

# MEMORANDUM

Building Safety and Housing Department



**DATE:** January 5, 2021  
**TO:** Mayor and Council  
**THROUGH:** Steve McHarris, City Manager *Steve McHarris*  
**FROM:** Sharon Goei, Building Safety and Housing Director  
**SUBJECT:** Affordable Housing Ordinance In-Lieu Fee Options

## Background:

On June 19, 2018, the City Council adopted Affordable Housing Ordinance No. 297 which applies to any land use entitlement application not deemed complete by July 20, 2018. The purpose of this Ordinance is to, "(a) Enhance the public welfare and assure that further housing development contributes to the attainment of the City's housing goals by increasing the production of residential units affordable by households of very low, low and moderate income, and (b) Assure that the limited remaining developable land in the City's planning area is utilized in a manner consistent with the City's housing policies and needs."

Under Ordinance No. 297, new residential developments with 10 or more units approved by the City Council must include 15% of very-low or low-income units for rental development and 15% of very-low, low, or moderate-income units for ownership development. These units must remain affordable for a minimum of fifty-five years. If the 15% calculation results in a fractional unit, an in-lieu fee may be paid for that fractional unit. The Ordinance allows several alternatives to providing the required affordable housing on-site:

- a) Payment of fees in-lieu of creation of affordable units. Upon request of the applicant, the City Council may permit the applicant to pay a fee in-lieu of constructing the affordable units that the applicant would otherwise be required to construct, known as the Affordable Housing fee. This fee is set by Resolution of the City Council. All payment of in-lieu fees is to be deposited into the Affordable Housing Fund and is required prior to issuance of building permits.
- b) Off-Site Projects. Upon request of the applicant, the City Council may permit an applicant to construct the requisite number of affordable units off-site and not physically within the development, subject to conditions.
- c) Land Dedication. Upon request of the applicant, the City Council may permit an applicant to dedicate land to the City or a City-designated local nonprofit housing developer in lieu of construction of some or all of the required affordable units, subject to conditions.
- d) Credit Transfers. Upon request of the applicant, the City Council may permit an applicant to apply for affordable unit credits for units constructed in excess of the number required in one project and use those credits to satisfy the requirements for another project in the City.

For each of the above options and exceptions to the on-site requirement, the following affirmative findings must be made prior to City Council approval:

1. The exception requested exceeds the minimum affordable requirements; and
2. The project is better served with the exception; or
3. The community benefits exceed the project benefits.

On March 5, 2019, the City Council adopted Resolution No. 8852, which approved the affordable housing fee schedule for a residential in-lieu fee and a non-residential impact fee. The Resolution became effective on July 1, 2019. The affordable housing fee level is adjusted July every year for inflation using the Engineering News Record Building Cost Index. If granted an exception to pay in-lieu fees, a developer must pay Affordable Housing Ordinance in-lieu fees prior to receiving a building permit.

On December 15, 2020, the City Council directed staff to place an item on the agenda for the first Council meeting in January 2021 to discuss a possible amendment to the Affordable Housing Ordinance that would remove the option for paying an in-lieu fee for rental or ownership housing developments.

### **Analysis:**

Staff is already working on draft administrative guidelines to help implement the Affordable Housing Ordinance and to answer frequently asked questions. As part of this work, staff has identified several minor changes to the Ordinance to add clarity. Changes to the in-lieu fee component of the Ordinance could be combined with this project.

### **Legal Analysis**

Before 2009, cities commonly required affordable units in both for-sale and for-rent projects. But in a California Court of Appeal decision in the case of *Palmer/Sixth Street Properties v. City of Los Angeles*<sup>1</sup>, the court held that a city inclusionary requirement to include affordable housing (or pay a fee in lieu of doing so) violated the Costa-Hawkins Rental Housing Act.<sup>2</sup> This is because the Costa-Hawkins Act reserves to residential landlords the right, with some exceptions, to set initial and subsequent rents. Inclusionary housing in the rental context conflicts with this right by requiring that landlords charge an “affordable” rent for certain units and taking away the right of the owner to set the initial rents.

As a result of the *Palmer* decision, local inclusionary requirements all over the state were repealed or simply not enforced. The Legislature tried to implement a Legislative ‘fix’ for this issue for years, including considering AB 1506, which would have repealed the Costa-Hawkins Act. Ultimately, another bill, AB 1505, was enacted in 2018. It amends existing Government Code § 65850, which enumerates specific powers held by local governments, to specifically include the authority to impose inclusionary requirements on residential rental projects through adoption of a local ordinance.

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<sup>1</sup> (2009) 175 Cal.App.4<sup>th</sup> 1396

<sup>2</sup> Civil Code § § 1954.50-1954.535

Under the new legislation and current law, cities adopting or amending an inclusionary mandate of more than 15% after September 15, 2017 that requires the units to be occupied by households at 80% or less of the area median income, may be required to submit their ordinances to HCD for review and may likewise be required to prepare an economic feasibility study to demonstrate that the new inclusionary mandate does not “unduly constrain the production of housing.”<sup>3</sup> In addition, any ordinance *must include alternative means of compliance*, such as payment of an in-lieu fee, land dedication, off-site construction, or the like.<sup>4</sup> In other words, a city may not mandate that the affordable units be provided on-site for a rental project, but may instead include the requirement with the option to comply by other means in the event a landlord does not want to provide the units on-site.

### Residential Development

Since the Affordable Housing Ordinance (Ordinance No. 297) took effect, two rental housing developments and three ownership housing developments subject to the Affordable Housing Ordinance have received entitlement approval from the City. Of these projects, one ownership development proposed to build affordable units and pay an in-lieu fee for one unit and a fractional unit and received City Council approval. Four residential projects (two rental and two ownership) proposed to build affordable units in numbers that were equal to or rounded up from the 15% calculation and received approval from the City Council and/or Planning Commission. One multifamily rental development in the planning application stage has proposed to include affordable units in the project submittal. So far, residential projects are mainly meeting their inclusionary housing obligations by incorporating affordable units on-site within the development.

### Affordable Housing In-Lieu Fees in Other Cities

Since December 16, staff communicated with cities in Santa Clara County regarding their affordable housing in-lieu fees and has received responses from the following three cities.

The City of Mountain View allows in-lieu payments for fractional units in certain circumstances. The City also allows the combination of in-lieu payments with on-site units or full in-lieu payments with Council approval. To proceed with a partial or full in-lieu fee option, a developer must demonstrate why it is in the City’s interest to receive fees instead of on-site units and must consider the following:

- i. The ability for the in-lieu fees to create more affordable units and/or deeper affordability levels than could be provided on-site.
- ii. The ability to create affordable housing for special-needs populations.
- iii. Helping 100 percent affordable housing projects in the City’s pipeline move forward that would not have otherwise been able to move forward or to move forward sooner than otherwise possible.
- iv. If an applicant proposes an early or prepayment of in-lieu fees, the time value of such payment.

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<sup>3</sup> Gov. Code § 65850.01

<sup>4</sup> Government Code § 65850(g).

Mountain View requires that in-lieu fees are greater than the value of developing affordable units on-site. The City updates the fee level every five years.

The City of Morgan Hill allows in-lieu fees when the ordinance results in fractional units instead of rounding up or down. The entire inclusionary obligation can be met with in-lieu fees with Council approval. To approve such an exception, the Council must consider the following:

- i. Whether the production of the proposed inclusionary units will fill a need in an affordable housing category or some other prioritized housing needs area.
- ii. Whether the proposed inclusionary units are in a category for which the City has already met its Regional Housing Needs Allocation goal and therefore payment of a fee may be preferred.
- iii. Whether there is a specific identifiable project that the City can support with the fees.
- iv. Whether affordable units are appropriate in the specific project.

The City of Campbell allows low-density housing developments (below six units per acre) to pay an in-lieu fee by right. All other ownership and rental projects must build on-site or use alternatives such as off-site construction or land dedication. For fractions of units, the City requires developers to round up or down rather than paying a fee.

### Policy Considerations

State law requires inclusionary housing programs offer alternative methods of compliance for rental projects. The most common methods are to build on-site, build off-site, dedicate land, pay an in-lieu fee, or to combine methods. In the Bay Area, many market rate developers prefer to have flexibility for compliance as each development is unique.

On-Site Affordable Units: Housing advocates argue that building affordable units on-site with market rate housing is faster and more efficient than having City Government collect and lend out funds to affordable housing developers. On-site units can also ensure that neighborhoods are diverse and accessible to households at different income levels. It is challenging for Bay Area affordable housing developers to compete for land with market rate developers, especially in areas near transit, parks, and high performing schools. In some cases, affordable housing developers gravitate to land in lower-income neighborhoods which can, over time, contribute to concentrated poverty. Ensuring that low-income residents have access to high opportunity areas is a state-mandated Fair Housing goal that the City is required to address in the upcoming Housing Element update.

In-Lieu Fees: In-lieu fees are a common alternative because they offer flexibility. For government, in-lieu fees can be used to leverage state and federal funding, to produce units that the inclusionary ordinance is not producing (e.g., deeply affordable units), or to fund new housing programs and services (e.g., \$200,000 funding of the Milpitas Rent Relief Program allocated from affordable housing fees). As for a timeline to achieve units, note that collecting in-lieu fees does not guarantee that funds can be used quickly as it can take years to accumulate sufficient funds to support a project. It is also important that in-lieu fee levels are set to reflect the actual cost of building affordable units. The fee levels need to be adjusted over time to reflect changes in construction costs and other market factors.

## **Summary**

In-lieu fees provide developers with another compliance option and provide cities with funding for housing programs or to subsidize deeply affordable units that would not otherwise be built. However, in-lieu fees can be slow and inefficient tools for creating new affordable housing. From a legal perspective, in-lieu fees are not required as an option for ownership projects and may be removed. For rental projects, alternative means of compliance must be provided, but in-lieu fees are not explicitly called for in state law.

Potential actions regarding in-lieu fee can include the following:

- Strengthen the findings required for City Council to approve in-lieu fee exceptions
- Return with additional analysis on how other cities in Santa Clara County approach in-lieu fees
- Research the legal risk of removing in-lieu fee provisions for rental projects
- Remove in-lieu fee option for ownership projects
- Continue to allow in-lieu fees for fractional units to generate a small amount of funding for City housing programs

If the City Council directs staff to change the in-lieu fee provisions, staff recommends conducting outreach to obtain stakeholder input. Staff proposes combining the in-lieu fee discussion with the draft administrative guidelines that staff began working on to help implement the Affordable Housing Ordinance. As part of this work, staff has identified several minor changes to the Ordinance to add clarity. Staff would conduct stakeholder outreach for the guidelines, minor changes to the Ordinance, and the in-lieu fee discussion together.

## **Attachment:**

[Municipal Code Title XII – Housing, Chapter 1 – Affordable Housing Ordinance](#)