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Federal Government Aid for Gulf Coast Reconstruction After the Hurricanes

Edward J **ROJAS**

Kimberly Crowder **MOORE**

On December 21, 2005, President Bush signed into law the Gulf Opportunity Zone Act of 2005, H.R. 4440 (the "GO Zone Act"). The new law appropriates $8.6 billion for reconstruction efforts in the Gulf coast region and encourages rebuilding and investment in areas devastated by the recent hurricanes. The law was initially intended to be a follow-up piece of legislation to the Katrina Emergency Tax Relief Act of 2005 but eventually became a more substantial piece of legislation that extends relief to areas hit by Hurricanes Rita and Wilma.

Central to the new law is the creation of special economic zones. The "Gulf Opportunity Zone" or "GO Zone" includes areas hit by Hurricane Katrina that are determined by the President to warrant individual or individual and public assistance under the Robert T. Stafford Disaster Relief and Emergency Assistance Act ("Disaster Relief Act"). Also created are a separate "Rita GO Zone" and "Wilma GO Zone", which include areas affected by Hurricanes Rita and Wilma for which the President has made similar determinations.

This Federal legislation should spur the investment community to help in the reconstruction. As yet, there has been very little use of these subsidies and the clock is ticking. Our firm expects to be very involved in structuring transactions with these tax advantages in the coming year.

Gulf Reconstruction continued on page 8

The Good, the Bad and the Uncertain: California Prevailing Wage Cases in 2005

Paul R **SCHRECONGOST**

As reported in past issues of this newsletter, legislative developments advocated by pro-labor interests between 2000 and 2004 attempted to expand the application of California's prevailing wage laws. From the outset, Pillsbury challenged labor interests' aggressive interpretations of the legislative changes, but because the new laws only recently became effective, their limits were not tested until 2005. This article summarizes a series of significant prevailing wage cases decided by California courts and the state's Department of Industrial Relations ("DIR") in 2005.

THE GOOD

In February 2005 the DIR issued a determination that the use of federal low-income housing tax credits under Section 42 of the Internal Revenue Code (the "Code") and low-income housing tax-exempt bonds under Section 142 of the Code do not trigger prevailing wage requirements (*see Rancho Santa Fe Village Senior Affordable Housing Project*, PW Case No. 2004-0016 (02/25/2005). Later in the year, the DIR further determined that the use of California state low-income housing tax credits does not subject a project to prevailing wage requirements either (*see Woodhaven Manor Apartments*, PW Case No. 2005-034 (11/16/2005).

Also exempt from prevailing wage requirements are soft money loans to restricted low-income projects. The case *Silverado Creek Family Apartments*, PW Case No. 2004-0049 (05/27/2005) involved an affordable project financed in

Prevailing Wage continued on page 10

Buyer Beware: Secondary Market Affordable Housing Acquisitions May Trigger Unexpected Real Property Transfer Taxes

James M **GROSSER**

Meredith Kersey **HORN**

Secondary market transactions, in which interests in portfolios of affordable rental properties are acquired through partnerships or limited liability companies, may trigger real property transfer taxes in a number of important jurisdictions. This often comes as a surprise to investors and other participants in these transactions, because typically no deeds are required to be granted or recorded.

Transfer taxes apply to secondary market transactions through statutes equating transfers of "economic interests" or "beneficial interests" in real property with actual transfers of legal title to real property for purposes of applying the real property transfer tax. Under the typical economic interest statute, a transfer of direct or indirect ownership of an entity holding legal title is treated as a transfer of the allocable share of the real property to the new owner. Because transfer tax rates often range as high as three percent of the fair market value of the underlying property, the bite from these taxes may materially alter the economics of secondary market transactions. Therefore, participants in secondary market transactions are well advised to consider fully the impact of transfer taxes on price and structure.

In planning for the impact of real property transfer taxes on secondary market transactions, the first task is to determine whether the portfolio assets are located in jurisdictions that tax economic interest transactions. Participants should keep in mind that even though economic interest provisions date back at least to the 1980s in some states, the set of jurisdictions taxing economic interest transactions is not static. Because economic interest transactions may be viewed as economically equivalent to transactions involving direct interests in real property, it should be expected that some state legislatures will face pressure, under the rubric of "loophole closing," to expand their transfer tax codes to pick up economic interest transactions. This is the case especially in times of lean state budgets.

For example, the Maryland legislature has considered an economic interest provision several times in recent years. In neighboring Virginia, a recently enacted provision exempting certain deeds to partnerships and limited liability companies applies only to the extent that the deed is not a "precursor" to a transaction conveying control of the partnership or limited liability company to a third party. Therefore, an investment in a Virginia affordable rental property, either through a secondary market transaction or through a quick resyndication, could cast a shadow on the exemption claimed upon conveyance of the property by deed to the ownership entity. Presently, a partial listing of the states with economic interest provisions in their transfer tax codes includes Connecticut, Delaware, the District of Columbia, Illinois, Maine, New York, and Washington.

Once it has been determined that the transfer tax laws of a particular jurisdiction include provisions for economic interest transactions, there are a number of opportunities and pitfalls that parties should keep in mind when analyzing the impact of real property transfer taxes:

Taxable Transactions: In some jurisdictions, the transfer of any economic interest, however slight, is taxable. In others, there is no tax unless the economic interest acquired is a "controlling interest." In those jurisdictions, transfer taxes may be avoided by structuring the portfolio so that the purchaser acquires less than a controlling interest in the properties located in the jurisdiction. Note that it is typically not possible to avoid economic interest provisions by utilizing additional pass-through ownership tiers.

Tax Base: In many jurisdictions, the tax base for an economic interest transaction is the fair market value of the underlying real property. Therefore, it may be advantageous to close taxable portfolio acquisitions when the fair market value of the target properties is as low as possible, for example prior to completion and stabilization. Also, care should be taken to document the fair market value of the target property by obtaining an appraisal.

Recording Obligation: It may be necessary to record a document with the appropriate local agency reflecting an economic interest transaction.

Payment Obligation and Price: Economic interest laws may impose the tax payment obligation on the property owner, the seller of the economic interest, or the purchaser of the economic interest. Liability may be joint and several. If the payment obligation is imposed on the property owner, the parties will need to consider how to fund that obligation (e.g., through a loan, a capital contribution, enforcement of a guaranty, etc.). If the statute imposes secondary liability on the purchaser of the economic interest, the investor may require payment guarantees and indemnifications from a credit-worthy entity. Finally, regardless of which party bears the legal obligation to pay the tax, the parties will need to negotiate the impact of the tax on the purchase price for the portfolio interest.

Real property transfer taxes arising in secondary market transactions under economic interest laws are of concern mainly to purchasers and sellers of investment interests, as these are the parties most likely to bear liability for payment of transfer taxes. However, because transfer taxes could conceivably fall within the parameters of a completion guaranty or an operating deficit guaranty in cases where the payment obligation rests with the property owner, developers should also be mindful of this issue.

James M. Grosser is a Partner in the Washington, D.C. office and can be reached at james.grosser@pillsburylaw.com or (202) 663-8258.

Meredith Kersey Horn is an Associate in the Washington, D.C. office and can be reached at meredith.horn@pillsburylaw.com or (202) 663-8370.

New Markets Tax Credits

Josephine S
LO

In The News

The New Markets Tax Credit ("NMTC") program, enacted in December 2000 as part of the Community Renewal Tax Relief Act, was designed to stimulate a total of $15 billion of equity investments in commercial and mixed-use projects in low-income communities through 2007. To take advantage of the credits, a taxpayer makes a qualified equity investment in a designated qualified community development entity ("CDE") and in return receives, over a seven-year period, NMTCs totaling 39% of the investment to offset Federal income taxes. A CDE receives a NMTC allocation from the Community Development Financial Institutions Fund of the Treasury Department ("CDFI") and typically makes loans to, or equity investments in, qualified active low-income community businesses. Since 2003, the CDFI has awarded three rounds of NMTC allocations in an aggregate amount of $8 billion. CDE demands for NMTC allocations have been, on average, approximately ten times more than the availability.

On September 29, 2005, the New Markets Tax Credit Reauthorization Act of 2005 was introduced in the Senate (S. 1800) and the House (H.R. 3957) to extend the NMTC allocations beyond 2007 by $3.5 billion (adjusted for inflation) each year from 2008 through 2012. A number of prominent industry groups have supported the passage of this legislation and we believe the proposed five-year extension of the NMTCs is justified in light of the enormous demands for the NMTCs to date and the crucial role the NMTCs have played in the revitalization of economically distressed areas.

In addition, a one-year, $3.5 billion extension, of the NMTC allocations to 2008 has been proposed in the Senate tax reconciliation bill, the Tax Relief Act of 2005 (S. 2020). There is no similar NMTC provision in the House tax reconciliation bill, the Tax Relief Extension Reconciliation Act (H.R. 4297). This one-year NMTC extension will be the subject of conference negotiations in February 2006.

Revitalizing The Community - NMTCs and the Arts

While many deals that we have been working on during the last year utilize the NMTCs for more conventional commercial purposes like mixed-use projects, office space and for sale affordable housing, some developers are harnessing the NMTCs to revitalize the arts in ways that might not be possible without the NMTC program.

ATLAS THEATRE

The $18 million rehabilitation of the historic Atlas Theatre in the H Street corridor of Northeast, Washington, D.C. provides a good example of the collaboration possible between the private and public sectors and the fusion of equity, loans, and gifts. A nonprofit organization represented by our firm acquired the theatre building using charitable donations and subsidies from the D.C. government. Upon completion of the rehabilitation, the building will become a unique performing arts center containing a 276-seat main stage theatre, a 250-seat theatre, two lab theatres, three dance studios, a café, as well as costume and production shops. It will be the vibrant cultural anchor for the renewal of an economically-distressed neighborhood, alive with jazz, modern dance, drama, poetry, and arts education.

The rehabilitation is being accomplished through a leveraged, sandwich lease structure generating both NMTCs and federal historic rehabilitation tax credits ("HTCs"). The nonprofit entered into a long-term ground lease of the building with a landlord that is a limited liability company. The landlord is conducting the rehabilitation and has leased the building to its investor member, the master tenant, for operations and subleasing. The nonprofit retains control of the building by serving as the developer for the rehabilitation and creating a for-profit subsidiary to manage both the landlord and the master tenant. Another for-profit entity that is unrelated to the nonprofit has created an upper-tier equity fund and a CDE to finance the rehabilitation costs. The fund obtained capital contributions from one bank and a loan from another bank (through the nonprofit's principals) to make an equity investment in the CDE, which owns 100% of the master tenant. The CDE in turn made a direct loan to the landlord and an indirect equity investment in the landlord through the master tenant. The NMTCs flow to the investor bank from the fund's equity investment in the CDE, while the HTC based on the rehabilitation expenditures will be transferred by the landlord to the master tenant through a pass-through election and will flow from the master tenant through the CDE and the fund to the investor bank. The landlord will repay the CDE loan from a combination of charitable donations raised by the nonprofit and rental income from subleasing the building to various arts groups.

Josephine S. Lo is a Partner in the Washington, D.C. office and can be reached at josephine.lo@pillsburylaw.com or (202) 663-8196.

California Real Property Tax Abatement: New Rules and a New Deal Structure

Gary P
DOWNS

We cannot remember a local affordable housing industry as divided on an issue as it was with the Board of Equalization's ("BOE") proposed rules clarifying the requirements for property tax abatement on affordable housing projects in California. After much rancor, opposing factions agreed that, in order to be eligible for property tax abatement, minimum nonprofit management must involve performance of at least five out of twelve enumerated duties (see below), in addition to annual physical inspections and various certifications. The BOE incorporated this compromise in its formal rulemaking process, which began on December 13, 2005. Rules 140 through 143 clarify, expand, and, in certain cases, change the current process for obtaining abatement. The California Constitution, and Revenue and Taxation Code provide abatement to affordable housing projects that are either wholly owned by nonprofits or that have a nonprofit managing general partner, even if the other partners are for-profit entities. The BOE and County Assessors are charged with implementing this program. To date, the BOE has not adopted formal rules governing property tax abatement for affordable housing projects. In this Article, we discuss the struggle to reach agreement on the rules, some of their important aspects, and necessary steps to achieve compliance.

> Although the proposed rules provide a more specific set of requirements than are currently administered, the new rules provide flexibility to the affordable housing community to put deals into various business models and still be eligible for the exemption

THE RULEMAKING PROCESS

Late in 2004 we heard rumblings that BOE staff was starting the rulemaking process. Within weeks of the rumor, a nonprofit-led group proposed rules that severely impacted the community's ability to produce additional affordable units. In addition, a number of County Assessors became involved arguing for stricter rules requiring more nonprofit involvement in projects applying for abatement. These groups argued that perceived abuses would create a public scandal unless the BOE drastically changed the rules. Other parts of the community reacted strongly against this call for change, arguing that the current system worked, and, in any event, that billions of dollars had been invested and must be protected against any change that would adversely impact the economic viability of existing abatement projects. On June 10, 2005, the BOE considered these arguments and others and concluded that there was essential community agreement on the proposed rules, except for Rule 140.1. At that meeting, the Board voted to defer the matter. At that time, proposed Rule 140.1 would have required the nonprofit managing general partner to perform 2 duties out of a list of 11. After many e-mails and phone calls, majorities on both sides agreed to a standard of at least 5 duties out of a list of 12. The operative compromise provision is as follows:

> "Substantial management duties" means that the managing general partner actually performs five or more of the following partnership management duties on behalf of the limited partnership:
>
> (i) rents, maintains and repairs the low-income housing property, or if such duties are delegated to a property management agent, participates in hiring and overseeing the work of the property management agent;
>
> (II) participates in hiring and overseeing the work of all persons necessary to provide services for the management and operation of the limited partnership business;
>
> (iii) executes and enforces all contracts executed by the limited partnership;
>
> (iv) executes and delivers all partnership documents on behalf of the limited partnership;
>
> (v) prepares or causes to be prepared all reports to be provided to the partners or lenders on a monthly, quarterly, or annual basis consistent with the requirements of the limited partnership agreement;
>
> (vI) coordinates all present and future development, construction, or rehabilitation of low-income housing property that is the subject of the limited partnership agreement;
>
> (vii) monitors compliance with all government regulations and files or supervises the filing of all required documents with government agencies;
>
> (viii) acquires, holds, assigns or disposes of property or any interest in property;
>
> (ix) borrows money on behalf of the limited partnership, encumbers limited partnership assets, places title in the name of a nominee to obtain financing, prepays in whole or in part, refinances, increases, modifies or extends any obligation;
>
> (x) pays organizational expenses incurred in the creation of the partnership and all operational expenses;
>
> (xi) determines the amount and the timing of distributions to partners and establish and maintain all required reserves; and
>
> (xii) ensures that charitable services or benefits, such as vocational training, educational programs, childcare and

after-school programs, cultural activities, family counseling, transportation, meals, and linkages to health and/or social services are provided or information regarding charitable services or benefits are made available to the low-income housing tenants.

On December 13, 2005, the BOE adopted these rules with the change in duties from 2 to 5, authorizing publication of the rules for discussion at a public hearing on March 28, 2006. This is the beginning of the formal rulemaking process. Since the rules were well vetted, we expect eventual adoption.

IMPORTANT CHANGES

Under the new rules, the nonprofit must perform at least 5 out of the 12 duties listed above. In many projects, this will expand the nonprofit's involvement in day-to-day management. The rules allow a nonprofit to delegate these duties if it is actually supervising performance of the delegated duties. In addition, the nonprofit managing general partner needs to conduct an annual physical inspection of the low income property to ensure compliance with Rule 140 as well as maintain the books and records for the project.

FUTURE WORK AND DEAL STRUCTURE

In anticipation of the pending regulatory changes, owners with projects in the pipeline would be wise to structure joint ventures that comply with the proposed rules. As for existing projects, the BOE did not adopt a grandfather provision that would have exempted projects that qualified for abatement prior to enactment of the new rules. Assuming that the new rules are adopted this year, owners will have until the January 1, 2007, lien date to be in compliance with the new regulations unless the BOE issues a written notice that they are not in noncompliance. If the Board has issued such notice to an owner, the owner will have 90 days from the date of the notice to comply with the regulations. Limited partnerships can be brought into compliance by amending the limited partnership agreement and, if necessary, increasing the managing general partner's involvement in the management and day-to-day operations of the project. Pillsbury has developed forms of omnibus amendments that should simplify the documentation process.

We have also confirmed with BOE staff that a nonprofit can use a wholly owned single member limited liability company to act as the managing general partner. This will create a statutory limited liability shield between the nonprofit operating company and the project owner. Any nonprofit managing general partner that is concerned about liability might consider amending all existing documents to add this shield to their ownership structure and structuring all new deals with this additional layer of protection.

Although the proposed rules provide a more specific set of requirements than are currently administered, the new rules provide flexibility to the affordable housing community to put deals into various business models and still be eligible for the exemption. We feel that the new rules are in line with California's original legislation to promote the production of affordable housing.

Gary P. Downs is a Partner in the San Francisco office and can be reached at gary.downs@pillsburylaw.com or (415) 983-1835.

Pillsbury Merger Bolsters Affordable Housing & Community Development

On April 4, 2005, Pillsbury Winthrop LLP and Shaw Pittman LLP merged. The expertise of the combined firm with respect to Affordable Housing and Community Development is second to none. We have equally strong real estate and tax practices on both coasts and are active throughout the United States, including specialists in all aspects of public finance, private investment and federal and state tax credits in our various offices. Shaw Pittman's experience counseling the largest investor and credit enhancer in the affordable housing industry adds a wealth of knowledge to Pillsbury Winthrop's developer and syndicator practices. Pillsbury Winthrop, one of the nation's leaders in public finance law, specializing in complex public sector financings and large-scale public/private partnerships, provides experience in all manner of government programs, supplementing the offerings already available to Shaw Pittman's private sector clients. We continue to represent all participants nationally in the Affordable Housing and Community Development Industry, including developers, investors, syndicators, underwriters, issuers, lenders and others and we look forward to seeing what we can do for you.

- Gary Downs

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Project Based Voucher Section 8 Rents: Are There More Limits to Come?

Irene C
KUEI

Under the federal low income housing tax credit ("LIHTC") program, a project owner may receive more than the maximum LIHTC rent for a particular unit so long as the additional rent is paid by a recognized tenant rental assistance program, such as the Department of Housing and Urban Development's ("HUD") Project-Based Voucher ("PBV") program. This rent overhang has historically provided an important source for necessary capital.

On October 13, 2005, HUD released its final rule governing the PBV program. Prior to the publication of the final rule, LIHTC project rent calculations under the PBV program were governed by HUD's Notice PIH 2002-22 (the "Notice"). The final rule went into effect on November 14, 2005, and brought about a significant change for owners of LIHTC projects receiving PBV rental assistance.

OLD RULE

Under the Notice, the gross rent for a PBV assisted unit in a LIHTC project located inside a qualified census tract ("QCT") could not exceed the lesser of 110 percent of the Fair Market Rent (or other HUD approved standard), or the rent charged for unassisted comparable units. Units in LIHTC projects could not be used for comparability determinations because they were considered assisted units.

For PBV-assisted LIHTC units located outside a QCT where the LIHTC rent was equal to or less than 110 percent of the Fair Market Rent (or other HUD approved standard), the maximum gross rent could not exceed the lower of 110 percent of the Fair Market Rent or the rent charged for unassisted comparable units. For PBV-assisted LIHTC Units located outside a QCT where rent exceeded 110 percent of the Fair Market Rent (or other HUD approved standard), the gross rent could not exceed the lower of the LIHTC rent or the rent charged for unassisted comparable units.

NEW (FINAL) RULE

HUD's final rule changes HUD's policy and now limits PBV rents to LIHTC rents for projects inside a QCT or outside a QCT where LIHTC rents are below 110 percent of the Fair Market Rent. The final rule did not change HUD's policy with respect to projects outside a QCT where the LIHTC rents are higher than 110 percent of the Fair Market Rent (or any HUD approved standard), because the old rule had already capped the PBV rent to LIHTC rent.

Additionally, because the final rule applies to both initial rent setting and annual rent adjustments, an owner's request for rent adjustment on a project with an existing multiyear Section 8 PBV HAP Contract could subject the unit rents to reduction. Even without a rental adjustment request, however, the final rule provides that the owner could face a negative rent adjustment anytime Fair Market Rents decrease by 5 percent or more.

In response to the final rule, the industry voiced concern that the policy would have a negative impact on existing Section 8 PBV projects underwritten and financed based on HUD's prior policies. In response, HUD indicated that the provisions of the final rule, including those with respect to Section 8 PBV rent levels, will not be applied to projects selected to receive PBV assistance prior to the effective date of the final rule, November 14, 2005. HUD is expected to issue official guidance in the near future that will make it clear that the new rule will not be applied to rent adjustments for projects selected for PBV assistance prior to the effective date of the final rule.

Finally, we note that because HUD's final rule with respect to Section 8 PBV rent limits was not contained in HUD's March 2004 proposed PBV rule, the changes were made without public notice and comment as required by the federal Administrative Procedure Act.

It is imperative that the industry voice concerns over the changes. Section 8 PBV program rent levels have served as a catalyst for the development and preservation of many affordable housing projects, particularly in high cost areas. These projects may not be feasible if the Section 8 PBV rents are limited by the LIHTC rents. Without an active voice from the industry, we would not be surprised if more limits followed.

Irene C. Kuei is an Associate in the San Diego office and can be reached at irene.kuei@pillsburylaw.com or (619) 544-3174.

Rural Development Questions with William E. Rice, Highland Property Development

Byron A RODRIGUEZ

In the last few years, we've seen an uptick in rehabilitation projects utilizing preservation support from the United States Department of Agriculture's ("USDA") rural development ("RD") program. Recently, I had the opportunity to discuss California's rural development rehabilitation market and recent changes to federal policy and regulations with William E. Rice, principal of Highland Property Development, one of the premier developers of rural affordable housing in California.

In a report released in late 2004, USDA consultants found that none of the over 300 Section 515 properties they examined had sufficient cash flow or reserves for long term maintenance. Will current federal appropriations be able to address the rehabilitation needs in the Section 515 portfolio, and what are the implications for the RD industry?

RD now requires a 20 year capital needs analysis for preservations. This report requires an assumption that *all* major systems will be replaced over 20 years regardless of condition. This type of analysis overestimates the likelihood that expensive systems will require replacement and thereby overestimates spending through the reserve budget.

In general RD preservations are requiring $500-$1,000 per unit in replacement reserves during a preservation application, which is double to quadruple the standard policies of most lending institutions. In addition, because of the limited distribution of the Section 515 loans, most properties that I have reviewed are generally in better condition than their market rate competition.

The same 2004 USDA report indicated that, even though over 60% of Section 515 projects (including all pre-1989 loans) have contractual prepayment rights, prepayment is only economically viable for around 10% of those projects. Is that consistent with your experience in developing in California and how does that affect the availability of projects for rehabilitation?

I think that understates the actual number of viable properties. It is often assumed that a 515 property requires 100% rental assistance to be a candidate. However, we have closed on several and are closing on 5 additional properties that have anywhere from no rental assistance to 60% rental assistance. It is true that states that have seen strong population growth and real estate price increases are likely to have larger portfolios of more economically viable 515 properties.

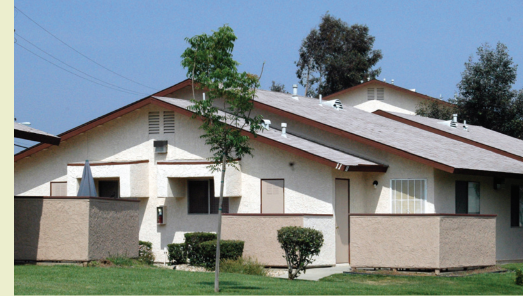
USDA's final regulations became effective in February 2005. One year in, what are your thoughts on the new regulations?

The new 3560 regulations incorporate a great deal of what was done in California prior to the final regulations by "exceptions" to the National Office. On the whole, I think the 3560 regulations offer a better road map towards what can be done to keep the 515 properties in the affordable realm while at the same time giving solid benefits to the existing owners.

Can you think of any cost neutral interpretations of ambiguous regulations that could assist in preservation?

Unfortunately preserving affordable housing has its costs (whether hidden or visible). RD preservations will likely require tax-exempt bonds, LIHTC equity, state and/or city financing in many cases. It's just a matter of how the costs are shared between the city, state and federal government.

Which other funding sources are you combining with RD support, and are there programs that you'd like to use but are avoiding because of uncertainties in the regulations?



Highland's 108-unit Noble Creek project in Beaumont, California

We have combined HOME funds, city funds, California voter approved MHP funds along with tax-exempt bonds and low-income housing tax credit equity to structure the preservations.

What is a good strategy for preserving RD properties with partial to no rental assistance from either USDA or HUD?

There are several different loan and grant programs that require deeper skewing than the 60% rent levels while providing funding with very attractive payback terms. While these developments take longer to structure, in the long run, resident displacement will be decreased and in many cases, more rehabilitation can be performed.

Where do you see the most need for new rural affordable housing in the next 10 years?

I have seen appraisal prices increase in some rural areas of Imperial, Riverside and San Bernardino Counties by almost 60% in two years time. These once rural communities are becoming suburbs for quickly growing major cities in the respective counties. As home prices increase well out of the range of a median income family, the need for more rural housing will grow.

Byron A. Rodriguez is an Associate in the San Francisco office and can be reached at byron.rodriguez@pillsburylaw.com or (415) 983-1265.

William E. Rice is a principal of Highland Property Development. www.highlandcompanies.com

Additional Bonding Authority for Hurricane Reconstruction

The GO Zone Act provides for the issuance of up to $14.8 billion in tax-exempt bonds (the "Gulf Coast Bonds") to assist in the reconstruction of the Gulf Coast areas of Mississippi, Alabama and Louisiana. Gulf Coast Bonds will be allocated to the states based on a formula of $2,500 per person in the GO Zone. The breakdown of bonding authority is approximately $7.9 billion for Louisiana, $4.8 billion for Mississippi, and $2.1 billion for Alabama. Beneficial rules applying to the Gulf Coast Bonds will make this enhanced capital source an important tool in the reconstruction effort.

QUALIFIED PROJECTS

Gulf Coast Bonds are treated as a new category of exempt facility bonds or qualified mortgage bonds. The Bonds may be issued to finance the acquisition, construction, reconstruction and renovation of non-residential real property (including fixed improvements associated with such property), qualified low-income residential rental property (under Code section 142(d)), and public utility property located in the GO Zone (collectively, the "Qualified Projects"). In the case of exempt facility bonds, 95 percent of the net proceeds (sale proceeds minus debt service reserve funds) of Gulf Coast Bonds must be applied to pay the costs of Qualified Projects. Capital or capitalizable costs associated with improving a facility also qualify. Gulf Coast Bonds cannot generally be used to finance movable fixtures or equipment; however, the legislative history makes clear that this is meant only to ensure that the property is not of a nature that will be taken outside of the GO Zone; and specifically provides that this prohibition on financing fixed and movable property does not apply to components that are assembled to construct an industrial plant. Gulf Coast Bonds may only be used to acquire an existing building if the rehabilitation costs of the building equal at least 50% of the acquisition cost of the building (this exceeds the 15% limit applicable to regular exempt activity bonds).

POLLUTION CONTROL FACILITIES

An interesting benefit from the Act is that it resurrects the ability to finance certain pollution control facilities with new money bonds. The legislative history to the Act provides explicitly that improving a facility by "installing equipment that enhances the pollution control" of a facility is permitted as long as the costs are of a capital or capitalizable nature.

> the GO Zone, the Rita GO Zone and the Wilma GO Zone are treated as difficult development areas for projects receiving allocations of Tax Credits beginning January 1, 2006 through December 31, 2008

PUBLIC UTILITY PROPERTY

The Act also treats as "Qualifying Costs" the financing of "Public Utility Property", which is property used predominantly in the trade or business of the furnishing or sale of (a) electrical energy, water or sewage disposal services, (b) gas or steam through a local distribution system, (c) telephone services, certain satellite communication services, or (d) transportation of gas or steam by pipeline, if the rates for the above are established or approved by a State or political subdivision thereof, an agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof. It should be noted that facilities for the sale, transmission, distribution or transportation of oil do not generally qualify as "public utility property;" however, many oil related facilities could presumably be financed as non-residential real property and buildings, structural components and fixed improvements thereof.

CASINOS CANNOT BE FINANCED

Gulf Coast Bonds may not be issued to finance gambling or racetrack facilities, private or commercial golf courses, country clubs, massage parlors, hot tub facilities, suntan facilities, or stores the principal purpose of which is the sale of alcoholic beverages for consumption off premises.

MULTIFAMILY HOUSING BOND BENEFITS

Gulf Coast Bonds issued for qualified low income residential rental housing benefit from more relaxed low income tenant set aside standards: (i) 20% of units must be set aside for tenants whose income does not exceed 60% of area median income (as opposed to 50% under current law) or (ii) 40% of units must be set aside for tenants whose income does not exceed 70% of area median income (as opposed to 60% under current law).

SUBJECT TO GENERAL EXEMPT FACILITY BOND LIMITS

Despite the many benefits offered by the Act, Gulf Coast Bonds are still subject to the same limitations generally applicable to exempt facility bonds including the 2% costs of issuance limitation, the arbitrage restrictions (e.g. 10% reserve fund limit) and 120% maturity limitations.

ISSUANCE OF ADVANCE REFUNDING BONDS

The Act provides for the issuance of one additional advance refunding for issues that would otherwise not be permitted. In particular, the Act allows for the 2nd or 3rd advance refunding of governmental purpose bonds and for the advance refunding of private activity airport bonds or docks and wharf bonds issued under the 1986 Code (the Act does not seem to allow for the advance refunding of private activity airport or dock and wharf bonds issued under the 1954 Code). The refunded bonds must have been issued by the states of Louisiana, Mississippi or Alabama, or a political subdivision thereof, and must have been outstanding as of August 28, 2005. Such advance refunding bonds must be issued before January 1, 2011. The authority to issue additional advance refunding bonds is allocated by the Governor of the each state as follows: Louisiana - $4,500,000,000; Mississippi - $2,250,000,000; Alabama - $1,125,000,000. The arbitrage rules under Code Section 148 will still apply to these bonds. The additional advance refunding must be for the entire outstanding amount of a bond issue (i.e. partial advance

refundings are not permitted). The additional advance refunding benefit does not apply to bonds financing certain redevelopment of blighted areas. In addition, Gulf Coast Bonds may not themselves be advance refunded.

AUTHORITY TO ISSUE BONDS

The Gulf Coast Bonds must be issued between the date of enactment of the Act and January 1, 2011. Determinations of which bonds will be entitled to the benefits of the Act are to be made by the respective Governor (or the State bond commission in the case of a bond which is required under state law to be approved by such commission).

TAX CREDIT BONDS

The Act allows Louisiana, Mississippi and Alabama to issue general obligation tax credit bonds, providing credits against federal income tax instead of interest payments. These bonds must be issued by the respective states and are limited as follows: Louisiana - $200,000,000; Mississippi - $100,000,000; Alabama - $50,000,000. The Governor of each state will allocate the authority to issue the Tax Credit Bonds. The Bonds may only be issued in 2006 and are limited to a 2 year maturity. The tax credit applies against both the regular tax and the alternative minimum tax liability.

ADDITIONAL BOND FINANCE BENEFITS

(i) Gulf Coast Bonds are not subject to the volume cap under Code Section 146.

(ii) Gulf Coast Bonds are not subject to the alternative minimum tax.

(iii) Gulf Coast Bonds qualify for the rebate exception for proceeds used to finance construction expenditures.

50% BONUS DEPRECIATION VS. TAX EXEMPT FINANCE

The Act provides special additional bonus depreciation for new property placed in service in a GO Zone consisting of an additional first-year depreciation deduction equal to 50% of the adjusted basis of qualifying property, which is added on to the regular depreciation benefits already existing for such property. This benefit applies to property acquired on or after August 28, 2005, and placed in service on or before December 31, 2007 (December 31, 2008 in the case of nonresidential real property and residential rental property). Qualifying for this bonus depreciation are (i) property subject to the modified accelerated cost recovery system with an applicable recovery period of 20 years or less (e.g. railroad tracks, single purpose agricultural structures, municipal sewers, etc.), (ii) certain computer software, (iii) water utility property, (iv) certain leasehold improvements and (v) certain nonresidential real property and residential rental property. Developers of projects that would otherwise be eligible for both bonus depreciation and Gulf Coast Bonds financing will be disappointed to find that the Act denies the benefits of the bonus depreciation to any property financed in whole or in part with tax exempt bonds under Section 103 of the Internal Revenue Code of 1986. Thus far, many companies seem to have decided that the benefits of the bonus depreciation exceed those offered by Gulf Coast Bonds and it will be interesting to see how many of them actually avail themselves of these bonds.

bonding authority is approximately $7.9 billion for Louisiana, $4.8 billion for Mississippi, and $2.1 billion for Alabama

Additional Tax Credits Available for Investment

Under existing law, States receive allocations of low-income housing tax credits ("Tax Credits") based on their population. For 2006, the national allocation is $1.90 per resident. To assist in the recovery from storm damage in the Gulf coast region, the Act authorizes an additional emergency allocation of Tax Credits for 2006, 2007 and 2008 for States in the GO Zone (Alabama, Louisiana and Mississippi) in an amount equal to the lesser of (i) the aggregate Tax Credits allocated by the housing agency to buildings in the GO Zone or (ii) $18.00 multiplied by the number of residents of each State located in the GO Zone. There are no GO Zone counties in Texas or Florida; however, Texas and Florida will each receive an additional $3.5 million in Tax Credits in 2006. In addition, the GO Zone, the Rita GO Zone and the Wilma GO Zone are treated as difficult development areas for projects receiving allocations of Tax Credits beginning January 1, 2006 through December 31, 2008, provided the project is placed in service in 2006, 2007 or 2008.

Properties placed in service in the GO Zone in 2006, 2007 and 2008 in a non-metropolitan area are eligible to substitute the "national nonmetropolitan median gross income" for "area median gross income" for purposes of determining income limits. This provision is not available for Texas or Florida.

The new law encourages clean up and demolition by allowing expensing of 50% of clean-up costs that otherwise would need to be capitalized. Costs must be incurred between August 28, 2005, and December 31, 2007, and must be for the removal of debris from, or for the demolition of, structures on real property in the GO Zone.

Further, the Act authorizes additional historic rehabilitation tax credits to encourage rebuilding of housing stock in areas devastated by the hurricane season. The new law increases rehabilitation credit from 10% to 13% of qualified expenditures for non-historic structures and increases from 20% to 26% of qualified expenses for any certified historic structures in the GO Zone. The new law also authorizes additional New Markets Tax Credits in 2005, 2006 and 2007 in the amount of $300 million, $300 million, and $400 million, respectively. The significant mission of the receiving entity must be the recovery and redevelopment of the Gulf Opportunity Zone.

Edward J. Rojas is Counsel in the New York office and can be reached at edward.rojas@pillsburylaw.com or (212) 858-1180.

Kimberly Crowder Moore is Counsel in the Northern Virginia office and can be reached at kimberly.crowder_moore@pillsburylaw.com or (703) 770-7568.

part by a low interest, deeply subordinated loan from the Sacramento Housing and Redevelopment Agency ("SHRA") out of the City's Housing Trust Funds. The SHRA's $2,200,000 loan bore an interest rate of 4% per annum and was payable in 360 months. Principal and interest payments were deferred for the first 168 months and interest-only payments were required for the next 12 months. Thereafter, unpaid principal and interest were to be fully amortized and repaid over the remaining 180 months of the term. Loans charged at less than fair market value constitute public funds under the amended Labor Code. However, the DIR determined that the SHRA's loan qualified for the exemption under Section 1720(c)(6)(E), which applies to loans that finance projects in which at least 40 percent of the units are restricted by a deed or regulatory agreement to occupancy by tenants earning no more than 80% of the area median income for at least 20 years. Based upon the *Silverado* determination, even extremely soft loans from public agencies will not trigger prevailing wage requirements so long as the requisite regulatory restrictions are in place.

In another case, the DIR interpreted the *de minimis* subsidy exception of Labor Code Section 1720(c)(3), concluding that a project receiving public subsidies equal to 1.64% of the total project cost is excepted from prevailing wage law requirements (*see New Mitsubishi Auto Dealership Victorville Redevelopment Agency*, PW Case No. 2004-024). Since the addition of Section 1720(c)(3) to the Labor Code, observers had speculated about whether the maximum "*de minimis*" percentage was 1% or 2% for purposes of the exclusion. While 1.64% lacks the convenience of a round number, it provides a safe harbor for developers who take small public grants or fee waivers to assist the financing of their projects.

Finally, it appears that the charter city exemption for affordable housing projects is alive and well despite all the recent amendments to the Labor Code. The charter city exemption is a creature of the California Constitution. It applies where a charter city undertakes a project that is considered a municipal affair, does not have effects outside the jurisdiction, and does not raise any matters of statewide concerns (see *San Diego Police Headquarters*, PW Case No. 2003-029 (1/28/05)). In November 2005 Pillsbury obtained a private no-coverage determination from the DIR on a project involving the sale by a charter city of several parcels of public land to a developer for $1. In exchange, the developer agreed to build for-sale affordable housing on the parcels. Although the conveyance clearly constituted a transfer of an asset for less than fair market value, the DIR wrote that any action by the agency to enforce state prevailing wage laws would be vitiated by the city's charter city status.

THE BAD

In September 2005 Governor Schwarzenegger vetoed Senate Bill ("SB") 940, which would have required the DIR to post available residential prevailing wage rates on the Internet. Prevailing wage rates for commercial projects are already available online. But for residential projects, the awarding body must request the applicable rates for *each project* from the DIR. This procedure can cause costly delays. For instance, the California Department of Housing and Community Development ("HCD") must request rates for all projects financed by MHP loans. But HCD will not submit its request to the DIR until a developer's funding application has been approved and HCD has actually committed funds to the project. The DIR typically determines the applicable rates 45 days after the request is made, and only then can the developer bid out the construction contract. In vetoing SB 940, the governor wrote that the DIR lacked the information necessary to make general residential rate determinations and insufficient funds to conduct wage surveys. His veto message concluded, "I encourage the Legislature to look at this issue more closely next year and send me legislation that truly addresses the problem."

Based upon the *Silverado* determination, even extremely soft loans from public agencies will not trigger prevailing wage requirements so long as the requisite regulatory restrictions are in place

In another negative development last year, the DIR ruled that a transfer of public property at a price set according to an appraisal method commonly used in redevelopment deals triggers prevailing wage requirements (*see Santa Ana Transit Village*, PW Case No. 2004-035 (12/5/2005)). In the Santa Ana case, the Santa Ana Redevelopment Agency ("RDA") agreed to sell certain publicly owned parcels of land to a developer pursuant to the terms of a Disposition and Development Agreement ("DDA"). Prior to the sale, the developer and the RDA obtained both a fair market appraisal and a fair reuse value appraisal for the parcels. They then set the acquisition price according to the much lower fair reuse value. The DIR determined that the sale of the land at a price based on its fair reuse value constituted "transfer…of an asset of value for less than fair market price" within the meaning of Labor Code Section 1720(b)(3).

In contrast to "fair market value," the appraisal methodology used to determine "fair reuse value" takes into consideration restrictions that a DDA imposes on the use of land conveyed by a public agency. The DIR discounted the concept of fair reuse value as a legitimate appraisal methodology. It concluded that, "[i]n order for a transfer to be considered at fair market price within the meaning of Labor Code section 1720(b)(3), there must be evi-

dence that the purchase price is determined by competitive forces in the 'market.'" Because the fair reuse value price chosen by the developer and the RDA was unsupported by such evidence, the DIR determined that the Santa Ana project was covered by prevailing wage requirements. In light of the determination in the Santa Ana case, developers should pay prices for public lands based on their appraised fair market value in order to avoid paying prevailing wages on construction projects.

THE UNCERTAIN

A recent California appellate court decision in a case called *Greystone Homes, Inc. v. Chuck Cake* (1st Dist Ct. App. docket no. A107763, filed 12/21/05) may raise new questions about the applicability of prevailing wage requirements to certain common development subsidies. In the *Greystone* case, a public agency provided assistance to a developer in the form of: (1) payment of a traffic impact mitigation fee, (2) reimbursement of land acquisition costs, and (3) a "gift" of public land. Reasoning that such subsidies did not constitute payment for actual *construction*, the court concluded that the project was not covered by prevailing wage requirements.

The *Greystone* case interprets Labor Code Section 1720 as it existed prior to the latest amendments to the law, including those effected by SB 975. Some observers believe that SB 975, which was enacted after the issue arose in *Greystone*, broadened the prevailing wage laws to cover any payment of public funds relating to a *project*, rather than only payments specifically for construction. In their view, *Greystone* has no impact on new projects. In fact, the *Greystone* decision is hard to reconcile with certain parts of the Labor Code as amended by SB 975. For instance, it is unclear how ground lease credits or gifts of public property could ever be considered payments for "actual construction."

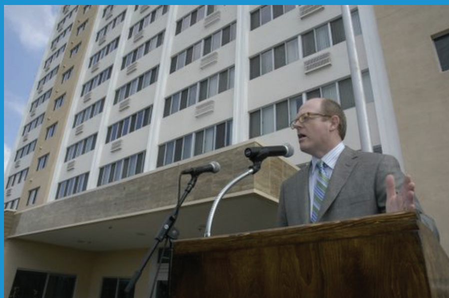
We believe that the *Greystone* case may narrow the application of the amended Labor Code significantly. Although SB 975 expanded the definition of what constitutes "public funds," it did not change the legal definition of "public works," which is "*construction…*done under contract and paid for in whole or in part out of public funds." It is worth noting that, in 2000, the California legislature expressly broadened the definition of "construction" to include work performed during the design and preconstruction phases of a project (such as inspection and surveying work) but stopped short of including things like land acquisition and impact fees that are not directly related to actual construction. *In other words, if lawmakers wanted prevailing wage laws to cover activities besides "construction… paid for by public funds," why would they preserve that fundamental definition but spend four years tinkering with the meanings of "construction" and "public funds?"* Until its limits are tested before the DIR or in California courts, the interaction of the *Greystone* decision and SB 975 will remain uncertain.

All in all, legal developments during 2005 proved favorable for the affordable housing industry and added certainty to the development process. Representatives of organized labor may seek to reverse the industry's gains in a number of ways. Unions could elect a pro-union governor, challenge DIR determinations in the courts, or sponsor further amendments to the Labor Code. Developers of affordable housing must remain vigilant if they are to preserve the exemptions from prevailing wage laws that they currently enjoy.

Paul R. Schrecongost is a Senior Associate in the San Diego office and can be reached at schrec@pillsburylaw.com or (619) 544-3151.

Spotlight: Allied Pacific Development

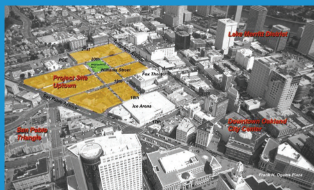
Congratulations to Steve Whyte and our client, Allied Pacific Development, on the opening of Golden West Tower Apartments in Torrance, California. The opening celebration was well attended by both residents and business parties and everyone had a great time.



Images courtesy of CNB Photography.

Uptown Oakland

Construction has already started on the Uptown Apartments project in Oakland. The project will consist of approximately 665 rental units in three five-story buildings and has been strongly supported by Oakland Mayor Jerry Brown. Pillsbury is representing California Urban Investment Partnership, a joint venture between MacFarlane Partners and CalPERS, in negotiations with Forest City to join in the development of the project. Upon completion, Uptown Apartments is expected to go a long way towards helping Mayor Brown achieve his bold vision of bringing 10,000 new residents to downtown Oakland.



Editor-in-Chief: **Byron A. Rodriguez** | byron.rodriguez@pillsburylaw.com

For mailing list inquiries, please email **real.estate@pillsburylaw.com.**
For further information on Pillsbury's **Affordable Housing & Community Development** Practice, please contact:

Gary P. Downs | Partner - San Francisco
gary.downs@pillsburylaw.com | (415) 983-1835

Lewis G. Feldman | Partner - Century City
lew.feldman@pillsburylaw.com | (310) 203-1188

Craig A. de Ridder | Partner - Washington, D.C.
craig.deridder@pillsburylaw.com | (202) 663-8712

www.pillsburylaw.com

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