Corinthian House
RESIDENCE INCORPORATED
A NON-PROFIT CORPORATION

EQUAL HOUSING OPPORTUNITY

Mrs. Ladeena Ford
State Board of Equalization
Property and Special Taxes Department
P.O. Box 942879
Sacramento, CA 94279-0064

February 23, 2005

Ref: March 16th Meeting on Welfare Exemption Rules

Dear Mrs. Ford:

My name is Paul Field and I am the Administrator of Corinthian House Residence, a 102 unit non-profit owned building located in Campbell, Santa Clara County. Built in 1981, Corinthian House Residence provides affordable housing for low and very low-income seniors, whose average age is 85 years. The waiting list to become a resident at Corinthian House Residence is estimated at 2 years.

Corinthian House Residence was developed using federally insured loans and state housing subsidies. The BOE's proposal to disqualify affordable housing projects financed with federally insured loans from eligibility for property tax exemptions will have a devastating impact on this property. Under our regulatory agreement, we cannot charge monthly rents greater than 30 percent of the resident's monthly income. Operating under a tight budget, there is little room to shift obligations around in the budget and begin paying property taxes. To do so, we would have to take money away from repairs and upkeep to the property, as well as services we have been able to offer residents to help keep them independent and in the community. If we were unable to absorb the additional costs, we would be in danger of violating our regulatory agreements and loan commitments.

If the BOE's proposal to disqualify projects financed by federally insured loans were the law in 1981, I think Corinthian House Residence would not have been developed. Affordable housing projects are fragile, risky deals because the financing is so difficult to secure. We tried numerous loan resources and were denied by all except the federally insured loan. Requiring such projects to pay property taxes would most likely render the deal financially untenable.

I believe that the type of subsidy used to finance affordable housing should not be the focus of whether or not an exemption applies. The test should be whether a property is required by contracts or regulatory agreements to keep rents restricted to an affordable level. I respectfully urge the BOE to maintain the current interpretations of who qualifies for exemption from property taxes.

Thank you for this opportunity to state my views.

Sincerely,

Paul D. Field

Paul D. Field, Administrator

cc: Betty T. Yee

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INSPIRED CONCEPTS OF LIVING LOVE BRING RESPONSIVE LIVING NOW
MEMBER ORGANIZATION OF RESIDENTIAL HOMES

County of Santa Clara

Office of the County Assessor

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70 West Hedding Street
San Jose, California 95110-1771
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E-mail: larry.stone@asr.co.santa-clara.ca.us

Lawrence E. Stone, Assessor

2005 MAR -4 PM 2:03

February 24, 2005

Douglas R. Bigley
Urban Housing Communities
2000 E. Fourth Street, Suite #205
Santa Ana, CA 92705

Dear Mr. Bigley:

I write in response to your letter to the State Board of Equalization, dated February 1, 2005. Like you, I "believe in the power of public/private partnerships to conquer some of the most significant social ills" including the State's housing crisis.

In fact, I am not only the Santa Clara County Assessor, I am also a for-profit developer of affordable housing. During the past eight years, I have developed over 500 affordable housing units in San Francisco and San Jose. I have been in the real estate investment and development business for 35 years. I started my career as a financial manager on Wall Street.

I am acutely aware of the roadblocks and impediments that sometimes face the affordable housing industry. Contrary to your letter, my office is <u>not</u> one of those impediments.

Given my experience as both an affordable housing developer and for the past ten years as the Santa Clara County Assessor, I understand the need for a property tax rule to clarify Revenue and Taxation Code section 214 (RTC § 214). It is my profound hope that proposed Rule 140 will provide long-overdue clarification of that statute.

As you know, current law encourages for-profit developers of affordable housing to partner with <u>qualifying</u> non-profit organizations to <u>manage</u> affordable housing projects. The law does not permit a for-profit developer to receive a property tax exemption, even if the property is well managed and units are rented consistently below market, unless a legitimate partnership is created in which the <u>qualifying non-profit is the managing general partner</u>. Similarly, it does not allow a for-profit developer to "go through the motions" and effectively "pay off" a qualifying non-profit to serve as a "managing general partner" just to receive the property tax exemption. An exemption granted under such circumstances in which the nonprofit was merely a "shell" or "front" would, in my opinion, constitute a gift of public funds. Unfortunately, as my letter to the State Board indicates (attached),

2-012

it appears that the practice of using non-profits only for the purpose of obtaining the exemption is increasing as developers recognize the lack of clarity in both the law and rules governing Assessors.

The issue that generated the need for proposed Rule 140 is principally about who manages and has control of the property, not the number of units produced. Specifically, the proposed rule is about the role of the managing general partner. As a developer you certainly understand what it means to designate an individual, or entity as a managing general partner. Property management is a service that cannot be provided once a quarter or once a year. Rather it is about consistent control and oversight. The purpose of exemption law is not only to provide an incentive to encourage development, but to also maintain affordable housing for <u>each year</u> the benefit is provided.

The intent of the Legislature in allowing the exemption was to use the property tax savings to further reduce rents to low income tenants, not to improve the developer's bottom line or to accelerate debt retirement. RTC § 214(g)(2)(b) provides that, "In order to be eligible for the exemption provided by this subdivision, the owner of the property shall…certify that the funds that would have been necessary to pay property taxes are used to maintain the affordability of, or reduce rents otherwise necessary for the units occupied by lower income households."

Rule 140 is intended to clarify the proper and appropriate application of RTC § 214, subdivision (g). With this clarification, both assessors and exemption claimants will have a clearer understanding of the requirements for granting the exemption. Thus it will help insure that those non-profits that legitimately qualify for the exemption are granted that exemption and those that do not qualify, do not receive it.

Some may even argue that clarification of the existing law will lead to less investment in affordable housing. I disagree. Legitimate developers will continue to develop affordable housing, with or without a non-profit managing general partner based upon the economics of the proposed development and the individual needs of the investors.

As an Assessor, I have recently become aware of several "sham" transactions that improperly use the welfare exemption to avoid property taxes. The following are transcripts of conversations I had with two for-profit affordable housing developers in San Jose. Their candid responses are astonishing.

Developer/Owner A
June 17, 2002
9:20 AM

> "We originally used (*blank*) but they wanted too much control and involvement over management. We now use Ray from Southern California. Ray's a 'hands off kind of guy', really doesn't do too much. He visits the property every now and then. We really do everything. He's there to qualify for the property tax abatement as the managing general partner. He provides no services. He would if we wanted him to but we don't want him to. He wants to see everything but he really doesn't do that much. He provides minimal

> oversight. He charges a 10% developer fee, but you can negotiate with him for a flat fee of $10 per door per month management fee."

Developer/Owner B
June 18, 2002
3:45 PM

> "We don't give them (*the manager*) control. We take control back after welfare exception is granted. We don't allow them to manage the property. Once a quarter they come by and survey the property. And that's all they do. They have no desire to property manage or operate the property. You don't have to have them do anything."

It is obvious that more and more for-profit developers of affordable housing are using non-profits as little more than "fronts" to earn the valuable property tax exemption. In the City of San Jose for example, the Housing Authority requires for-profit developers of affordable housing to create "token" partnerships with non-profit managing general partners so that both the developer and San Jose Housing Authority can reap the financial benefit of the property tax exemption.

As Assessor I am required by law to identify these unlawful arrangements and levy escape assessments when property taxes were improperly avoided. (RTC § 254.5(e); 254.5(f); 532.2, (b))

It appears from your letter that you disagree with the policies, goals and purposes of the welfare exemption process enacted by the Legislature. You appear to champion a qualification process in which any developer of affordable housing is eligible for an exemption from property taxes regardless of any connection to a charitable goal or purpose. If that is your purpose, your goal would be better served by either approaching the Legislature to seek legislation, or using the California initiative process whereby popular vote can change the State Constitution. The change you propose is profound and beyond the scope of an agency's authority to promulgate regulatory law. It must be made by the Legislature. In the absence of legislative or constitutional changes, I urge you to work with California Assessors Association and the State Board of Equalization to find solutions within the parameters of existing statutes.

Please call me if you have questions. I can be reached at (408) 299-5588.

Sincerely,

Lawrence E. Stone

Lawrence E. Stone
Assessor

LES:dy

c: Ledeena Ford, SBE
R. Glenn Barnes, President, CAA

Encl. (1)

URBAN HOUSING COMMUNITIES

February 1, 2005

Ladeena Ford
State Board of Equalization
Property and Special Taxes Departments
P.O. Box 942879
Sacramento, CA 94279-0090

Dear Ms Ford

I am not sure where to begin. I have been involved in the production of affordable housing since the early 1990s and over that time I have witnessed the slow, but certain erosion of the programs, specifically with respect to the federal tax credit and tax-exempt bond programs. I view the welfare exemption as an interregnal part of the programs and its administration is a symptom of a much larger problem.

As we are all aware in California we have a housing crisis. I believe in the power of public/private partnership to conquer some of the most significant social ills of this nation. Fundamental to the success of the partnership is the ability of the public sector to clearly define the objective of each program and to attract expertise and capital from the private sector. If a program arbitrarily limits access and therefore stifles competition it is never a good thing and is contrary to the fundamental principal of attracting expertise.

So given all of this: What is the core objective of the welfare exemption? If the goal is to subsidize the production of affordable housing then why have we limited access to the not-for-profits? By doing so you have effectively limited competition and increased costs.

Recently someone forwarded a letter to me written by Lawrence E. Stone Assessor for the County of Santa Clara to you dated October 21, 2004. I found this letter most troubling. If this letter reflects the view of the State Board of Equalization or other County offices charge with monitoring compliance then we are deeply divided. I can only hope that Mr. Stone is an isolated incident and that he can become more educated as to the issues that we in the industry face. Mr. Stone completely lost site of the core objective which is to subsidize the production of affordable housing. Providing a welfare exemption exclusively for qualifying non profits **never** should have happen. Simply stated the welfare exemption is just one way the counties assist the cities in meeting their affordable housing requirements mandated by the state. If the welfare exemption were

2000 E. Fourth Street Suite #205 Santa Ana, CA 92705 *tel* 714.835.3955 *fax* 714.835.3275

unavailable then this would create an additional gap the cities would have to fill or those units would never be produced.

You have requested comments regarding specific changes being made to the welfare exemption act. I for one will support any change that will increase access to the welfare exemption and therefore foster competition, I will support any change that will focus the program on the **production** of affordable housing rather then the **producer** of affordable housing, and I will support any change that will try and not "split hairs" between the poor and very poor, but rather will provide housing to all the "working poor" who need it and simply cannot afford it.

Several years ago I had an opportunity to witness the mass demolition of a huge public housing project developed under a program provide by the Department of Housing and Urban Development. It is likely that the demise of this program was a long time in coming, but people simply missed the early warning signs. Let's not let this happen again.

I would welcome any opportunity to discuss this with you further. Should you have any questions please do not hesitate to call me at 323.351.7700.

Sincerely

Douglas R. Bigley
President

Cc: John Bigley
Roger Davila
Jim Kroger
Tom Fischer
Russell Ginise
Darren Smith
Stephen Ryan
Patrick Sabelhaus
Lawrence E. Stone

County of Santa Clara

Office of the County Assessor

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Lawrence E. Stone, Assessor

October 21, 2004

Ladeena Ford
State Board of Equalization
Property and Special Taxes Department
PO Box 942879
Sacramento, CA 94279-0090

Dear Ms. Ford,

I write to recommend language for proposed Rule 140, *Managing General Partner as a Qualifying Organization for the Welfare Exemption.* The purpose of our recommended language is to clarify the requirements whereby a non-profit, managing general partner qualifies property owned by a limited partnership for the Welfare Exemption.

The exemption from property taxes for affordable housing was originally designed exclusively for qualifying, non-profit developers. Subsequently, the law was modified to reflect additional methods of financing and managing affordable housing. One of those methods occurs when a for-profit limited partnership is created to finance and develop an affordable housing project that is subsequently managed by a qualifying non-profit organization. This arrangement is consistent with the original intent of the Welfare Exemption to provide relief from property taxes to those non-profit entities that manage and provide affordable housing.

Unfortunately, some for-profit developers have sought the benefit of the property tax exemption without actually delegating to the qualifying non-profit, the authority and responsibilities consistent with managing the day-to-day operations of the affordable housing project. Last year the value exempted of non-profit affordable housing jumped 25% to almost $2 billion in Santa Clara County. I believe the increase is partly attributable to more and more for-profit developers of affordable housing using non-profits as little more than "fronts" to earn the valuable property tax exemption. In the City of San Jose for example, the housing authority <u>requires</u> for-profit developers of affordable housing to create "token" partnerships with non- profit, managing general partners so that both the developer and San Jose Housing can reap the financial benefit of the property tax exemption.

The enclosed attachment (Attachment A) discloses the content of conversations that I had with two for-profit developers who have established joint venture arrangements with non-profit organizations to serve as the managing general partners for several, large affordable housing properties in Santa Clara County. Their candid responses are astonishing.

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The absence of a Rule defining the explicit authority and responsibilities of a non-profit, managing general partner makes it extremely difficult to investigate these transactions and where appropriate, rescind the Welfare Exemption. The proposed rule provides a "bright line" test easily understood by both developers of affordable housing and assessors.

I look forward to participating in the Rule making process.

Sincerely,

Lawrence E. Stone
Assessor

LES:dy

c: Hon. Cris Andrews, President, California Assessor's Association
Fran Wagstaff, President, Mid-Peninsula Housing Coalition
Matt Schwartz, Executive Director, California Housing Partnership Corporation

Attachments

Limited Partnerships with Nonprofit Managing General Partners as Qualifying for the Welfare Exemption

In order for a Limited Partnership ("LP") to qualify for the welfare exemption under Revenue and Taxation Code section 214(g)(1), the Managing General Partner ("MGP") must be an eligible nonprofit corporation.

There shall be a written and signed Limited Partnership Agreement ("Agreement"), of the type described in section 214(g)(1), that defines the responsibilities, rights and obligations of each party to include the following:

A. The Agreement shall have a specified beginning and ending date.
B. Upon request, a copy of the Agreement and all amendments shall be submitted to the County Assessor in any county in which the LP or MGP files a claim for Welfare Exemption based upon the nonprofit status of the organization serving as MGP.
C. The County Assessor shall have the right to audit the books and records of the MGP and the LP to insure that the contractual obligations are met.

The MGP shall, at a minimum, be required by the terms of the Agreement to direct, conduct and control the business of the limited partnership and to perform all of the following functions.

A. Exclusively manage, operate, supervise and lease the property, have authority over the affairs of the partnership, and participate materially in the management decisions of the partnership.
B. Prepare and implement a mutually agreeable overall budget and/or business plan as agreed by the LP and the MGP.
C. Collect rents and other charges from tenants and all other charges and revenues. The MGP shall have authority to institute legal proceedings on behalf of the owner for collection when deemed appropriate.
D. Establish bank accounts for the purpose of maintaining a general operating account and security deposit trust account.
E. Maintain complete and separate books, records and documents relating to the management and operation of the property, including without limitation all contracts, original leases, amendments, extensions and agreements relating to contracts and leases, files, correspondence with tenants and prospective tenants, vendors, and federal, state, county or municipal authority; computations of rental adjustments; maintenance, construction records and inventories of personal property and equipment. All such books and records shall be maintained at either the property or the MGP's principal office.
F. Demonstrate that the MGP has on-site or local staff qualified to manage the property. Maintain the condition of the property in the state prescribed by the LP. Regularly inspect the accessible areas of the property and arrange to make all necessary repairs.
G. Make and enter into contracts on behalf of the LP for all budgeted expenses and equipment leases as required in the ordinary course of business for the operation and maintenance of the property.

H. Cause to be placed and kept in force a Comprehensive General Liability (CGL) insurance policy with respect to acts which may affect of employees of the MGP, as well as Worker's Compensation Insurance and other insurance as designated by the LP.

I. Hire, train, supervise, direct the work of and discharge all personnel necessary for the on-site management of the property.

J. Pay all salaries, wages, and other compensation and fringe benefits of all personnel as an expense of the MGP without reimbursement by the LP, including, but not limited to, compensation of executive personnel and employees of MGP charged with general administration of MGP's contractual agreement for performance, a property manager for the property who is experienced in the administration and operation of property management and who will devote time as is necessary to the on-site supervision of the property, bookkeepers etc.

K. Receive compensation from the LP in an amount that is consistent with the market for the management of similar residential properties.

The MGP may not further delegate any of the responsibilities listed in item II unless such delegation is to another non-profit corporation eligible for the Welfare Exemption as provided in section 214 of the State of California Revenue and Taxation Code.

ATTACHMENT A

Developer/Owner A
June 17, 2002
9:20 AM

"We originally used *** but they wanted too much control and involvement over management. We now use Ray from Southern California. Ray's a 'hands off kind of guy', really doesn't do too much. He visits the property ever now and then. We really do everything. He's there to qualify for the property tax abatement as the managing general partner. He provides no services. He would if we wanted him to but we don't want him to. He wants to see everything but he really doesn't do that much. He provides minimal oversight. He charges a 10% of developer fee, but you can negotiate with him for a flat fee of $10 per door per month management fee."

Developer/Owner B
June 18, 2002
3:45 PM

"We don't give them (the manager) control. We take control back after welfare exception is granted. We don't allow them to manage the property. Once a quarter they come by and survey the property. And that's all they do. They have no desire to property manage or operate the property. You don't have to have them do anything."

March 4, 2005

VIA E-MAIL

CALIFORNIA STATE BOARD OF EQUALIZATION

450 N Street
Sacramento, California 94279-0064
Attention: Betty T. Yee
Bill Leonard
Claude Parrish
John Chiang
Steve Westly

Re: Proposed Welfare Exemption Rules - March 16, 2005 Hearing
Dear Board Members:

I am writing with respect to the Board's consideration of changes to the Welfare Exemption and, more particularly, Section 214(g) of the Revenue and Taxation Code. While consideration of the efficacy of the program is always an appropriate undertaking for the Board, I am quite concerned that any changes to the present system will drastically curtail the production of much needed affordable housing in California.

The property tax savings created by the Welfare Exemption are a vital component to financing virtually all affordable housing production in California at the present time. The financial institutions that provide the vast majority of the equity and debt financing for affordable housing projects size their investments based on the expectation that a properly structured and managed project will qualify for a Welfare Exemption. These financial institutions now rely on the present system and appreciate the fact that it is predictably, consistently and efficiently managed by the Board and its staff.

The present system strikes the proper balance between encouraging development of affordable housing in California, on the one hand, and regulating the use of the Welfare Exemption, on the other hand, in a manner consistent with Section 214(g). Tinkering with the present system would jeopardize virtually all of California's affordable housing production. This risk is simply too great and unnecessary in light of the fact that there is no verifiable evidence of any significant disregard for the system and its legislative requirements. Before making changes to the present system that could have far reaching repercussions for California's most needy citizens, a thoughtful and careful study and analysis of the facts and issues should be conducted under the most exacting standards. Our citizens deserve no less.

When adopting Section 214(g) in 1987, the legislature made clear that alleviating the looming affordable housing crisis was of paramount concern. That crisis is now greater than ever. The importance of the Welfare Exemption to the production of affordable housing is thus more critical than ever. We do not need changes to the present system. We need more affordable housing.

I have attached our paper which describes at greater length our views on this matter. We would welcome the opportunity to discuss these matters at greater length with you and look forward to seeing you at the hearing on March 16, 2005.

Respectfully submitted,
/s/
Stephen C. Ryan

Attachment
cc: Mary Ann Alonzo, Esq., Senior Tax Counsel
Mrs. Ladeena Ford

3/7/2005

COX CASTLE NICHOLSON

POLICY PAPER:
CALIFORNIA STATE BOARD OF EQUALIZATION
PROPOSED WELFARE EXEMPTION RULES
March 4, 2005

This policy paper addresses a major affordable housing issue identified in the California State Board of Equalization's (the "BOE's") January 14, 2005 letter concerning proposed new "welfare exemption" rules. Issue #7 identified in the BOE's January 14 letter relates to what authorities and duties should be required of a qualifying "managing general partner" under California Revenue and Taxation Code ("R&T") Section 214(g)(1). This paper addresses the managing general partner concept and, at a more general level, discusses the BOE's current regime for administering R&T Section 214(g) ("Section 214(g)").

Specifically, this paper:

- Describes how affordable housing developments are financed today in California.
- Reviews the history and purpose of 214(g).
- Analyzes some of the more radical suggestions for change and points out the dangers of such radical reform.
- Concludes that the current BOE-administered system is achieving the California legislature's goal of increasing the state's affordable housing stock and supports the BOE's current administrative regime for managing the 214(g) welfare exemption.

EXECUTIVE SUMMARY

The BOE has developed a sound administrative process for implementing the welfare exemption granted under 214(g) to partnerships in which a nonprofit corporation serves as the managing general partner. The BOE's self-certification system – whereby a managing general partner of a project-owning partnership must certify, under penalty of perjury, that it has certain enumerated, substantial management authority and duties befitting a "managing" general partner – is true to the text of, and the legislative intent behind, 214(g). It strikes the proper balance between encouraging development of affordable housing in California, on the one hand, and regulating the use of the welfare exemption, on the other hand.

Contrary to the suggestions of certain critics of the BOE's compliance regime, there is no evidence that for-profit developers regularly manipulate nonprofits to abuse the welfare exemption. Even if there was an indication of individual instances of such abuse, the BOE and the county assessors (who jointly administer the welfare exemption system) already have the authority to audit suspected offenders and deny or revoke welfare exemptions.

The welfare exemption is a vital element in sustaining the financial viability of virtually every affordable housing development in California. The financial institutions that provide the vast majority of the equity and debt financing for these projects are willing to size their investments based on the expectation that a properly structured and managed project will qualify for a welfare exemption. These financial institutions now rely on the BOE system and appreciate the fact that it is predictably, consistently and efficiently managed by the BOE staff. The BOE should carefully consider any proposal for reforming the present system. Any change to the present system risks creating uncertainty in the financial community, which may result in a direct loss of affordable housing.

ANALYSIS

How Privately-Owned Affordable Housing Developments are Financed Today; How Lenders and Investors Police Welfare Exemption Compliance

(1) Overview of the System

California has a housing crisis. The evidence for this crisis is compelling and overwhelming. As the California Department of Housing and Community Development ("HCD") reported in its May, 2000 study entitled "Raising the Roof: California Housing Development Projections and Constraints, 1997 – 2020":

> "California will need an unprecedented amount of new housing construction—more than 200,000 units per year through 2020—if it is to accommodate projected population and household growth and still be reasonably affordable. It will need more suburban housing, more infill housing, more ownership housing, more rental housing, more affordable housing, more senior housing, and more family housing."

This paper focuses on the manner in which developers (for profit and nonprofit), lenders and investors have responded to the affordable housing portion of the California housing crisis. While there are larger social factors that have contributed to the affordable housing crisis, much of it is attributable to market factors that make it extremely difficult for affordable housing developers to compete with market rate developers for suitable multi-residential properties. In response, affordable housing development has become increasingly reliant upon a complex financial structure that leverages tax exempt bond financing, publicly subsidized financing, low income housing tax credits, and the welfare exemption.

A unique attribute of affordable housing finance is the involvement of large financial institutions in all aspects of affordable housing development. Some of the nation's largest and most reputable financial institutions are actively involved as lenders and/or equity investors in affordable housing in California. The participation by these institutions offers unique assurances that affordable housing programs, including the welfare exemption, are properly monitored and utilized. At the same time, these financial institutions require predictability and efficiency as to the availability of housing incentives such as the welfare exemption, if they are to underwrite such programs into the financing structure.

In practice, the welfare exemption is absolutely essential in maintaining affordability. The welfare exemption decreases the expenses associated with the ownership and operation of an affordable housing development, and therefore increases the size of the loans that lenders are willing to offer to project owners. Indeed, it is difficult for lenders to underwrite their loans for affordable housing projects without the property tax exemption. The Senate Revenue & Taxation Committee, in its July 15, 1987 hearing to consider the bill that was later codified as Section 214(g), recognized this financial reality, acknowledging that "some prospective low income projects may not 'pencil out' without the property tax exemption" (emphasis added).

(2) Tax Credits

In order to take full advantage of the low income housing tax credit authorized by Internal Revenue Code Section 42, the overwhelming majority of for-profit and non-profit developers in California utilize a limited partnership structure to own and operate affordable housing developments. A well-established, institutional tax credit investor (often a Fortune 500 company) or a syndicated fund of such investors make an equity investment in the limited partnership in exchange for virtually all the low income housing tax credits generated by a project. The tax credit investor utilizes the tax credits to offset federal taxes on a dollar-for-dollar basis over a 10-year period, and, therefore, is willing to make capital contributions to the project-owning partnership for these credits.

(3) Tax-Exempt Bond Financing

An affordable housing project developer often uses debt financed the issuance of low-interest, tax-exempt bonds, usually in addition to tax credits. Typically, a California state or local governmental entity issues private-activity multifamily housing revenue bonds under the state's bond volume cap, and loans the proceeds of those bonds to the project-owning partnership, receiving a deed of trust on the property as security. Tax-exempt multifamily housing revenue bonds are either publicly-offered or privately-placed.

Where such bonds are publicly-offered, investors with no firsthand knowledge of the project or the project-owning partnership purchase the bonds. Such distribution is handled by an investment banking firm with mandated obligations to utilize due diligence in any distribution of securities. Such investment bankers focus on the ability of the affordable housing project to service the repayment obligations on the bonds. Thus, these investment bankers are uniquely focused on the underwriting standards for expenses, including the availability of the welfare exemption.

At the same time, in order to keep the interest rate on such bonds low, a credit-enhancer (typically a major national bank or financial institution) offers a letter of credit or other form of guaranty that the bonds will be repaid, even if the affordable housing project underperforms expectations and the project-owning partnership fails to repay the loaned bond proceeds. The credit enhancer thus plays the role of the real estate lender, taking all of the real estate-related risk, and conducting due diligence (including review of the availability of the welfare exemption) similar to the investment bankers' review.

Where such bonds are privately-placed, a well-established lender (typically a major national commercial bank or national financial institution) will purchase all of the bonds and loan the proceeds directly to the project-owning partnership. These lenders conduct extensive underwriting due diligence, including review of the availability of the welfare exemption.

(4) Conventional Financing and/or Loans from Governmental Agencies

Some developers choose not to obtain tax-exempt bond loans, and instead utilize conventional real estate loans (typically from a major national or regional bank) or loans from federal, state or local agencies. Sometimes a developer will obtain both a conventional loan and one or more loans from government agencies. These loans go through the same underwriting (including review of welfare exemption availability) and due diligence scrutiny as discussed above for tax-exempt bond loans.

(5) Conclusion: How Lenders and Investors Police the Property Tax Exemption

As discussed above, the tax credit equity investors, tax-exempt bond credit enhancers/lenders and conventional lenders that provide the lion's share of affordable housing project financing are some of the largest and most sophisticated financial institutions in the world. These investors and lenders subject affordable housing projects to intense underwriting scrutiny at the outset, and intense compliance oversight on an ongoing basis.

Without a predictable welfare exemption, obtainable in a timely manner, lenders would not include welfare exemption savings into their underwriting, making affordable housing projects next to impossible to finance. Moreover, in order to ensure that project-owning partnerships can afford to cover the debt service on loans underwritten to include welfare exemption savings, these lenders provide ongoing welfare exemption compliance oversight, thus providing a backstop to the BOE's and assessors' roles in policing against welfare exemption fraud.

Moreover, the BOE's managing general partner regime <u>requires tax credit equity investors to cede a certain amount of power to nonprofits</u>. These Fortune 500 financial institutions require strict statutory compliance by their partners (including the managing general partner), as a necessary element in protecting their equity investments in affordable housing projects. Contrary to the insinuations of the current regime's critics, these institutional tax credit investors would not enter into a written agreement granting substantial management powers to a nonprofit, and then blithely ignore that agreement in practice.

History and Purpose of R&T 214(g)

Section 214 was enacted in 1945 to implement Section 4(b) of Article XII of the California Constitution, which provides that the California legislature may exempt from taxation "property used exclusively for religious, hospital or charitable purposes and owned or held in trust by corporations or other entities." The original policy rationale for enacting Section 214's "welfare exemption" was to treat certain privately owned property, which was used to provide a charitable activity, in the same manner as publicly owned property which would otherwise be used by government to perform that same charitable function.

(1) Managing General Partner

(a) General Discussion.

In furtherance of the spirit of the exemption, Section 214 was amended in 1987 to add subsection (g), which provides that:

> "[p]roperty used exclusively for rental housing and related facilities and owned and operated by religious, hospital, scientific, or charitable funds, foundations, or corporations, *including limited partnerships in which the managing general partner is an eligible nonprofit corporation* . . ."

shall be entitled to a full or partial property tax exemption, subject to the conditions set forth in Section 214(g) (emphasis added).

The participation of an eligible nonprofit corporation, either as the owner of the property or as the managing general partner of a limited partnership that owns the property, is constitutionally necessary. Without the participation of a nonprofit corporation, the welfare exemption granted by Section 214(g) would not comply with the tax exemption requirement set forth in California Constitution Section 4(b) of Article XII of the California Constitution.

In adopting 214(g), the California Legislature did not focus its attention on the attributes of a "managing general partner." Indeed, the highlighted language quoted two paragraphs above was inserted into the proposed text of Section 214(g) a mere twenty-one days before Governor George Deukmejian signed it into law.

The legislative history shows no debate accompanying the addition of the managing general partner concept. Rather, the legislative history reveals a debate focused almost exclusively on the benefit of increasing California's stock of affordable housing, on the one hand, versus the cost associated with the loss of property tax revenues, on the other hand. The addition of the managing general partner concept into 214(g) appears to have been an extension of the economic reasoning behind the bill, summarized succinctly by the Senate Revenue & Taxation Committee in its July 15, 1987 hearing on 214(g):

> "The justification for the exemption would be that the funds which are currently paid in property taxes could better be used in furtherance of the goals of providing low income housing. Also, it may be that some prospective low income projects may not 'pencil out' without the property tax exemption."

(b) <u>What is a "Managing" General Partner?</u>

Notably, the legislature chose the phrase "<u>managing</u> general partner" rather than "general partner." The California Revised Limited Partnership Act contains extensive provisions setting forth the obligations of a "general partner," but makes no mention of a "managing" general partner. By choosing to use the term "managing" general partner, the legislature clearly indicated its understanding that property-owning partnerships could have <u>other</u>, <u>for-profit</u> general partners, so long as the nonprofit general partner was the "managing" general partner.

Certain affordable housing developers have suggested to the BOE that "managing general partners" should be required to provide an expanded array of operational assistance at low income housing projects. These developers have further indicated that this assistance can only be provide by nonprofit organization who are well-capitalized and have extensive staffs. If this recommendation were to be implemented, it would limit the number of qualified organizations to a very few developers and clearly undercut the intent of 214(g).

This suggestion also denigrates the many well-established and well-qualified nonprofits who are small organizations but have demonstrated the capability to develop and operate from one to a multiplicity of affordable housing projects. These organizations have accomplished this by hiring a few staff and retaining experienced property management companies and consultants. If the BOE were to impose a "litmus test" that defined a "managing general partner" according to an organization's balance sheet and/or staffing level, it would seriously undercut, if not destroy, the ability of these nonprofits to contribute to the development of affordable housing in California.

The legislative history also demonstrates a governmental sensitivity to the need to support continued participation by underfunded nonprofit organizations in affordable housing development, and a recognition that the welfare exemption would provide that support. In its Enrolled Bill Report, submitted in late September, 1987, the HCD recognized that nonprofit organizations suffer from "limited budgetary conditions." The HCD report goes on to state that the final proposed text of 214(g)would address "the Governor['s] expressed interest in . . . preserving affordable housing and assuring a continued role for nonprofits in affordable housing."

Nonprofit participation in affordable housing is as important today as it was in 1987, and therefore the BOE should resist pressure from an exclusive group of nonprofits calling for rule changes that would increase the expense of nonprofit participation in affordable housing projects.

(2) Use of Property Tax Savings

Under Section 214(g), the owner of the property must:

> "[c]ertify that the funds that would have been necessary to pay property taxes are used to maintain the affordability of, or reduce rents otherwise necessary for, the units occupied by lower income households."

On August 18, 1987, the State Assembly amended the bill that was later codified as Section 214(g) to provide that property owners should only be required to *certify*, rather than affirmatively *demonstrate*, that the property tax savings are actually helping to maintain affordability or reduce rents. In its August 26, 1987 bill analysis, the BOE emphasized the expense of administering a requirement that a property owner affirmatively demonstrate compliance, and explained that "[i]t is not clear how the owner of the property could demonstrate that this requirement is satisfied."

By adopting a "certification" standard rather than the earlier-proposed "demonstration" standard, the Legislature moved away from requiring property owners to file financial information. Such a system would have imposed a nearly impossible burden on owners to track – perhaps on a dollar-for-dollar basis – how property tax savings are applied.

Moreover, 214(g) allows owners to certify that the property tax savings are used to maintain affordability *or* reduce rents. This standard, together with the self-certification regime, evidences the Legislature's desire to steer clear of managing exactly how affordable housing projects are run and exactly how property tax savings are applied. Instead, the Legislature focused on the broader goal of providing financial assistance for purposes of maintaining and increasing California's stock of affordable rental housing.

In practice, the welfare exemption is absolutely essential in maintaining affordability. As discussed above, the welfare exemption decreases the expenses associated with the ownership and operation of an affordable housing development, and therefore increases the size of the loans that lenders are willing to offer to project owners. Indeed, it is difficult for lenders to underwrite construction and permanent loans for affordable housing projects without the property tax exemption.

Radical Reforms Are Ill-Advised

Since the BOE's reform proposal was announced in January, 2005, a very small but vocal element has suggested that there is systemic and widespread abuse of the welfare exemption. While this is a dramatic proposition, there is simply no evidence whatsoever of such abuse. Indeed the only "evidence" to date consists of anecdotal, third-hand statements by a few members of the public regarding singular examples of perceived abuse. While the BOE should certainly take accusations of fraud seriously, it would be rash to suggest that a few such allegations warrant wholesale changes to the present system.

Another theme running through some of the vocal criticism of the present system is the implicit suggestion that some nonprofits are less worthy than others. This criticism is essentially a "straw man" argument. It diverts attention from the real public policy issue at hand, namely meeting the legislature's mandate for the production of more affordable housing, and tries to focus attention on the perceived qualities of certain nonprofits. This is an entirely subjective and relative matter. There is no litmus test for what is a nonprofit, nor should one be imposed. Moreover, such a consideration is outside of the mission of the BOE and would unnecessarily burden the BOE's already overused resources. The Internal Revenue Service ("IRS") and California's Franchise Tax Board ("FTB") are the appropriate authorities for such determinations, and these agencies already vet prospective nonprofits at the outset, before such entities can even consider becoming involved in the welfare exemption process. Indeed, the BOE's proposed Rule 140 requirements regarding BOE review of a nonprofit's "charitable" purposes, as presented at the BOE public meeting on March 2, 2005, are wholly duplicative of IRS and FTB responsibilities and, therefore, are unnecessary.

A final suggestion proffered by a few critics is that only nonprofits involved in the physical operation of an affordable housing project merit the welfare exemption. Presumably, only nonprofits with their own management companies or construction companies could ever meet a stringent application of this test. That proposed standard is entirely inappropriate. The welfare exemption has never been construed to require such ground level involvement, as discussed in the legislative history section above. Rather, essential management and oversight, as required by the BOE's present system, is the critical test. Requiring a nonprofit to have extensive assets and capital is antithetical to the legislative history, which noted that nonprofits suffer from "limited budgetary conditions."

The Current BOE-Administered System is Achieving the Goals of 214(g)

The current BOE-administered system for assuring compliance with 214(g), as set forth in the BOE's Assessor's Handbook Section *Welfare, Church and Religious Exemptions*, is achieving the original purpose of 214(g): namely, to increase California's stock of affordable rental housing. The BOE's proposed Rule 140, as presented at the March 2 public meeting, would amend the present system by adding additional requirements that are, at heart, substantially similar to the present requirements. The BOE should carefully consider the cost associated with making changes to the present system. Unless change is urgently needed (and this paper has argued that it is not needed), and unless the proposed changes would fundamentally reform the present system (and this paper has argued that the changes proposed by Rule 140 do not), then the BOE should carefully consider the administrative cost of tinkering with a system that already predictably and efficiently achieves the legislature's goals.

With respect to "managing general partner" duties, the BOE's self-certification standard – whereby a managing general partner of a project-owning partnership must certify, under penalty of perjury, that it has certain enumerated management authority and the substantial duties befitting a "managing general partner" – is in keeping with the legislative intent behind 214(g). As discussed above, the legislature consciously chose to adopt a "*certification*" system rather than a "*demonstration*" system for assuring compliance with 214(g)'s requirement that property tax savings be applied towards reducing rents or maintaining affordability. The BOE's managing general partner self-certification standard stays true to the original legislative intent behind 214(g): increasing California's affordable housing stock, rather than imposing governmental control over exactly how affordable housing projects are run.

Further, since 214(g) does not discuss a managing general partner's duties or attributes, there is no clear legislative authorization for the BOE to expand the reasonable list of duties that managing general partners are required presently to attest to on forms BOE 267-L1 and BOE 277-L1. Indeed, the suggestion from a few critics of the current self-certification regime that it allows "nonprofit shells" to obtain property tax exemptions on behalf of for-profit developers is not only factually incorrect – it also runs counter to the very purpose of 214(g).

However, should either the BOE or a county assessor suspect that a particular managing general partner is failing to exercise the managerial control that it is certifying to on forms BOE 267-L1 or BOE 277-L1, both the BOE and the county assessor have the right to audit the potentially offending parties. Forms BOE 267-L1 and BOE 277 L-1 both clearly alert a filing non-profit of this fact, stating in bold letters: "**Welfare Exemption claims and supporting documents are subject to audit by the Board of Equalization and by the Assessor**." Therefore, in response to any suggestion from critics that some fraudulent managing general partners are abusing the welfare exemption system, the BOE and the county assessors can and should emphasize that they have the power to audit any and all limited partnerships that obtain a welfare exemption, and the power to revoke improperly obtained welfare exemptions.

Also, from an economic efficiency standpoint, if the property tax exemption is to be accounted for in a lender's initial underwriting, it must be knowable, predictable, and timely obtained. In an era where tax credit investors, credit enhancers and conventional lenders make long-term financial commitments to each affordable housing project that they finance, the predictability of the BOE's bright-line certification process provides a necessary source of predictability. Without that predictability, financial institutions would not count on the availability of property tax savings, and would reduce the amount of money that they would be willing to lend and/or invest in affordable housing projects. Any decrease in available financing would only worsen the ability of developers to try to meet California ever-increasing need for affordable rental housing.

The BOE's certification system (supported by the BOE's and the county assessors' audit rights), when coupled with the strict, ongoing oversight provided by tax credit investors, credit enhancers and conventional lenders, assures that managing general partners will continue to wield essential management authority, rather than operating as a "nonprofit shell" for the purposes of obtaining the property tax exemption.

Lastly, the authors of this policy paper would like to support the BOE staff's positions outlined in the BOE's February 24 follow-up letter signed by Dean R. Kinnee. The authors of this paper support the BOE's ongoing efforts to add predictability to all remaining unsettled areas of 214(g) administration and practice.

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Foundation For Social Resources

March 4, 2005

Mr. Dean Kinnee
State Board of Equalization
Property and Special Taxes Department
450 N Street
Sacramento, CA 94279-0064

Dear Mr. Kinnee,

Foundation for Social Resources, Inc. ("FSR") is a 501 (c) (3) non-profit formed in 1988 for the purpose of providing and preserving affordable housing opportunities for low-income families and the elderly. Our comments will address several issues raised in the BOE's January 14, 2005 Notice to Interested Parties concerning proposed new "welfare exemption" rules, most particularly Proposed Rule 140.

As Managing General Partner in many limited partnerships which have developed and or preserved affordable housing in California, we know first hand how great the need for affordable housing is and how difficult it is to make such projects financially feasible. The welfare exemption is an essential part of the available tools for making housing projects "work" for owner/developers. I'm sure you have seen the analysis done by the County of Orange on the impact of the welfare exemption in that county. As it (and the attached Pillsbury Winthrop comment reviewing those results) amply demonstrates, without the welfare exemption, cities and counties interested in production/preservation of affordable housing stock would have to subsidize projects to a far greater extent than they currently do to generate the same number of affordable housing units.

We urge the BOE to take particular note of the comments contained in the Policy Paper of Cox Castle & Nicholson (distributed today and attached hereto) outlining both the continuing need for affordable housing and the legislative intent to address this need by the adoption of R&T Code section 214 (g) in 1987. While we too have heard anecdotal evidence of alleged "abuses" of the exemption we have not seen evidence that such activity is widespread. As Mr. Ryan points out in his paper there are adequate existing safeguards to address such "abuses" of the exemption. Thus, significant changes in the operation of the exemption are not warranted, especially when material changes would threaten the future production of affordable housing----the very production they were designed to promote.

Respectfully Submitted,

Jonathan Webb
Executive Director

cc: Kristine Cazadd

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Comment Submission and Response to BOE Notice

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To: Members and Staff of the Board of Equalization

Re: BOE Notice to Interested Parties Dated January 14, 2005
Welfare Exemption for Affordable Housing Developments

<u>COMMENT SUBMISSION AND RESPONSE TO BOE NOTICE</u>

Tax policy and housing policy have long been inextricably linked, and tax incentives have always played an important role in the state's housing policy. In light of the high cost to develop affordable housing in California, the "Welfare Exemption" under California Revenue & Taxation Code Section 214(g) has become an increasingly important development incentive which affordable housing owners have relied upon as vital. Given the unfortunate dual circumstances of a chronic shortage of affordable units and the increasing costs to develop in California, now is not the time to change tax policy which will impact the number of housing units to be developed. In light of the importance of the Welfare Exemption to the affordable housing industry in California, we respectfully submit the following comments to the Board of Equalizations Notice to Interested Parties dated January 14, 2005 (the "BOE Notice"). The BOE Notice stated the BOE will consider four proposed rules relating to the implementation of the Welfare Exemption based upon certain "key issues" to be addressed at its March 16, 2005 meeting. We believe changes to the existing implementation of the Welfare Exemption as averred to in the BOE Notice will have an adverse impact on the development of affordable units throughout the state. The purpose of this submission is to (i) provide context to the importance of the Welfare Exemption within the affordable housing industry, and (ii) comment specifically on certain "key issues" identified in the BOE Notice. We understand the rule making process "commences" on the BOE's March 16th meeting, however, there are proponents which have or will be submitting requests to the BOE which will drastically change the exemption from its current use. The following is submitted to facilitate dialogue with those proponents for change, as well as for the benefit of the BOE in its consideration of the four proposed rules.

Affordable Housing Industry's Use of Exemption & Its Multiplier Effect

Absent rent subsidies or government financing, tax relief is one of the few incentives available to property owners of affordable housing developments. Nonprofits and joint-ventures between for-profit and exempt owners of affordable housing have long used the Welfare Exemption to maintain affordable rents to low-income residents, fund tenant programs and to make certain affordable projects viable. Owners have further strengthened the effect of the tax relief by leveraging the amount of the tax abatement into additional loan or equity proceeds from the private capital markets. The additional proceeds are then used to finance the development of more units, maintain deeper-skewed rents, increase services or to defray increasing development costs. Together, the Welfare Exemption and its "multiplier effect" have resulted in greater financial feasibility of affordable projects and significantly more units being created or maintained as affordable in California. Thus, the affordable housing industry has strengthened the efficacy of the State's tax incentive, and to date, the Welfare Exemption is one of the most efficient forms of public housing subsidies in California.

Tax Relief is a Cost Effective Program

Use of the Welfare Exemption has been shown to be a cost-effective resource for the development of affordable housing. In a survey of properties conducted by the Department of Housing and Community Development ("HCD") in 2003-03, HCD reviewed the fiscal impact to the County of Orange, California as it related to the cost of the tax abatement for five (5) affordable housing projects. The five (5) projects collectively delivered 563 rent-restricted units to low-income residents.

The HCD survey measured the amount of the tax relief against (i) the additional subsidies required, and/or (ii) the additional rent required, to offset an increase in ad valorem property taxes without the exemption. HCD concluded the total annual value of the tax exemption for the five projects was $846,950 (See Table 1- Column (E) below). Based upon Orange County's share rate of 7% of the 1% ad valorem taxes for the 5 properties, the fiscal impact to Orange County was $59,287. However, HCD concluded that if these projects were required to pay ad valorem taxes, the county would be required to increase public subsidies totaling about $9 million to deliver the same number of affordable units. If rents were increased in lieu of (or together with the additional subsidies required in certain instances), rents would have necessitated an increase in average rent of $125 per unit per month. For a two-bedroom unit affordable to a family earning 50% of Area Median Income in 2002-03, this would result in a 15% rent increase, and would raise the income needed to afford the unit to 57% of Area Median Income which would make the project ineligible for many subsidy programs. The HCD study cited the main financial impact to affordable housing developments of a requirement to pay the ad valorem property taxes would be a decrease in the amount money available to service debt. The loss in debt service leaves a financial gap in the project, which either can be filled by (1) additional sources of below market rate financing (in the amount of $9 million), and/or (2) increasing the rents. The purpose of the preceding illustration is to evidence the Welfare Exemption's increasingly important role in the development of affordable housing in California. Undoubtedly, the amounts of additional sources of below-market rate financing and rent increases to finance the funding gap would be larger in 2005-06. It is also worthy to note the County of Orange maintained its Welfare Exemption program.

Table 1 (next page) is taken from the HCD study discussed above. Table 1 provides a summary of estimated property tax exemptions for the five affordable housing developments in Orange County, California in 2002-03. The Table also presents estimates of the additional subsidy and/or the additional rent required to offset the increase in property taxes in the event that payment of ad valorem taxes were to be required.

For-Profit Development Community Contribution

The primary contributor to the development of affordable units in California in recent years has been for-profit, non-exempt entities, either in collaboration with non-profit entities in joint-ventures or as sole project sponsors. Based upon information provided by the California Tax Credit Allocation Committee ("CTCAC") and the California Debt Limit Allocation Committee ("CDLAC") for their most recent competitive rounds for tax credits and tax-exempt bond allocation, respectively, joint-ventures and for-profit project sponsors have been the primary contributors of affordable units in California. In the recent CTCAC competitive round for 9% tax credits, eleven (11) of the sixty-eight (68) recipients of credits were non-profit sponsored. The remainder of the recipients were joint-ventures and for profit sponsored. In the recent CDLAC competitive round for allocation of private activity bond volume cap, eleven (11) of thirty-eight (38) recipients of tax-exempt bond allocation were non-profit applicants. Once again, the remainder of recipients were joint-ventures between for-profit and exempt entities, or exclusively non-exempt entities which could share the ownership and operation of projects with exempt entities. Unfortunately, government and nonprofit groups alone will not be able to produce the units that are lost due to decrease in joint-venture or for-profit unit production. Many of these entities do not have the additional capacity or resources to replace the units which could be lost by changes to the implementation of the Welfare Exemption.

Loss or Limitation of Welfare Exemption Will Likely Impact Housing Production

The BOE Notice indicates four proposed rules for the implementation of the Welfare Exemption will be considered by the BOE based upon consideration of certain "key issues." The tenor and effect of each key issue in the BOE Notice would be to limit the availability or scope of the Welfare Exemption. The staff of the BOE has submitted a written response to our firm to clarify its position and recommendations for the four proposed rules, as well as to suggest that no significant changes are to be recommended. We concur with many of the BOE staff recommendations, and laud the BOE staff for its proactive response to our firm's client alert on the proposed changes. However, we also believe there will be several recommendations from industry participants to significantly change the scope or availability of the Welfare Exemption from its current use. And as such, we submit that any change to the current implementation of the Welfare Exemption will likely impact the production of affordable housing units.

Limiting the scope or availability of the Welfare Exemption to existing project beneficiaries could result in adverse financial circumstances for projects located in softer markets or which have taken on additional costs as a result of the tax relief. As highlighted in the HCD study, existing projects would need to seek additional below-market rate financing or increase tenants rents to offset the increase in property tax liability. An inability to do exercise either option due to rental restriction require-

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Table 1: Impact of No Ad Valorem Property Tax Exemption

Project	Units	With Ad Valorem Exemption			Without Ad Valorem Property Tax Exemption						
		(A) Annual Taxes Payable	(B) County Subsidy (one-time subsidy)	(C) County Subsidy Per unit	(D) Annual Taxes Without Exemption (Year 1)	(E) Total Increased Taxes [County 7%]	(F) Total (A) Subsidy Increase	(G) Increased Subsidy Required Per Unit	(H) Total Subsidy Required (B+F)	(I) Total Subsidy Per Unit Required (C+G)	(J) Est. Increase in Rent Needed to Offset Taxes
Dorado Senior Apartments	150	$ 48,000	**$1,200,000**	**$8,000**	$288,000	$240,000 [$16,800]	$2,487,263	$16,582	**$3,687,263**	**$24,582**	$133
Linbrook Court	81	$ 25,346	**$800,768**	**$9,886**	$152,076	$126,730 [$8,871]	$1,352,905	$16,703	**$2,153,673**	**$26,589**	$130
Talega I**	124	$214,072	**$2,553,438**	**$20,592**	$405,489	$191,417 [$13,339]	$2,101,835	$16,950	**$4,655,273**	**$37,543**	$129
Vintage Shores	122	$28,564	**$472,578**	**$3,874**	$171,385	$142,820 [$9,997]	$1,473,424	$12,077	**$1,946,002**	**$15,951**	$98
Westminster Intergeneration. *	86	$29,196	**$687,000**	**$7,988**	$175,179	$145,982 [$10,219]	$1,679,866	$19,533	**$2,366,866**	**$27,522**	$141
TOTAL	**563**	**$345,179**	**$5,713,784**		**$1,192,129**	**$846,950 [$59,287]**	**$9,095,293**		**$14,809,077**		
Percentage Increase in 2 bedroom rent@ 50% of median ($850/month)											15%
Affordability level with property tax payment											57%

***Preliminary information- not yet approved by the Board for subsidy.**

**** The Talega project taxes include the payment of Mello Roos fees.**

Assumptions: Tax Rate = 1% County share = 7% of 1% Assessed Value= Based on Total Development Cost

Subsidy Per Unit is calculated across all units, although in the case of the Vintage Shores development, the County is restricting only 11 units, the remainder of units are restricted by other funding sources.

ments or market characteristics could result in foreclosures or forced sales of existing affordable developments. For future housing production, the scope and availability of the Welfare Exemption needs to be examined in light of the current economic and regulatory environment facing the affordable housing industry. Without tax relief, property owners would need to seek additional below-market rate financing from housing programs with already limited resources. Moreover, developers of affordable housing have experienced significant increases in construction due to price increases of supplies such as lumber, cement, steel, etc, as well as substantial increase in labor costs due to the application of prevailing wage requirements. Developers are also wary of rising interest rates, and the impact of the State and federal budget deficits which often result in decreased funding for affordable housing programs. On the local level, the State and federal budget deficits have resulted in local jurisdictions offering fewer incentives such as impact fee or permit fee waivers, as well as grant and loan money. Changes to the current implementation of the Welfare Exemption will have a disparate impact on for-profit production of affordable units. Many industry insiders believe the loss of the Welfare Exemption won't preclude for-profit developers from continuing development in its entirety, but it will likely impact the number of units produced in the aggregate.

Proponents For Change to Welfare Exemption and Its Current Implementation

Many of the proponents for change to the current implementation of the Welfare Exemption have been motivated by stories of abuse of the incentive. These are valid concerns. However, we do not believe drastic changes to the Welfare Exemption or its implementation are the appropriate response these concerns. There are existing federal and state agencies with tested enforcement mechanisms which are more appropriate venues for these concerns. We believe tax and housing policies should be based upon developing a continuum of incentives to encourage more affordable housing for the States residents, and not upon isolated cases of abuse. Specifically, the California Attorney General on the state level and the IRS on the federal level are the appropriate agencies to address issues of abuse by non-profit entities or transactions in which private parties are unduly benefiting from an affiliation with a non-profit, exempt entity. Every exempt entity and non-profit organization operating in California is subject to the jurisdiction of the California Attorney General as it relates to State matters and the IRS as it relates to federal matters. There is also substantial case law, guidance and a precedent for sanctions published by the IRS relating to private benefit and joint-ventures between for-profit and exempt entities, as well as it relates to private inurement by controlling officer and directors of non-profits. Also, since the non-profit managing general partner is certifying under "penalty of perjury" as to its submission of the BOE-267-L1, Welfare Exemption Supplemental Affidavit, Housing-Lower-Income Households (Limited Partnership), and the OE-277-L1, Claim For Supplemental Clearance Certificate For Management General Partner, there are potential criminal actions for those engaged in fraud.

Some proponents of change are also motivated by the prospect of enhancing their ability to compete in the marketplace. However, public policy should be based upon affordable unit production in the State and not an exempt entity's ability to compete in the market place. Based upon our experience and interpretation of the statistics from CTCAC and CDLAC over the last several years, government and nonprofit groups alone will not be able to produce the units that are lost due to decrease in joint-venture or for-profit unit production.

Proposed Changes Result in Chilling Effect

Many industry participants have expressed concern over the number of changes instituted and/or proposed by the BOE as it relates to the Welfare Exemption. Recent changes to the Welfare Exemption program, as well as proposals to consider changing the current implementation of the Welfare Exemption, may have a "chilling" effect on the willingness of lenders to underwrite the exemption. If the BOE determines no substantive changes should be made to the Welfare Exemption, many in the affordable housing industry would welcome an affirmative position or commitment to maintaining an expansive interpretation of the exemption's availability for low-income housing.

COMMENTS TO CERTAIN KEY ISSUES

Key Issue: Whether Section 214, Subd. (g)(2)(B) requires owners to charge lower-rents than those prescribed by statute (Health and Safety Code) or the regulatory agreement for the property.

We concur with the current BOE staff interpretation of Revenue and Taxation Code Section 214(g)(2)(B) on this key issue, but provide the following additional comments. We understand the current BOE staff recommendation to be that Section 214, subd. (g)(2)(B) does not require lower rents than those required by the regulatory agreement or the Health and Safety Code. Tax relief or abatement is necessary to the viability of financing of the project in an affordable housing program that requires rent restrictions. The rent restrictions of existing government financing programs decrease gross revenue which in all cases significantly affects (decreases) loan sizing. Abatement is a partial equalizing subsidy that allows the project to earn more proceeds which, in almost all cases, is necessary to complete construction or the acquisition rehabilitation project. Generally, tax relief for an 100% affordable project increases the loan by 10%. Ongoing tax abatement is, of course, necessary to meet debt service and operating expense obligations. This is good public policy. Developers would build very little affordable housing except for the available subsidies.

In sum, we submit the following positions/comments:

- Section 214, subd. (g)(2)(B) does not require lower rents than those prescribed by the Health and Safety Code.
- Tax abatement is necessary to the viability of financing of the project in an affordable housing program that requires rent restrictions. The Welfare Exemption is a partial equalizing subsidy that allows a project to earn a little more proceeds, which in almost all cases is necessary to complete construction or the acquisition rehabilitation project.
- Welfare Exemption is an efficient and effective incentive for developers of affordable housing. The HCD Study has shown the relatively small impact to the County of Orange, California, in light of the amount of the greater level of benefit derived from the current implementation of the Welfare Exemption.
- Rent restrictions different than those required under existing government financing programs under the Health and Safety Code would unduly over-regulate the affordable industry by running counter to sister-agency requirements.

Key Issue: Whether properties without government financing that are awarded federal low-income housing tax credits and operating under regulatory agreements that restrict a portion of the property for rental to lower income housing continue to be eligible for exemption after the period in which the property received tax credits has expired.

We concur with the current BOE staff interpretation of Revenue and Taxation Code Section 214(g)(2)(B) on this key issue, but provide the following additional comments. We understand the current BOE staff recommendation to be properties that receive federal and/or state lower income housing tax credits would be eligible for exemption for the duration of the regulatory agreement. This needs to be the case in order for affordable housing programs to continue to operate effectively in California.

Under the federal low income housing tax credit program, an eligible property owner receives tax credits for 10 years starting from the placed in service date of the project. However, under State and Federal rules, the project remains subject to a recorded regulatory agreement for at least 30 years and in many cases 55 years. The recorded regulatory agreement requires low income tenancy and rent restrictions based on 60% of the area median income as determined by HUD or less. Tax credit regulatory agreements are similar to other regulatory agreements required due to a governmental subsidy, such as tax-exempt bond financing. Projects subject solely to a tax credit regulatory agreement should be afforded the same property tax benefits as a property subject to a tax-exempt bond regulatory agreement. In both situations, project gross revenues are limited by the regulatory agreements necessitating the expense savings of property tax abatement for economic viability. Although matching property tax abatement with the 10-year tax credit period provides a significant subsidy, it runs short of the remainder of the restricted term and in light of actual practice within the industry. Conventional lenders on these projects underwrite the abatement enabling the lender to loan more loan proceeds which loan proceeds are used for qualified uses under the tax credit program. Conventional loans are almost always structured to run at least the 15 year minimum tax credit compliance period under the Internal Revenue Code as required by the tax credit investment community. Conventional lenders will be unable to underwrite the abatement if it is lost in year 11, well prior to the amortization and maturity of their loan. In other words, since debt service is roughly level, abatement is necessary to make loan payments if the loan was sized assuming abatement. Project owners would likely default in year 11 if the abatement period is shortened.

In sum, we submit the following positions/comments:

- Properties that receive federal and/or state lower income housing tax credits should be eligible for exemption for the duration and term of the regulatory agreement.
- Tax abatement is necessary to the viability of financing of the project in an affordable housing program that requires rent restrictions. Project owners would likely default in year 11 if the abatement period is shortened to match the ten-year credit period.
- Terms of Welfare Exemption benefits shorter than the rent restrictions agreed-upon by owners under government financing programs under the Health and Safety Code would likely result in shorter terms of affordability.

Key Issue: Whether the requirements with respect to the management authority and duties of a managing general partner should be strengthened beyond those currently required on BOE-267-L1, Welfare Exemption Supplemental Affidavit, Housing-Lower-Income Households (Limited Partnership), or OE-277-L1, Claim For Supplemental Clearance

Certificate For Management General Partner. These forms are posted on the BOE's Web site at :

www.boe.ca.gov/proptaxes/pdf/boe267l1.pdf; and www.boe.ca.gov/proptaxes/pdf/boe277l1.pdf

We believe the respective provisions of (i) the California Revised Limited Partnership Act, Corporation Code Sections 15611-15681, as amended (ii) the substantive body of contract law, and (iii) the IRS' guidance on activities of non-profit entities, should be determinative on the issue as to whether a non-profit managing general partner of a limited partnership owner has the requisite management authority of the owner entity.

Although Section 214, subd.(g) does not specifically define what is a qualifying managing general partner nor delineate what duties it should possess for purposes of the exemption, we believe the BOE should defer to the existing legal and statutory framework for such determination. Specifically, the guidance found in (i) the California Revised Limited Partnership Act, Corporation Code Sections 15611-15681, as amended (ii) the substantive body of contract law, and (iii) IRS' guidance on activities of non-profit entities, each provide the appropriate level of guidance for non-profits engaged in joint-ventures with non-exempt entities. Each of these preceding bodies of law are highly evolved and provide sufficient guidance to non-profit entities, in both scope and breadth, when an exempt entity is acting as a general partner in a limited partnership with non-exempt entities.

We understand the BOE staff position to be that the managing general partner should have management authority and duties in the partnership operations that it actually performs, rather than having the sole purpose of obtaining the property tax exemption. However, we do not believe there should be any specific requirements as to the identity or duties of a non-profit managing general partner in addition to those required under BOE-267-L1, Welfare Exemption Supplemental Affidavit, Housing-Lower-Income Households (Limited Partnership), and the OE-277-L1, Claim For Supplemental Clearance Certificate For Management General Partner. Moreover, because the non-profit managing general partner is certifying under penalty of perjury when it signs these documents, criminal sanctions or actions could be pursued for abusive or fraudulent transactions. Additional requirements imposed on non-profit entities engaged in joint-ventures with non-exempt entities could contradict existing guidance.

Any instances of abuse or fraud by non-profits should be addressed by the appropriate agencies with enforcement expertise. Current legal framework address and protect against for-profit and non-profit abuse of benefit. There are existing enforcement federal and state mechanisms which are more appropriate venues for these concerns to be addressed. We believe policies of tax incentives should be based upon developing a continuum of incentives to encourage more affordable housing for the States residents, and not upon isolated cases of abuse. The California Attorney General on the state level and the IRS on the federal level are the appropriate agencies to address issues of abuse by non-profit entities or transactions in which private parties are unduly benefiting from an affiliation or venture with a non-profit, exempt entity.

In sum, we submit the following positions/comments:

- There should be no additional requirements for managing general partners. The BOE should defer to provisions of (i) the California Revised Limited Partnership Act, Corporation Code Sections 15611-15681, as amended (ii) the substantive body of contract law, and (iii) IRS' guidance on activities of non-profit entities, on the issue as to whether a non-profit managing general partner of a limited partnership owner has the requisite management authority of the owner entity.
- Any instances of abuse or fraud by non-profits should be addressed by the appropriate agencies with enforcement expertise. Current legal framework address and protect against for-profit and non-profit abuse of benefit. There are existing enforcement federal and state mechanisms which are more appropriate venues for these concerns to be addressed.
- Certain proponents for changing the current implementation of the Welfare Exemption are requesting restrictions on fees, distributions or other attributes of project ownership and contract rights. These types of changes will unduly interfere with the contractual relationship among parties and likely hinder cooperation among parties with disparate resources and expertise.

Key Issue: Whether the exemption on low-income housing properties should be limited to the stated percentage specified in the regulatory agreement(s) that the owner is legally required to restrict for rental to lower income households.

Tax abatement is necessary to the viability of financing of the project in an affordable housing program that requires rent restrictions. The rent restrictions of existing government financing programs decrease gross revenue which in all cases drastically affects loan sizing. Abatement is a partial equalizing subsidy that allows the project to earn a little more proceeds, which is in almost all cases necessary to complete construction or the acquisition rehabilitation project. Without tax abatement, project owners will need to seek additional below-market rate financing or increase tenants rents.

We believe this key issue is also focusing on what the affordable housing community calls "mixed-income projects." That is projects that due to the government financing requirements, project owners have only set-aside 20% or 40% of their units for very low tenants (50% of area median income) or low income tenants (50% of area median income), respectively, at affordable rents. The problem of financial viability is often further exacerbated with mixed-income projects, as these projects tend to be located in more expensive markets. Without the incentive programs, many similarly situated projects will not be built, or if built, then without restricted units in order to meet the higher debt loads. Certain mixed-income projects are owned by joint-ventures in which a non-profit entity is acting as a its managing general partner. These owners apply for property tax abatement based on the percentage of qualifying tenants in the applicable year. In many cases, abatement is provided for more than the rent restricted units under the regulatory agreement. Once again, the ability of these projects to apply for greater than the restricted percentage is important for debt underwriting and to maintain affordable rents to these projects. Lenders will generally underwrite the amount of the tax relief, which underwriting is necessary for project feasibility. Moreover, in many mixed-income projects abatement savings is traced to tenant programs or social service programs administered in connection with the project. These program invariably benefit the low income tenant more that the market rate tenant. Abatement should be afforded to all tenant units that benefit from these programs that would not exist but for the regulatory agreement and abatement.

In sum, we submit the following positions/comments:

- Tax abatement should be in an amount equal to the percentage tenancy by low-income individuals. Tax Abatement is necessary to the viability of financing of the project in an affordable housing program that requires rent restrictions. Often these projects are in expensive markets. Without the incentive programs, many similarly situated projects will not be built, or if built, then without restricted units.

REMAINDER OF KEY ISSUES IDENTIFIED IN BOE NOTICE

We concur with the recommendations of the staff of the BOE on the remainder of the key issues identified in the BOE Notice. Specifically, we understand the positions and staff recommendations to be as follows:

Key Issue: Exemption qualification of properties that have refinanced government loans. The BOE staff is researching this issue, but will likely recommend that the properties remain eligible for exemption if the property remains subject to a regulatory agreement that restricts all or a portion of the property for rental to lower- income households.

Key Issue: Exemption qualification of properties with federally-insured loans. The BOE staff position is that properties with federally-insured loans satisfy the "government financing" criteria under section 214, subd. (g)(1)(A), and the regulatory agreement issued for the loan meets the requirement that a regulatory agreement restricts the property for rental to lower-income households.

Key Issues: Exemption qualification of property with multiple agreements. Where there are multiple regulatory agreements for a single project, the agreements may be combined to determine the percentage of units eligible for exemption.

Key Issue: Exemption qualification of projects with section 8 tenant vouchers. Properties without either tax credits or government financing are not qualified for exemption solely on the basis that some units are rented to lower-income households with tenant vouchers. The tenant vouchers are a federal government rent subsidy for the lower income tenant, and as such, do not satisfy the requirement that the property have government financing in section 214, subd. (g)(1) (B). The staff is researching the issue of whether properties without either tax credits or government financing, but having project-based section 8 may be considered to satisfy the government financing criteria and be eligible for exemption.

COX CASTLE NICHOLSON

POLICY PAPER:
CALIFORNIA STATE BOARD OF EQUALIZATION
PROPOSED WELFARE EXEMPTION RULES
March 4, 2005

This policy paper addresses a major affordable housing issue identified in the California State Board of Equalization's (the "BOE's") January 14, 2005 letter concerning proposed new "welfare exemption" rules. Issue #7 identified in the BOE's January 14 letter relates to what authorities and duties should be required of a qualifying "managing general partner" under California Revenue and Taxation Code ("R&T") Section 214(g)(1). This paper addresses the managing general partner concept and, at a more general level, discusses the BOE's current regime for administering R&T Section 214(g) ("Section 214(g)").

Specifically, this paper:

- Describes how affordable housing developments are financed today in California.
- Reviews the history and purpose of 214(g).
- Analyzes some of the more radical suggestions for change and points out the dangers of such radical reform.
- Concludes that the current BOE-administered system is achieving the California legislature's goal of increasing the state's affordable housing stock and supports the BOE's current administrative regime for managing the 214(g) welfare exemption.

EXECUTIVE SUMMARY

The BOE has developed a sound administrative process for implementing the welfare exemption granted under 214(g) to partnerships in which a nonprofit corporation serves as the managing general partner. The BOE's self-certification system – whereby a managing general partner of a project-owning partnership must certify, under penalty of perjury, that it has certain enumerated, substantial management authority and duties befitting a "managing" general partner – is true to the text of, and the legislative intent behind, 214(g). It strikes the proper balance between encouraging development of affordable housing in California, on the one hand, and regulating the use of the welfare exemption, on the other hand.

Contrary to the suggestions of certain critics of the BOE's compliance regime, there is no evidence that for-profit developers regularly manipulate nonprofits to abuse the welfare exemption. Even if there was an indication of individual instances of such abuse, the BOE and the county assessors (who jointly administer the welfare exemption system) already have the authority to audit suspected offenders and deny or revoke welfare exemptions.

The welfare exemption is a vital element in sustaining the financial viability of virtually every affordable housing development in California. The financial institutions that provide the vast majority of the equity and debt financing for these projects are willing to size their investments based on the expectation that a properly structured and managed project will qualify for a welfare exemption. These financial institutions now rely on the BOE system and appreciate the fact that it is predictably, consistently and efficiently managed by the BOE staff. The BOE should carefully consider any proposal for reforming the present system. Any change to the present system risks creating uncertainty in the financial community, which may result in a direct loss of affordable housing.

ANALYSIS

How Privately-Owned Affordable Housing Developments are Financed Today; How Lenders and Investors Police Welfare Exemption Compliance

(1) Overview of the System

California has a housing crisis. The evidence for this crisis is compelling and overwhelming. As the California Department of Housing and Community Development ("HCD") reported in its May, 2000 study entitled "Raising the Roof: California Housing Development Projections and Constraints, 1997 – 2020":

> "California will need an unprecedented amount of new housing construction—more than 200,000 units per year through 2020—if it is to accommodate projected population and household growth and still be reasonably affordable. It will need more suburban housing, more infill housing, more ownership housing, more rental housing, more affordable housing, more senior housing, and more family housing."

This paper focuses on the manner in which developers (for profit and nonprofit), lenders and investors have responded to the affordable housing portion of the California housing crisis. While there are larger social factors that have contributed to the affordable housing crisis, much of it is attributable to market factors that make it extremely difficult for affordable housing developers to compete with market rate developers for suitable multi-residential properties. In response, affordable housing development has become increasingly reliant upon a complex financial structure that leverages tax exempt bond financing, publicly subsidized financing, low income housing tax credits, and the welfare exemption.

A unique attribute of affordable housing finance is the involvement of large financial institutions in all aspects of affordable housing development. Some of the nation's largest and most reputable financial institutions are actively involved as lenders and/or equity investors in affordable housing in California. The participation by these institutions offers unique assurances that affordable housing programs, including the welfare exemption, are properly monitored and utilized. At the same time, these financial institutions require predictability and efficiency as to the availability of housing incentives such as the welfare exemption, if they are to underwrite such programs into the financing structure.

In practice, the welfare exemption is <u>absolutely essential</u> in maintaining affordability. The welfare exemption decreases the expenses associated with the ownership and operation of an affordable housing development, and therefore <u>increases</u> the size of the loans that lenders are willing to offer to project owners. Indeed, it is difficult for lenders to underwrite their loans for affordable housing projects <u>without</u> the property tax exemption. The Senate Revenue & Taxation Committee, in its July 15, 1987 hearing to consider the bill that was later codified as Section 214(g), recognized this financial reality, acknowledging that "<u>some prospective low income projects may not 'pencil out' without the property tax exemption</u>" (emphasis added).

(2) <u>Tax Credits</u>

In order to take full advantage of the low income housing tax credit authorized by Internal Revenue Code Section 42, the overwhelming majority of for-profit and non-profit developers in California utilize a limited partnership structure to own and operate affordable housing developments. A well-established, institutional tax credit investor (often a Fortune 500 company) or a syndicated fund of such investors make an equity investment in the limited partnership in exchange for virtually all the low income housing tax credits generated by a project. The tax credit investor utilizes the tax credits to offset federal taxes on a dollar-for-dollar basis over a 10-year period, and, therefore, is willing to make capital contributions to the project-owning partnership for these credits.

(3) <u>Tax-Exempt Bond Financing</u>

An affordable housing project developer often uses debt financed the issuance of low-interest, tax-exempt bonds, usually in addition to tax credits. Typically, a California state or local governmental entity issues private-activity multifamily housing revenue bonds under the state's bond volume cap, and loans the proceeds of those bonds to the project-owning partnership, receiving a deed of trust on the property as security. Tax-exempt multifamily housing revenue bonds are either publicly-offered or privately-placed.

Where such bonds are publicly-offered, investors with no firsthand knowledge of the project or the project-owning partnership purchase the bonds. Such distribution is handled by an investment banking firm with mandated obligations to utilize due diligence in any distribution of securities. Such investment bankers focus on the ability of the affordable housing project to service the repayment obligations on the bonds. Thus, these investment bankers are uniquely focused on the underwriting standards for expenses, including the availability of the welfare exemption.

At the same time, in order to keep the interest rate on such bonds low, a credit-enhancer (typically a major national bank or financial institution) offers a letter of credit or other form of guaranty that the bonds will be repaid, even if the affordable housing project underperforms expectations and the project-owning partnership fails to repay the loaned bond proceeds. The credit enhancer thus plays the role of the real estate lender, taking all of the real estate-related risk, and conducting due diligence (including review of the availability of the welfare exemption) similar to the investment bankers' review.

Where such bonds are privately-placed, a well-established lender (typically a major national commercial bank or national financial institution) will purchase all of the bonds and loan the proceeds directly to the project-owning partnership. These lenders conduct extensive underwriting due diligence, including review of the availability of the welfare exemption.

(4) Conventional Financing and/or Loans from Governmental Agencies

Some developers choose not to obtain tax-exempt bond loans, and instead utilize conventional real estate loans (typically from a major national or regional bank) or loans from federal, state or local agencies. Sometimes a developer will obtain both a conventional loan and one or more loans from government agencies. These loans go through the same underwriting (including review of welfare exemption availability) and due diligence scrutiny as discussed above for tax-exempt bond loans.

(5) Conclusion: How Lenders and Investors Police the Property Tax Exemption

As discussed above, the tax credit equity investors, tax-exempt bond credit enhancers/lenders and conventional lenders that provide the lion's share of affordable housing project financing are some of the largest and most sophisticated financial institutions in the world. These investors and lenders subject affordable housing projects to intense underwriting scrutiny at the outset, and intense compliance oversight on an ongoing basis.

Without a predictable welfare exemption, obtainable in a timely manner, lenders would not include welfare exemption savings into their underwriting, making affordable housing projects next to impossible to finance. Moreover, in order to ensure that project-owning partnerships can afford to cover the debt service on loans underwritten to include welfare exemption savings, these lenders provide ongoing welfare exemption compliance oversight, thus providing a backstop to the BOE's and assessors' roles in policing against welfare exemption fraud.

Moreover, the BOE's managing general partner regime <u>requires tax credit equity investors to cede a certain amount of power to nonprofits</u>. These Fortune 500 financial institutions require strict statutory compliance by their partners (including the managing general partner), as a necessary element in protecting their equity investments in affordable housing projects. Contrary to the insinuations of the current regime's critics, these institutional tax credit investors would not enter into a written agreement granting substantial management powers to a nonprofit, and then blithely ignore that agreement in practice.

History and Purpose of R&T 214(g)

Section 214 was enacted in 1945 to implement Section 4(b) of Article XII of the California Constitution, which provides that the California legislature may exempt from taxation "property used exclusively for religious, hospital or charitable purposes and owned or held in trust by corporations or other entities." The original policy rationale for enacting Section 214's "welfare exemption" was to treat certain privately owned property, which was used to provide a charitable activity, in the same manner as publicly owned property which would otherwise be used by government to perform that same charitable function.

(1) Managing General Partner

(a) General Discussion.

In furtherance of the spirit of the exemption, Section 214 was amended in 1987 to add subsection (g), which provides that:

> "[p]roperty used exclusively for rental housing and related facilities and owned and operated by religious, hospital, scientific, or charitable funds, foundations, or corporations, *including limited partnerships in which the managing general partner is an eligible nonprofit corporation . . .*"

shall be entitled to a full or partial property tax exemption, subject to the conditions set forth in Section 214(g) (emphasis added).

The participation of an eligible nonprofit corporation, either as the owner of the property or as the managing general partner of a limited partnership that owns the property, is constitutionally necessary. Without the participation of a nonprofit corporation, the welfare exemption granted by Section 214(g) would not comply with the tax exemption requirement set forth in California Constitution Section 4(b) of Article XII of the California Constitution.

In adopting 214(g), the California Legislature did not focus its attention on the attributes of a "managing general partner." Indeed, the highlighted language quoted two paragraphs above was inserted into the proposed text of Section 214(g) a mere twenty-one days before Governor George Deukmejian signed it into law.

The legislative history shows no debate accompanying the addition of the managing general partner concept. Rather, the legislative history reveals a debate focused almost exclusively on the benefit of increasing California's stock of affordable housing, on the one hand, versus the cost associated with the loss of property tax revenues, on the other hand. The addition of the managing general partner concept into 214(g) appears to have been an extension of the economic reasoning behind the bill, summarized succinctly by the Senate Revenue & Taxation Committee in its July 15, 1987 hearing on 214(g):

> "The justification for the exemption would be that the funds which are currently paid in property taxes could better be used in furtherance of the goals of providing low income housing. Also, it may be that some prospective low income projects may not 'pencil out' without the property tax exemption."

(b) What is a "Managing" General Partner?

Notably, the legislature chose the phrase "managing general partner" rather than "general partner." The California Revised Limited Partnership Act contains extensive provisions setting forth the obligations of a "general partner," but makes no mention of a "managing" general partner. By choosing to use the term "managing" general partner, the legislature clearly indicated its understanding that property-owning partnerships could have other, for-profit general partners, so long as the nonprofit general partner was the "managing" general partner.

Certain affordable housing developers have suggested to the BOE that "managing general partners" should be required to provide an expanded array of operational assistance at low income housing projects. These developers have further indicated that this assistance can only be provide by nonprofit organization who are well-capitalized and have extensive staffs. If this recommendation were to be implemented, it would limit the number of qualified organizations to a very few developers and clearly undercut the intent of 214(g).

This suggestion also denigrates the many well-established and well-qualified nonprofits who are small organizations but have demonstrated the capability to develop and operate from one to a multiplicity of affordable housing projects. These organizations have accomplished this by hiring a few staff and retaining experienced property management companies and consultants. If the BOE were to impose a "litmus test" that defined a "managing general partner" according to an organization's balance sheet and/or staffing level, it would seriously undercut, if not destroy, the ability of these nonprofits to contribute to the development of affordable housing in California.

The legislative history also demonstrates a governmental sensitivity to the need to support continued participation by underfunded nonprofit organizations in affordable housing development, and a recognition that the welfare exemption would provide that support. In its Enrolled Bill Report, submitted in late September, 1987, the HCD recognized that nonprofit organizations suffer from "limited budgetary conditions." The HCD report goes on to state that the final proposed text of 214(g)would address "the Governor['s] expressed interest in . . . preserving affordable housing and assuring a continued role for nonprofits in affordable housing."

Nonprofit participation in affordable housing is as important today as it was in 1987, and therefore the BOE should resist pressure from an exclusive group of nonprofits calling for rule changes that would increase the expense of nonprofit participation in affordable housing projects.

(2) Use of Property Tax Savings

Under Section 214(g), the owner of the property must:

> "[c]ertify that the funds that would have been necessary to pay property taxes are used to maintain the affordability of, or reduce rents otherwise necessary for, the units occupied by lower income households."

On August 18, 1987, the State Assembly amended the bill that was later codified as Section 214(g) to provide that property owners should only be required to *certify*, rather than affirmatively *demonstrate*, that the property tax savings are actually helping to maintain affordability or reduce rents. In its August 26, 1987 bill analysis, the BOE emphasized the expense of administering a requirement that a property owner affirmatively demonstrate compliance, and explained that "[i]t is not clear how the owner of the property could demonstrate that this requirement is satisfied."

By adopting a "certification" standard rather than the earlier-proposed "demonstration" standard, the Legislature moved away from requiring property owners to file financial information. Such a system would have imposed a nearly impossible burden on owners to track – perhaps on a dollar-for-dollar basis – how property tax savings are applied.

Moreover, 214(g) allows owners to certify that the property tax savings are used to maintain affordability *or* reduce rents. This standard, together with the self-certification regime, evidences the Legislature's desire to steer clear of managing exactly how affordable housing projects are run and exactly how property tax savings are applied. Instead, the Legislature focused on the broader goal of providing financial assistance for purposes of maintaining and increasing California's stock of affordable rental housing.

In practice, the welfare exemption is absolutely essential in maintaining affordability. As discussed above, the welfare exemption decreases the expenses associated with the ownership and operation of an affordable housing development, and therefore increases the size of the loans that lenders are willing to offer to project owners. Indeed, it is difficult for lenders to underwrite construction and permanent loans for affordable housing projects without the property tax exemption.

Radical Reforms Are Ill-Advised

Since the BOE's reform proposal was announced in January, 2005, a very small but vocal element has suggested that there is systemic and widespread abuse of the welfare exemption. While this is a dramatic proposition, there is simply no evidence whatsoever of such abuse. Indeed the only "evidence" to date consists of anecdotal, third-hand statements by a few members of the public regarding singular examples of perceived abuse. While the BOE should certainly take accusations of fraud seriously, it would be rash to suggest that a few such allegations warrant wholesale changes to the present system.

Another theme running through some of the vocal criticism of the present system is the implicit suggestion that some nonprofits are less worthy than others. This criticism is essentially a "straw man" argument. It diverts attention from the real public policy issue at hand, namely meeting the legislature's mandate for the production of more affordable housing, and tries to focus attention on the perceived qualities of certain nonprofits. This is an entirely subjective and relative matter. There is no litmus test for what is a nonprofit, nor should one be imposed. Moreover, such a consideration is outside of the mission of the BOE and would unnecessarily burden the BOE's already overused resources. The Internal Revenue Service ("IRS") and California's Franchise Tax Board ("FTB") are the appropriate authorities for such determinations, and these agencies already vet prospective nonprofits at the outset, before such entities can even consider becoming involved in the welfare exemption process. Indeed, the BOE's proposed Rule 140 requirements regarding BOE review of a nonprofit's "charitable" purposes, as presented at the BOE public meeting on March 2, 2005, are wholly duplicative of IRS and FTB responsibilities and, therefore, are unnecessary.

A final suggestion proffered by a few critics is that only nonprofits involved in the physical operation of an affordable housing project merit the welfare exemption. Presumably, only nonprofits with their own management companies or construction companies could ever meet a stringent application of this test. That proposed standard is entirely inappropriate. The welfare exemption has never been construed to require such ground level involvement, as discussed in the legislative history section above. Rather, essential management and oversight, as required by the BOE's present system, is the critical test. Requiring a nonprofit to have extensive assets and capital is antithetical to the legislative history, which noted that nonprofits suffer from "limited budgetary conditions."

The Current BOE-Administered System is Achieving the Goals of 214(g)

The current BOE-administered system for assuring compliance with 214(g), as set forth in the BOE's Assessor's Handbook Section *Welfare, Church and Religious Exemptions*, is achieving the original purpose of 214(g): namely, to increase California's stock of affordable rental housing. The BOE's proposed Rule 140, as presented at the March 2 public meeting, would amend the present system by adding additional requirements that are, at heart, substantially similar to the present requirements. The BOE should carefully consider the cost associated with making changes to the present system. Unless change is urgently needed (and this paper has argued that it is not needed), and unless the proposed changes would fundamentally reform the present system (and this paper has argued that the changes proposed by Rule 140 do not), then the BOE should carefully consider the administrative cost of tinkering with a system that already predictably and efficiently achieves the legislature's goals.

With respect to "managing general partner" duties, the BOE's self-certification standard – whereby a managing general partner of a project-owning partnership must certify, under penalty of perjury, that it has certain enumerated management authority and the substantial duties befitting a "managing general partner" – is in keeping with the legislative intent behind 214(g). As discussed above, the legislature consciously chose to adopt a "*certification*" system rather than a "*demonstration*" system for assuring compliance with 214(g)'s requirement that property tax savings be applied towards reducing rents or maintaining affordability. The BOE's managing general partner self-certification standard stays true to the original legislative intent behind 214(g): increasing California's affordable housing stock, rather than imposing governmental control over exactly how affordable housing projects are run.

Further, since 214(g) does not discuss a managing general partner's duties or attributes, there is no clear legislative authorization for the BOE to expand the reasonable list of duties that managing general partners are required presently to attest to on forms BOE 267-L1 and BOE 277-L1. Indeed, the suggestion from a few critics of the current self-certification regime that it allows "nonprofit shells" to obtain property tax exemptions on behalf of for-profit developers is not only factually incorrect – it also runs counter to the very purpose of 214(g).

However, should either the BOE or a county assessor suspect that a particular managing general partner is failing to exercise the managerial control that it is certifying to on forms BOE 267-L1 or BOE 277-L1, both the BOE and the county assessor have the right to audit the potentially offending parties. Forms BOE 267-L1 and BOE 277 L-1 both clearly alert a filing non-profit of this fact, stating in bold letters: **"Welfare Exemption claims and supporting documents are subject to audit by the Board of Equalization and by the Assessor."** Therefore, in response to any suggestion from critics that some fraudulent managing general partners are abusing the welfare exemption system, the BOE and the county assessors can and should emphasize that they have the power to audit any and all limited partnerships that obtain a welfare exemption, and the power to revoke improperly obtained welfare exemptions.

Also, from an economic efficiency standpoint, if the property tax exemption is to be accounted for in a lender's initial underwriting, it must be knowable, predictable, and timely obtained. In an era where tax credit investors, credit enhancers and conventional lenders make long-term financial commitments to each affordable housing project that they finance, the predictability of the BOE's bright-line certification process provides a necessary source of predictability. Without that predictability, financial institutions would not count on the availability of property tax savings, and would reduce the amount of money that they would be willing to lend and/or invest in affordable housing projects. Any decrease in available financing would only worsen the ability of developers tc try to meet California ever-increasing need for affordable rental housing.

The BOE's certification system (supported by the BOE's and the county assessors' audit rights), when coupled with the strict, ongoing oversight provided by tax credit investors, credit enhancers and conventional lenders, assures that managing general partners will continue to wield essential management authority, rather than operating as a "nonprofit shell" for the purposes of obtaining the property tax exemption.

Lastly, the authors of this policy paper would like to support the BOE staff's positions outlined in the BOE's February 24 follow-up letter signed by Dean R. Kinnee. The authors of this paper support the BOE's ongoing efforts to add predictability to all remaining unsettled areas of 214(g) administration and practice.

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