



Memorandum

TO: COMMUNITY AND ECONOMIC
DEVELOPMENT COMMITTEE

FROM: Jacky Morales-Ferrand

SUBJECT: SEE BELOW

DATE: September 10, 2018

Approved

Date

9/12/18

COUNCIL DISTRICT: Citywide

SUBJECT: SMALL PROJECT INCLUSIONARY HOUSING

RECOMMENDATION

Accept this staff report and forward to the full City Council for approval with the following recommendations on the design of the structure of a Small Project Inclusionary Housing Ordinance imposed on new developments:

- a) Build on-site as the preferred compliance option
- b) Provide an in-lieu fee, based on a per square foot basis, as an alternative compliance option
- c) Apply the requirement to projects with a unit size between one (1) to nineteen (19) units

OUTCOME

Input from the Community and Economic Development (CED) Committee will be used to develop a recommendation to the City Council regarding the creation of a Small Project Inclusionary Housing Ordinance (Small Project IHO). If the Housing Department's recommendations are approved, then the Small Project IHO will apply to for-sale and rental residential developments with nineteen (19) or fewer units.

BACKGROUND

The City of San José implements two programs that tie to the creation of affordable homes to the construction of market-rate housing: an Inclusionary Housing Ordinance (IHO) program that applies to rental and for-sale residential developments of twenty (20) units or more and an Affordable Housing Impact Fee (AHIF) program that applies only to rental residential developments of three (3) to nineteen (19) units ("small" rental projects). For-sale residential

projects of nineteen (19) units or less (“small” for-sale projects) are not covered under either program. See Table A which summarizes the current Affordable Housing Programs.

Table A. Current Affordable Housing Programs

	For-Sale	Rental
20 units or more	Inclusionary Housing Ordinance: Multiple compliance options	Inclusionary Housing Ordinance: Multiple compliance options
19 units or less	N/A	Affordable Housing Impact Fee (unit threshold 3-19 units): Fee only compliance option, fee per square foot basis.

Inclusionary Housing Ordinance (IHO)

The Inclusionary Housing Ordinance (IHO), Chapter 5.08 of the San José Municipal Code, was adopted on January 12, 2010. The IHO (“Large Project IHO”) applies to market rate residential developments of twenty (20) or more units, and provides the requirement for such developments to either build affordable housing as part of the overall development or to comply with other compliance options including paying an in-lieu fee to the City to build the affordable units elsewhere. The adopted IHO applies to all developments with 20 or more units, for-sale or rental.

Although the Ordinance was operative on January 1, 2013, its implementation was prevented by an injunction imposed by the Santa Clara County Superior Court, resulting from a challenge submitted by the California Building Industry Association (CBIA), in *California Building Industry Association v. City of San José*. That injunction was terminated when the Superior Court’s decision invalidating the ordinance was overturned by the 6th District Court of Appeal, the ordinance was held to be valid, and the case was remanded to the Superior Court to render a decision consistent with the decision of the Appellate Court. The CBIA filed a petition for a writ of certiorari with the U.S. Supreme Court seeking review of the California Supreme Court’s unanimous ruling that upheld the City’s Ordinance. On February 29, 2016, the Supreme Court declined to hear that petition and the IHO on for-sale developments of 20 or more units became effective on July 1, 2016.

The Large Project IHO was suspended with respect to rentals due to another court case: *Palmer v. City of Los Angeles*. As a result, at its commencement the IHO only applied to for-sale developments with 20 or more units.

Affordable Housing Impact Fee (AHIF)

While the Palmer case suspended application of the IHO to rentals, the Housing Department had a Residential Nexus Analysis prepared by Keyser Marston Associates, Inc. (KMA) to support the creation of an Affordable Housing Impact Fee (AHIF). The Nexus Study established a reasonable relationship between the development of market-rate rental housing and the increased need for affordable housing. On November 18, 2014, the City Council adopted the AHIF

Resolution, establishing the AHIF Program which required rental developments with three (3) or more units to pay an AHIF at Building Permit issuance. The AHIF was based on a \$17 per square foot fee and included a 2.4% escalator (increasing the fee by 2.4% at the start of each fiscal year).

On December 6, 2016, after a staff proposal to amend the AHIF to raise its threshold from three (3) units to a twenty (20) units to match the IHO the City Council maintained that the AHIF program at three (3) or more units, and directed the City Attorney to prepare a confidential memorandum to Council with their legal analysis of the recommendation to reduce the threshold size of projects to which the IHO applies from twenty (20) units down to three (3) units. The City Attorney followed up with the Housing Department and recommended the development of a separate new ordinance for small projects instead of amending the existing IHO.

Transition between the AHIF and IHO

On September 29, 2017, the Governor signed Assembly Bill (AB) 1505, clarifying the State Legislature's intent to supersede the court decision in *Palmer v. City of Los Angeles*, thus allowing the IHO requirements to apply to rental residential developments effective January 1, 2018.

Previous City Council Direction

On October 24, 2017, the Housing Department provided the City Council with a report regarding potential changes to the AHIF and IHO Programs and the impact of AB 1505 on those programs. The City Council considered initial recommendations on an ordinance to establish a separate inclusionary housing requirement for small projects (Small Project IHO) but deferred this work so that staff could concentrate on the Large Project IHO and building units. During that discussion and motion to defer, City Council requested information about the policies of neighboring jurisdictions and the number of projects in the pipeline to which a Small Project IHO would apply. Additionally, the City Council indicated that if a Small Project IHO were created, it should encourage compact, infill developments located near public transit and discourage larger, low-density detached single-family homes.

On December 19, 2017 the City Council adopted resolution 78473 amending the Housing Impact Fee Resolution to provide a framework for a transition process between the existing AHIF and the Large Project IHO between January 1, 2018 and June 30, 2018 for projects with 20 or more rental units. Staff also clarified that rental developments with three (3) to nineteen (19) units are still subject to the AHIF and that for-sale projects with nineteen (19) or fewer units are exempt from both the Large Project IHO and AHIF.

On March 26, 2018, the CED Committee heard initial policy considerations for a Small Project IHO and an overview of inclusionary programs among three Bay Area counties: Santa Clara, San Mateo, and Alameda. Staff was asked to conduct a financial analysis on a potential in-lieu fee option if a Small Project IHO was developed. Housing was asked to return to the CED Committee for further input prior to returning to the City Council for consideration of an

inclusionary program that would apply to small projects (developments with nineteen (19) units or fewer).

This direction to create an ordinance to address small for-sale projects came from previous City Council direction and was reinforced by the Mayor's 15-point "Responding to the Housing Crisis" strategy and the recently Council adopted "Affordable Housing Investment Plan." The "Response to the Housing Crisis" establishes a goal of developing 25,000 residential units over the next five years, of which 10,000 units would be affordable. The development of a Small Project IHO would be an additional tool to achieve this five-year housing goal.

ANALYSIS

This memo addresses the City Council and CED Committee direction to return with analysis and policy considerations in developing an affordable housing program that applies to small projects that are either for-sale or rental. This analysis section will explore the potential ways a Small Project IHO program may be structured. Table B below summarizes all the policy considerations that are discussed below:

Table B. Policy Considerations for a Small Project IHO

Compliance Options	
Option 1	Build On-Site (preferred option)
Option 2	Build On-Site or In-Lieu Fee

In-Lieu Fee Compliance Option	
Option 1	In-Lieu Fee (per unit basis)
Option 2	In-Lieu Fee (per square foot)

Threshold Unit Size	
Option 1	1-Unit Threshold
Option 2	3-Unit Threshold

Build On-Site as the Preferred Compliance Option

Staff is seeking Council feedback on the potential compliance options of the Small Project IHO. The existing Large Project IHO has a preference for building units on-site by calculating the on-site requirement to be 15% of the total units of the project. If the developer selects an alternative compliance option such as building the units off-site or paying an in-lieu fee, the requirement increases to 20%. Other compliance options included, but are not limited to dedicating land and acquiring and rehabilitating existing units (off-site). Housing staff recommends that the Small Project IHO would have fewer mitigation options than the existing Large Project IHO, because the smaller scale of the former makes some alternative mitigations less feasible.

Housing staff is proposing that the preferred compliance option is building on-site and that in order to use another alternative such as paying an in-lieu fee, the developer would need to get an additional approval. Staff is exploring how this preference for building on-site could be reasonably structured and what the review and approval process would be if the alternative compliance option is requested.

Since the existing Large Project IHO follows traditional rounding methods, the proposed Small Project IHO should include an exception where if the development has three (3) or fewer units, it will only pay the in-lieu fee without any approval process. See the following calculations:

On-Site (3 or fewer) 3 units x 15% = 0.45 units (payment of in-lieu fee)
On-Site (4 or more) 4 units x 15% = 0.60 units (rounds to 1 unit)

With this exception in mind, the following outlines the pros and cons to requiring a Build On-Site as the preferred compliance option:

Pros	Cons
<ul style="list-style-type: none"> The focus of this proposed Small Project IHO is building units on-site, resulting in affordable units to be built more quickly. There is more than one compliance option available to developers. Fewer compliance options than the existing Large Project IHO makes it easier to implement and administer. Building units encourages mixed-income developments ensuring income integration and economic diversity. 	<ul style="list-style-type: none"> It may take time to develop a reasonable process for approving the payment of an in-lieu fee. For small projects, most developers will prefer the in-lieu fee, resulting in a burden on the approval process. If building on-site is the initial compliance option, then the need for developers to seek further City approval to use another alternative compliance option may require more staff time and pose delays to the development of a small project that prefers to pay the in-lieu fee.

In-Lieu Fee Compliance Option (Per Unit Basis or Per Square Foot)

The most common alternative compliance option to satisfy the affordable housing requirement is the payment of an in-lieu fee. The in-lieu fee would be used by the Housing Department to replace the unit that was not produced on-site. The in-lieu fee for the Large Project IHO program requires the developer to pay for every affordable housing unit they would have been required to build. An alternative to a per unit fee is a fee based on the square footage of the unit. The Housing Department recommends that the fee be established on a square footage basis.

A per unit fee incentivizes the production of larger units – and therefore fewer units and less density on a site – because the fee could be spread over more square feet. Conversely, a per square foot fee incentivizes the production of smaller units to maximize the density on a

particular site, which would align with Council’s priority of maximizing units and facilitating compact, infill development.

With this variation to the in-lieu fee, the following outlines the pros and cons to changing the in-lieu fee to a per square foot basis:

Pros	Cons
<ul style="list-style-type: none"> • A per square foot fee is easier for developers to determine the per square foot development cost of their project. • A per square foot fee incentivizes the production of smaller units to maximize the density on a particular site, which also supports City Council direction to facilitate compact, infill development. • The current AHIF program is based on a per square foot basis, so it is familiar to staff and developers. 	<ul style="list-style-type: none"> • By making the Small Project IHO in-lieu fee per square foot, developers may be even more inclined to choose the in-lieu fee, rather than build on-site. • Depending on the level of the fee, a per square foot fee may not compensate the Housing Department to pay for and replace the affordable unit elsewhere. • It would mean that “large” projects with 20 or more units have a different in-lieu fee standard than “small” projects with 19 or fewer units.

Threshold Unit Size

Previous City Council direction was to create a Small Project IHO that would apply to small for-sale and rental projects. Staff is recommending that the threshold unit size be lowered from three (3) to one (1) unit. As seen in **Attachment A**, 18% of residential development projects permitted between July 1, 2010 and June 30, 2018 (since the current General Plan was adopted) consist of projects with one (1) or two (2) units. Assuming a similar composition of project sizes going forward, a program that covers projects with one (1) to nineteen (19) units would include meaningfully more units – and therefore more affordable housing units may be built or fees collected – than a program that covers only projects with three (3) to nineteen (19) units. Additionally, according to developer feedback, single-family developments can absorb the cost of an in-lieu fee more easily.

The following outlines the pros and cons to lowering the unit threshold from three (3) to one (1):

Pros	Cons
<ul style="list-style-type: none"> • More projects may be subject to the potential Small Project IHO, if the unit threshold is lowered to one (1). • By including developments projects with one or two units, the responsibility of addressing the “Housing Crisis” is shared. 	<ul style="list-style-type: none"> • As described above, if a project with three (3) or fewer units chooses the build on-site option, traditional rounding would not allow a project to build on-site. Thus lowering the unit threshold means projects with three (3) or fewer units would not

	build on-site, but would pay the in-lieu fee or undertake other mitigation.
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Applicability

Staff is recommending that the Small Project IHO apply to all new residential development with two exceptions: Accessory Dwelling Units (ADUs) and renovation of existing homes. The City wants to encourage the development of ADUs. In terms of home renovations, the existing Large Project IHO applies to residential developments that modify units. Depending on the size and type of the renovation, a planning permit may not be needed, thus to avoid intensive staff time to track down and evaluate renovations, it is recommended to only apply the Small Project IHO to residential developments that create new one (1) to nineteen (19) units excluding ADUs and renovations.

Potential Number of Parcels that May Be Subject to the Small Project IHO

Staff analyzed the maximum allowable density for each residential and mixed use General Plan land use designation to approximate the number of parcels where 1-19 unit projects could be built. Staff determined there are approximately 7,261 parcels citywide where residential development can occur, of which 3,891 could potentially accommodate a 1-19 unit project. Of these parcels, 3,627 are located in low density neighborhoods (the Residential Neighborhood General Plan Designation) and 264 parcels are located in areas with higher density land use designations. Additional analysis would be needed to determine how many of these sites are currently vacant, underutilized, or likely to be redeveloped in the near future.

Conclusion

Housing staff is recommending that a Small Project Inclusionary Housing Ordinance be created that will apply to for-sale and rental developments with nineteen (19) units or fewer. The preferred compliance option is to build on-site and if the developer chooses the alternative compliance option to pay the in-lieu fee, based on a per square foot basis, then they must seek approval from the City. Housing staff are exploring how this preference for building on-site could be implemented.

The outcome of this analysis is to have two distinct programs as shown in Table C below:

Table C. Affordable Housing Programs

	(Existing) Large Project IHO	(Proposed) Small Project IHO
Applicability	20 units or more units, for-sale and rental	1 to 19 new units, excluding ADUs and renovations, for-sale and rental
Compliance Options	<ul style="list-style-type: none"> • 15% On-Site • 20% In-Lieu Fee (per unit) • 20% Off-Site • Land Dedication 	<ul style="list-style-type: none"> • 15% On-Site (preferred option) • 20% In-Lieu Fee (per square foot)

	<ul style="list-style-type: none"> • Surplus Inclusionary Credits • Acquisition and Rehabilitation • HUD Restricted Units • Alternative/Combination of Methods 	
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Next Steps

If staff recommendations are approved, staff will initiate the following:

- 1) Develop a Small Project IHO with build-on site as the preferred compliance option and an alternative square foot in-lieu fee;
- 2) Complete financial analysis and draft a separate Small Project IHO; return to Council for adoption;
- 3) Create documents including implementation guidelines and posting of requirements;
- 4) Update the schedule of fees and charges.

EVALUATION AND FOLLOW-UP

Accept this report and forward to the full City Council for approval.

POLICY ALTERNATIVES

Alternative #1 ***Continue to apply the Affordable Housing Impact Fee (AHIF) only to rental developments with three (3) to nineteen (19) units***

Pros: Market-rate for-sale developments with nineteen (19) or fewer units would not be charged an AHIF by the City.

Cons: Limiting the AHIF to apply to only rentals is not effective when a majority of developments with nineteen (19) or fewer units are for-sale projects.

Reasons for not Recommending: Creating a Small IHO program that will cover for-sale and rental developments with nineteen (19) or fewer units will help provide funding for more affordable housing.

PUBLIC OUTREACH

As mentioned in the previous CED Committee memo, Housing Department staff met with representatives from the Building Industry Association (BIA), the Santa Clara County Association of Realtors, and individual developers to discuss the City's inclusionary programs and potential recommendations. Stakeholders expressed concerns about applying the same

requirements to small and large developers. Although no fee is the preferred option, large developers express that if there was to be a program that they liked the per square foot fee structure of the AHIF.

COMMISSION RECOMMENDATION/INPUT

The Housing Department's recommendations were presented to the Housing and Community Development Commission (HCDC) on August 10, 2017. HCDC accepted staff's report and unanimously supported the potential development of a Small Project IHO program. At the August 8, 2018 HCDC, Housing staff provided a status update to the development of a Small Project IHO program through the Commission's Director's Report.

COST IMPLICATIONS

Currently there are no revenue or expense impacts in Fiscal Year 2018-2019. The current resources used to assess the current AHIF and IHO programs will cover the staff costs of creating the Small Project IHO program, if adopted.

COORDINATION

This item has been coordinated with the City Attorney's Office and the City Manager's Budget Office.

CEQA

Not a Project. File Nos. PP17-009, Staff Reports, Assessments, Annual Reports, and Informational Memos that involve no approvals of any City action; and PP17-002, Consultant Services for design, study, inspection, or other professional services with no commitment to future action.

/s/
JACKY MORALES-FERRAND
Director, Housing Department

For questions, please contact Amy Chen, Senior Development Officer, at (408) 975-4489.