered affordable if it has an initial purchase price no more than 95% of the median purchase price for a condominium unit in the county, and if it is sold to a household earning no more than 100 percent of the area median income for a family of four. Portland grants the tax exemption only to the units in a condominium that are affordable by this definition. The unit must remain owner-occupied to retain the exemption and, if sold, must be sold to another qualified household in order to continue the exemption. If the unit is sold to an unqualified buyer, then only that unit loses the tax exemption.

The Portland program is attractive because there is no question of “windfall” benefits to buyers of more expensive condominiums, and each buyer of an exempt unit is in control of his or her own destiny with respect to the tax exemption.

**RECOMMENDATION: Pursue an amendment to RCW 84.14 that would enable the City to implement tax exemption provisions for home ownership similar to those in Portland.**

# SPECIAL ISSUES FOR COUNCIL CONSIDERATION

In the first year of the tax exemption program, the Executive has identified four special issues that do not call for program amendments at this time. However, these issues are significant enough to warrant Council attention. As part of subsequent annual reviews of the Tax Exemption Program, the Executive may follow-up on these issues with appropriate program amendment proposals.

## 1. LAND APPRECIATION UNDER TAX EXEMPTION

There may be a potential for the 84.14 tax break to be rendered ineffective by the real estate market. Once sellers of residential property become aware of the property tax break there will be the tendency to inflate asking prices for residential real estate to reflect the capitalized value of the tax break. Asking prices are normally set to reflect the net income that can be derived from the property and market expectations of return. As the tax break will favorably impact net operating income, sales prices per unit will likely rise to reflect this additional income potential. So, in cases where a developer already owns the property in question then the tax benefit will accrue to the developer, and presumably the tax incentive has a chance to be effective. In cases where the developer does not yet own the property, the tax benefit will accrue to the existing landowner and provide windfall profits at the expense of other taxpayers. In the latter case, developers will be forced to seek the tax break to achieve even the pre-tax break rate-of-return, presumably negating any incentive to develop provided by the tax break.

## 2. POTENTIAL IMPACT OF RENT RESTRUCTURING UPON THE EXPIRATION OF THE TAX EXEMPTION BENEFIT

Once, after ten years, a project's tax exemption benefit expires, along with the requirement for accommodating lower-income households, property owners may choose to restructure all rents within a project. For lower income households within a project, the restructuring of rents upon the expiration of the tax exemption benefit may result in significant short-term rent increases, depending on the level of local market rents.

If Seattle continues to experience low vacancy rates and increasing rents, the conversion of affordable units, that are home to lower income households, to higher market rents is likely in most of the tax exemption program neighborhoods. Rent restructuring, under these circumstances, will result in the displacement of lower income tenants.

Since this is an issue that has not yet been thoroughly examined by the Executive nor the City Council, and because it is still to early in the Program to be able to fairly assess the potential for displacement, the Executive recommends that this issue be raised and examined closely as part of the required three-year review of the tax exemption program.

## 3. DCTED PROPERTY TAX EXEMPTION FOR LOW-INCOME HOUSING

In its 1999 session, the State Legislature approved a property tax exemption specifically for nonprofit organizations providing low-income rental housing. Under this legislation, a project that provides at least 75% of its units for very-low-income households (defined as households with incomes at or below 50% of median income) and is funded in part by a local levy or through the State Department of Community, Trade and Economic Development (DCTED) is eligible for a property tax exemption. A project can qualify for partial exemption if fewer than 75% of the units are for very-low-income households. This exemption is for the full amount of property tax and has no time limit. Nonprofits may apply to DCTED for this property tax exemption for not only new construction but also for existing projects that meet the affordability criteria of the program. The implications of the DCTED low-income housing property tax exemption program include:

1. Nonprofit participation in the City's Program will diminish. None of the four tax exemption projects, sponsored by nonprofit developers in 1999, would have qualified for the DCTED low-income property tax exemption. Projects qualifying for the DCTED low-income exemption are not expected to use the City's Multifamily Property Tax Exemption Program.

2. Revenue Impacts. Approximately 35 projects (new and existing) containing close to 2,000 units in Seattle have applied for the DCTED tax exemption. Earlier estimates that \$1-\$1.5 million annually, for all taxing jurisdictions, would be shifted to other property owners from this exemption appear to remain relatively accurate. It was also estimated that a small amount of future property tax revenue from new low-income housing construction, about \$20,000 per unit, would be forgone.

## 4. EFFECTIVENESS OF AFFORDABILITY REQUIREMENTS

Attachment C compares affordable rents under the tax exemption program with preliminary data on market rents in program neighborhoods. Neighborhoods experiencing development activity appear to be experiencing higher affordable housing benefits as a result of this requirement, than are neighborhoods with minimal development activity.

In program neighborhoods where there has been minimal private development activity, market rents in newer buildings are often lower than the maximum rent allowable under the tax exemption affordability provision. This is especially true where the 25/80 requirement is present (i.e., 25% of project units affordable at 80% of median income).

For program neighborhoods experiencing moderate to significant private development activity, especially Pike/Pine where 40% of project units must be affordable at 60% of median income, affordable rents (i.e., @ 60%) are below market rents in newer buildings.

A close examination of the rent data in Attachment C points to the following more specific conclusions (which are discussed earlier in this report):

- In stronger market neighborhoods, a 60% requirement results in a rent benefit when compared to market rents in newer buildings. Except for larger rental units, where reliable market data is not available, the 80% requirement does not appear to result in a comparative benefit in these neighborhoods.
- In weaker market neighborhoods (all of which have the 80% requirement), the affordability requirement may result in some marginal benefits for studios and 1-bedroom units in the Denny Triangle and Pioneer Square. In general, development activity has not been significant enough in many neighborhoods where the 80% requirement is in place to support an estimate of market rents that could then be compared with “affordable” rents.

Of all of the cities in Washington State to have adopted tax exemption programs under RCW 84.14, Seattle is the only city to have included affordability requirements in its program. The City is not able to benefit from the experiences of other jurisdictions with respect to the structure and implementation of affordable housing provisions, under 84.14.

The Executive raises this issue at this time for discussion purposes only. While the Executive recognizes that early experience with the program indicates that adjustments to affordability requirements may be necessary, more information is needed on market rents in program neighborhoods and on the perspectives of developers and neighborhoods on this issue before appropriate affordability revisions can be developed.