

ACQUISITION OPTIONS REPORT

SANTA ROSA SUBREGIONAL LONG-TERM WASTEWATER PROJECT

Prepared for

**City of Santa Rosa
and
U.S. Army Corps of Engineers**

October 1993

Prepared by

ECONOMIC & PLANNING SYSTEMS
18154 4TH STREET, SUITE B, BERKELEY, CA 94710 ! 510-841-9190

For

HARLAND BARTHOLOMEW & ASSOCIATES, INC.

ACQUISTION OPTIONS REPORT

SANTA ROSA SUBREGIONAL LONG-TERM WASTEWATER PROJECT

Prepared for

**City of Santa Rosa
and
U.S. Army Corps of Engineers**

October 1993

Prepared by

ECONOMIC & PLANNING SYSTEMS
18154 4TH STREET, SUITE B, BERKELEY, CA 94710 ! 510-841-9190

for

HARLAND BARTHOLOMEW AND ASSOCIATES, INC.

I. INTRODUCTION

PURPOSE OF REPORT

The acquisition of land for wastewater treatment is a key phase of the Santa Rosa Long-Term Wastewater Project that must be considered when evaluating the Project's impact on the environment. The purpose of this report is to assess the options for acquiring land needed for the storage of treated wastewater prior to its re-use. The report addresses general issues regarding methods of acquiring land and funding the acquisition.

The conclusions of this report present a recommended land acquisition strategy for a storage site for the Santa Rosa Long-Term Wastewater Project. The strategy addresses the appropriate method for acquiring the site and mechanism for funding the acquisition.

APPROACH AND METHODOLOGY

An integrated approach that combines the consultant team's experience in land acquisition and quantitative analyses has been used to assess the acquisition options and develop a strategy for the Project. In this draft report, the team has drawn upon key staff members' extensive experience in land economics and real estate transactions in order to identify the costs and benefits of the available land acquisition methods. The discussion of funding mechanisms for land acquisition draws upon the firm's public finance experience and a review of other reports.

ORGANIZATION OF REPORT

Chapter II discusses the various methods available to the City of Santa Rosa of acquiring the land for a storage site. This chapter addresses concerns to the seller, such as capital gains taxes and liability, and concerns to the buyer. The chapter also presents a description of the advantages and disadvantages of the various methods by which the City of Santa Rosa can acquire the land. **Chapter III** presents an overview of the financing options.

II. METHODS OF ACQUIRING LAND

INTRODUCTION

This chapter discusses some appropriate methods that could be used by the City of Santa Rosa, or its designee, to acquire land. Issues of concern to the seller, such as tax liability, and issues of concern to the buyer, such as environmental liability will be discussed. Ultimately this survey of land acquisition techniques will help to develop a recommended land acquisition strategy for the Santa Rosa Long-Term Wastewater Project. Since the land is to be acquired for a very specific purpose -- water storage -- there are some land acquisition techniques that will not be appropriate. Specifically, the purchase of conservation easements or leases which leave the underlying fee interest in the hands of the owner are not feasible methods. The survey of potential land acquisition techniques described below is limited to fee simple acquisition methods.

ISSUES OF CONCERN TO SELLER

The issues of concern to the seller can be grouped into four major categories:

- price and terms;
- transaction costs;
- tax implications;
- personal considerations.

PRICE AND TERMS

The first issue of concern is the landowner's desire to receive a "fair price" for his or her property. If the acquisition includes multiple landowners, it will be important for the City of Santa Rosa, or its designated agency, to establish uniform acquisition procedures and appraisal standards so that landowners are clear about how they will be treated, and will not be left wondering whether another landowner may be getting a better deal. While real estate negotiations are generally conducted in a confidential manner between private entities, a public agency has certain public disclosure requirements, and the price it pays for a piece of property becomes public knowledge.

TRANSACTION COSTS

The second issue of concern, transaction costs, includes fees associated with preparing appraisals, completing title searches, legal documentation, documentary stamp tax and escrow fees, as well as the time spent negotiating the transaction and bringing it to closure.

Therefore, the public agency could reduce transaction costs by paying for some of these fees. In addition, the seller may reduce transaction costs on a sale to a public agency, as opposed to a sale to a private entity, because there should be no broker's fees to pay.

Many landowners will also be concerned that the sale may be more onerous and time consuming because it is with a public agency. The City of Santa Rosa should provide assurances that the sale will be a streamlined process and that the acquisition funds are clearly identified. The first sales under this program will be very important as they will send a signal to other potential sellers as to what they can expect from the City of Santa Rosa.

TAX IMPLICATIONS

Tax implications will be of particular importance to those sellers in the higher tax brackets and who have owned their land for many years during which it has enjoyed substantial appreciation in value. There are several things that the City of Santa Rosa and the landowner can do in order to defer or reduce capital gains tax on the sale. These tax deferred sales and donative sales are discussed in more detail later in this chapter.

PERSONAL CONSIDERATIONS

Each seller may have different tax, financial and family considerations to take into account when negotiating for the sale of his or her land. The timing of the sale proceeds may be critical for income or estate tax planning purposes; and there may be concerns about removal of personal property from the land, and about future liabilities that the seller may incur after the sale of the land to the City of Santa Rosa. These concerns should be addressed in as flexible a manner as possible by the buyer.

ISSUES OF CONCERN TO BUYER

The main issues of concern for the public agency buyer are:

- price and terms;
- transaction costs;
- transaction risks and liabilities.

PRICE AND TERMS

The City of Santa Rosa, like any other buyer, is motivated to get the best deal at the lowest price. The City may be subject to charges of wasteful expenditures of public money if the purchase prices are perceived to be too high. However, the City of Santa Rosa may not be able to find any willing sellers if the land prices are considered too low, and they will be forced to conduct all the purchases by condemnation, which is an inefficient method of land

acquisition. Therefore, the public agency or its designee has a delicate balance to attain. All of this will be made easier with a thoughtful public information campaign and strong political support for the program.

TRANSACTION COSTS

Transaction costs include all of those listed above for the buyer plus the additional concerns of needing staff who will be dedicated to completing the landowner negotiations in a timely fashion.

TRANSACTION RISKS AND LIABILITIES

Transaction risks and liabilities include concerns about receiving clear title that is free of encumbrances, concerns about future liabilities and potential environmental hazards, and concerns about public relations. An option agreement may be a particularly useful tool to buy time for the City of Santa Rosa while the property is further evaluated, in order to minimize these types of risks. Option agreements and other methods of land acquisition are described in more detail below.

POTENTIAL ACQUISITION METHODS

The City of Santa Rosa, or other public entity operating on its behalf, will have to consider a variety of acquisition techniques to acquire the land needed for treated wastewater storage sites. As in any public funded activity there will be the need to stretch limited funds and to achieve multiple public policy goals as efficiently as possible.

There are several methods of buying land that may offer advantages to both the buyer and the seller. In particular, a governmental entity has the right of eminent domain and may be able to offer the seller certain tax benefits resulting from a sale under threat of condemnation. Also, gifts of land to a government agency (or a nonprofit agency acting on its behalf) may make the donor eligible for certain tax benefits. Donative transactions are discussed in more detail in a later section. The next section describes several fee simple land acquisition techniques which assume a full fair market value sale.

FAIR MARKET VALUE SALES

Contract Sale - All Cash

Land may be thought of as a bundle of rights which may include, but are not limited to: mineral rights, air rights, water rights, and development rights. When all these rights are conveyed by the seller, this is called a fee simple transaction. In a fee simple transaction, a price is negotiated, a sale contract is drawn up between the buyer and the seller, and the deed is transferred in return for payment of the sale price. The sale contract usually

includes, in addition to the price and terms of the sale, in this case -- all cash upon closing; warranties and representations made by the seller regarding the condition of the title and any outstanding liabilities; and any potential environmental hazards.

Appraisal Process

Sales to a public agency may involve additional regulations and requirements. In particular most public agencies spending public funds are required to justify a purchase price for a piece of land with a qualified appraisal. Appraisal procedures will need to be established early on as part of the acquisition strategy and all potential sellers notified of the procedures to be used. Landowners may choose to obtain their own independent appraisal for tax deduction purposes if there is a donative element to the transaction.

Environmental Liability

Environmental liability issues are of increasing concern to all landowners and will be especially important in this case where treated wastewater will be stored for subsequent use. Recently strengthened environmental protection laws now hold all landowners in the chain of title liable if toxics are discovered on the property after the sale. For this reason alone, the public agency may wish to use the purchase option agreement as a way of buying time to evaluate any potential environmental hazards associated with a property, prior to paying the entire purchase price.

Option Agreements

An option agreement grants the prospective buyer (the public agency) the exclusive right to purchase a property during a time period specified by the agreement in exchange for an option consideration (fee) that usually represents a small fraction of the property's value. The option fee usually contributes to the purchase price if the option is exercised. By negotiating an option the buyer is able to gain control of the site with a minimal investment of time and money, and so remove the threat of development of the site, or sale to another buyer during the option term.

The advantages to the seller are that he or she will receive some fraction of the property's value while the buyer considers the purchase. If the buyer backs out and lets the option expire the seller will keep the option fee and therefore will be partially compensated for the lost time. Obviously it is easier to negotiate an option agreement in a slow real estate market or with a public-spirited (charitably inclined) seller.

Risks are further minimized for the buyer because options carry no obligation to purchase if the buyer decides that the property will not be suitable for the intended purpose as a water storage site. If the option expires there is no consequence other than the forfeiture of the option fee. Option agreements may be as flexible as the parties negotiating them. The basic elements that will have to be negotiated are the price and terms for the purchase of the property; the length of the option agreement and the date of closing after the option has been exercised; the acceptable conditions of title, representations and warranties, especially those related to the presence of toxics; and possibly, provisions for extending the option agreement.

Once an option has been purchased, the public agency can complete any necessary geological work to determine if the land is suitable for water storage, conduct research into any suspected environmental hazards, and arrange for financing or the transfer of funds to complete the transaction.

Sale Under Threat of Condemnation

If land is acquired through condemnation proceedings or "under threat of condemnation" this is known as an involuntary conversion or taking. If the seller realizes a capital gain (i.e. the landowner sells the land for more than the basis) as a result of a condemnation sale, the seller is eligible for special tax treatment.

Generally, upon the sale of appreciated property, such as land, the capital gain must be reported in the year that the gain is recognized, usually the year of the sale unless an installment sale method is used. However, in a sale under "threat of condemnation" the seller can defer recognition of the gain for two or three taxable years succeeding the year of condemnation, depending on the type of property. In the case of condemned property used in a trade or business, or held for investment, the seller has three taxable years in which to reinvest the proceeds of the sale in similar property and can defer any payment of capital gains tax during that period.

Voluntary sales due to threat of condemnation can qualify as involuntary conversions and receive special tax treatment, without the actual commencement of condemnation proceedings. However, if the landowner and the public agency cannot agree on the price offered for the property, the negotiations may result in legal proceedings whereby the fair market value will be determined through the judicial process. Condemnation litigation tends to be a long and expensive procedure and is not an efficient method of acquiring land.

In addition to the substantial time and money needed to conclude the transaction, many public agencies do not relish the adverse publicity that often accompanies such condemnation cases. Before the City of Santa Rosa considers the use of condemnation they should seek legal opinion regarding the appropriateness of using the right of eminent domain for acquiring land for wastewater storage sites.

Like-kind Exchanges

Another situation in which a seller may defer recognition of any capital gains realized as a result of a sale of property is known as the like-kind exchange. If the seller invests the sale proceeds from a sale of land in another piece of property (improved or unimproved) that he or she wishes to hold for investment, or for use in a business, the capital gain will be deferred. In order for a like-kind exchange to qualify, the property exchange must take place within the same tax year.

Installment Sales

A sale of property that allows for deferment of at least one tax payment to the tax year after the year in which the sale occurs is known as an installment sale. Under the installment

method a portion of each payment represents part of the seller's capital gain. The profit percentage applied to each payment is figured by dividing the gross profit by the sale price. The installment purchase note may be amortized over a fixed time period, or it may be interest only for a fixed period, with a balloon payment of all the principal at the end of the term.

This method has potential advantages for both the buyer and the seller. The buyer can stretch the payments over several years and thereby avoid having to pay the entire purchase price at once. The seller can avoid recognition of **all** the capital gains in the year of the sale. Capital gains tax deferment may be particularly beneficial if the seller expects to be in a lower tax bracket in future years due to retirement or other changed circumstances. It may also be possible to structure an installment sale so that interest payments made by the governmental agency on the note are tax exempt for the seller.

CHARITABLE SALES/GIFTS

Governmental entities are treated as qualifying donee organizations for the purposes of federal and State tax laws that define charitable donations. Therefore, a gift of land, or a below market sale (bargain sale) of land to a qualifying donee organization may result in tax benefits to the seller, under both federal and California State tax laws. Actual tax benefits will vary depending on the individual donor's tax status, financial position, and charitable intent. All landowners should be advised to consult with their tax consultants before making a donative transaction.

In general, the longer the land has been held by the current landowner and the greater the appreciation (the lower the basis in the land), the larger the potential tax savings. However, the donor will need to have sufficient current taxable income to take advantage of the income tax benefits offered by a charitable donation. For example, the owners of agricultural land are often "land rich" and "cash poor," and therefore may not always be in a position to use tax benefits. The following notes some possible tax savings that may be applicable as a result of a gift or bargain sale of land by an individual to the City of Santa Rosa.

Outright Gift

A gift of appreciated or capital gain property (property owned for more than one year) is generally deductible at full fair market value (FMV) for the purposes of computing income taxes. An appraisal is the key element in any donative transaction. A qualified appraisal is required to substantiate the value of the gift for the Internal Revenue Service (IRS). If accepted by the IRS, the appraisal establishes the property's FMV. FMV is defined as the price at which the property would change hands between a willing buyer and a willing seller, assuming that both parties are in full possession of any relevant facts concerning the property.

The deduction for a gift of appreciated property, such as land, is limited to 30 percent of adjusted gross income in the year of the gift. Any value exceeding the 30 percent limitation

for gifts of appreciated property may be carried forward and used in the next five

succeeding years. Each year has a similar 30 percent limitation and the maximum available must be applied each year. Thus, taxpayers have a total of six years in which to absorb a gift.

Bargain Sale

A bargain sale transaction is a sale of property at a price below the FMV. A bargain sale consists of two elements: the gift portion and the sale portion. The landowner may be able to take a charitable deduction for the gift portion. The net cash flow to the seller at a bargain sale price may closely approximate that from a FMV sale, depending on the taxpayer's financial situation and on the amount of capital gain that could be recognized upon the sale.

As in the case of an outright gift, the appraisal is very important. The FMV, as determined by a qualified appraisal, is used to establish the tax deduction the property owner may receive. The charitable donation is equal to the difference between the FMV and the bargain sale price. The charitable donation may then be deducted (up to the 30 percent limitation) from adjusted gross income in the year of the gift and the next five succeeding years if necessary.

The sale portion of the bargain sale transaction is then computed like any other sale of capital gain property. The FMV is also used to calculate the capital gain, which is the appreciated value of a property since it was purchased by the property owner. The seller must declare this capital gain as income, whether or not a property is sold at market rate or through a bargain sale. As of January 1, 1993 federal tax laws require that capital gains be treated the same as ordinary income except that they are subject to a tax rate cap of 28 percent. Therefore, long term capital gains enjoy preferential tax treatment, since the top marginal income tax bracket for other types of income is now 39.6 percent (Omnibus Budget Reconciliation Act of 1993, August 10, 1993).

Capital gains for a market rate transaction are calculated by subtracting the original price, the basis, from the selling price. For bargain sales, the IRS requires that the basis be adjusted in order to maintain the same proportional relationship between the capital gain and the sale price. The IRS rules require that the following formula be applied:

$$\text{Adjusted Basis} = \frac{\text{Bargain Sale Price}}{\text{FMV}} \times \text{Original Cost Basis}$$

In computing the capital gain resulting from a bargain sale the seller must subtract the adjusted basis from the bargain sale price. For example, if landowner X owns a piece of property with a fair market value of \$500,000; a basis (original purchase price) of \$100,000; and sells the property to a governmental entity at the bargain sale price of \$300,000 -- the gift portion of the transaction will be equal to \$200,000 (\$500,000 FMV less \$300,000 bargain sale price) and the capital gain portion of the transaction will be equal to \$240,000 (\$300,000 sale price less the adjusted basis of \$60,000).

The charitable deduction resulting from a bargain sale transaction may be greater than the additional capital gains tax liability that results from the sale. Consequently, the property owner who enters into a bargain sale transaction may receive a significant tax shelter against his or her current income.

It should be noted that a bargain sale may be structured in all the different ways described above for market rate sales -- bargain sales may be purchased through option agreements or contract sales and they may be all cash or installment sales. It may also be possible to do a bargain sale under threat of condemnation, which would enable the seller to enjoy the tax deduction immediately for the gift portion, and to delay the recognition of the capital gain on the sale portion for two to three years, depending on the type of property involved.

III. FINANCING OPTIONS

INTRODUCTION

This chapter outlines the financing options that are available to fund the long-range wastewater project. The financing information was adapted from CH2MHill's **Development of Reclamation Alternative Phase 2 Draft Report, April 1990** as part of the Santa Rosa Subregional Water Reclamation System Long-Term Detailed Studies.

FINANCING ALTERNATIVES

Capital projects may be financed by a variety of methods ranging from full "pay-as-you-go" to total financing through long-term debt such as revenue bonds. Selection of one or a combination of financing methods will depend on several issues, such as the estimated cost and timing of the plant construction and the land acquisition program, the political acceptability of user rate increases (monthly service charge and/or connection fee), and the availability of existing capital reserves. Quantitative comparisons of financing options can be made once land acquisition costs and phasing are more defined.

Some alternative financing strategies are described in a later section in this chapter. Further research will be conducted about these alternative financing methods when there is more information available on the EIR/EIS alternatives. The following sections describe the methods most often used by cities to finance wastewater treatment and disposal projects.

FINANCING WITH REVENUE BONDS

Revenue bonds are a commonly used method for financing large facilities such as a major treatment plant or conveyance system expansion and may also be used for land acquisition. With revenue bonds, debt service costs are repaid over a period of time. Because of this, revenue bonds repaid from user rates involve repayment by both existing and new users. With revenue bonds, fees (revenues) are set at a level sufficient to cover interest and principal payments plus a reserve fund to assure bond holders that the funds necessary for repayment of the bonds will be available. The total of these fees, collectively referred to as a coverage, is typically 1.25 times the actual amount needed to make principal and interest payments.

FINANCING WITH ASSESSMENT BONDS

Assessment bonds are commonly used to raise capital by forming a special assessment district. The members of the assessment district agree to pay an assessment (usually on an annual basis) for specific benefits they will receive. The authority to form special assessment districts is generally recognized as a manifestation of the government's power

of taxation. The bond is ultimately secured by liens on property parcels in the assessment district. Assessment bonds, like revenue bonds, increase the cost of the project because of issuance costs, reserve requirements, and interest costs.

The primary requirements of assessment bonds are that the area receiving the benefit be well defined, that assessment be directly related to the benefit received, and that those assessed have an opportunity to discuss the assessment method in a public hearing. These requirements make assessment bonds less desirable than revenue bonds for wastewater facilities in larger communities where wastewater flow is monitored and benefits can be defined on a basis other than assessed property value.

GOVERNMENT LOAN/GRANT FUNDING

Grant funding has historically been a significant source of funding for wastewater facilities through the EPA Clean Water Grant Program. However, federal budget constraints have resulted in an elimination of the grant program with the federal contributions for clean water programs now funneled through the State revolving loan program.

The U.S. Bureau of Reclamation (USBR) Small Project Loan Program (P.L. 84984) is a potential funding source for a portion of the improvements associated with the Project. The Small Projects Act was enacted to encourage State and local participation in the development of new projects and in the improvement of older projects. The Act emphasizes rehabilitation and betterment of existing projects to conserve water, energy, the environment, and to control water quality. The Act requires that an organization wishing to apply for a loan submit a proposal to the Secretary of the Interior.

A small reclamation project may be solely for irrigation or drainage of irrigated land. The project may also be for multipurpose water resource development authorized (or eligible for authorization) under federal reclamation laws. Commercial irrigation or irrigation drainage must be a viable function of all projects funded under the Act. Other purposes may include development of municipal and industrial water supply and treatment, hydroelectric power, flood control, fish and wildlife enhancement, or outdoor recreation.

A maximum limit is placed on the estimated total cost of a project that may be constructed under the Act. The Act requires the Secretary of Interior to establish this limit annually by applying the USBR's composite construction cost index for January of the current year to a January 1971 base cost of \$15 million. The maximum federal loan and/or grant that may be obtained in any given calendar year is limited to two-thirds of the allowable maximum estimated total project cost for the year in which the project is approved. In 1990 the estimated maximum project limit was \$46 million.

Interest is not assessed on that portion of the loan that is attributed to irrigation development. The interest rate assessed for interest-bearing portions of the project is determined by the Secretary of the Interior each year, and is based on the yields of government securities.

Grants may be made for flood control, outdoor recreation, fish and wildlife enhancement, and cultural resources mitigation when these purposes benefit the general public. Specific requirements are provided in the Small Projects Act loan program guidelines for determining the maximum amount of grants allowable for a project.

OTHER FINANCING ALTERNATIVES

Farmland Conservation Funding Sources

Since the land is to be acquired for wastewater storage, which will provide irrigation for farmlands in the region, the agricultural value of these lands will be enhanced and broader public benefits will be derived from this Project. To the extent that the goals of the City of Santa Rosa are complementary to the goals of farmland conservation organizations and agencies, there may be additional funds available from these sources, even though they do not traditionally fund wastewater treatment facilities.

Like-kind Exchanges

The City of Santa Rosa should also consider investment lands that it currently owns as potential exchange properties. As discussed in **Chapter II**, sellers may defer recognition of capital gains if they exchange one piece of property for a similar type of property of equal or greater value. In a like-kind exchange it is not necessary to exchange farmland for other agricultural land. Generally an exchange of realty for realty (improved or unimproved) will meet the like-kind test.

A like-kind exchange has tax advantages to the seller if the subject property has appreciated significantly and a sale would normally result in a large capital gains tax. The advantage to the City of Santa Rosa (the buyer) is that they may not need to seek additional funding sources if they already own suitable land of equal or greater value which the seller is interested in acquiring.

"Pay-As-You-Go" Method

With the pay-as-you-go method, special one time project revenues are channeled into capital construction and land acquisition reserves, as are revenues collected through monthly service charges and connection fees. The pay-as-you-go method is more feasible and appropriate for utilities with relatively constant annual capital facilities needs, or for smaller, less expensive facilities because, with pay-as-you-go financing, debt service costs are avoided. This method is often used in combination with revenue bond financing. In such a case, revenue accumulated through connection and other fees is typically used to pay preliminary planning and design work. The construction of the facility and land acquisition is then financed through revenue bonds. Santa Rosa has typically used this latter pay-as-you-go method to finance planning and design work.

Conventional Lending

Conventional lending sources such as banks, savings and loans, and other lending institutions are typically sources of short-term financing. This option normally carries a premium in financing costs because of loan origination fees, financing charges, and higher interest rates (because short-term taxable rates are typically higher than long-term tax free rates). If shorter term loans are needed to cover temporary cash shortfalls, a more viable financing option may be to arrange advances from city or district reserve accounts or general funds. Interest rates normally correspond to the City's opportunity cost of capital, or the rate that the City or district normally earns on its invested cash reserves. This interest rate is typically much lower than conventional short-term rates.

SOURCES OF REVENUES

To repay the debt holders (bonds or loans), the Subregional System requires a continuous source of revenue. This revenue will come from some type of user rate or assessment. User rates (service charges and connection fees) will be set by the individual entities that comprise the Subregional System. The charges will reflect the rates the Subregional System charges the entities. The entities must decide how to allocate costs between monthly service charges and connection fees. In addition, user rates between entities will vary widely because entities have different base costs for wastewater collection and administration.

Service Charges

Increases in service charges should not be assumed to automatically cover inflation or annual changes in operation and maintenance costs. Each increase or schedule of increases must be passed by the rate-setting entity and represent a "real" financial increase to the rate payers. Since users ultimately pay for all capital costs for new facilities (not for expansion) and the land required, periodic rate increases should be assumed to be a necessary and acceptable revenue source. Monthly sewer service charge estimates are developed based on project cost estimates and project schedules.

Demand Fees

Demand fees are intended to cover the additional capital costs of system expansion to provide additional capacity for, and connection of, new users. These fees should therefore be viewed as the primary source of funding for additional facilities and land to service new users, whether the initial funding is through debt service or other means. Projections of the number and phasing of new users (dwelling units, commercial and industrial acreage) must be used to formulate appropriate demand fees and capital recovery schedules.