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New Incentives Could Encourage Office-to-Residential Conversions

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Office-to-residential conversions, where an existing office building is renovated and turned into housing, could be an important tool to help address both housing affordability and urban decay. Although there are obstacles, several government programs could help make these projects profitable.

The economy has shifted dramatically in the aftermath of the pandemic, and a number of interlinked factors have the potential to create a "doom loop" environment in many urban areas. The rise of remote working (among other economic factors) has led to a sharp decline in demand for commercial office space, and many office buildings have been unable to replace tenants leaving the market.

Vacancy rates are higher than they've been in thirty years. This has led to a concomitant loss of foot traffic in city centers, meaning fewer people using public transit and frequenting businesses downtown. As downtown businesses reliant on foot traffic (retail, food service, etc.) shutter at an alarmingly high rate, this leads to a loss of tax revenue and raises concerns about how cities will continue to provide essential services in an efficient and effective manner.

Meanwhile, the demand for affordable housing remains incredibly high, as the number of Americans paying greater than 30% of their income on housing continues to grow each year. Nationwide, it's estimated there is a shortage of at least seven million affordable housing units. For these reasons, office-to-residential conversions appear attractive, a way to kill two birds with one stone and restore urban areas while increasing the housing supply. There are, however, several obstacles to the feasibility of these conversion projects.

These obstacles include:

- **Expensive to renovate**. Many downtown office buildings, especially those built after World War II, are not architecturally suited for conversion without dramatic changes to the floorplan. These buildings tend to have deeper floor plates, making it difficult to comply with requirements that each bedroom must have at least one opening window. Many conversion projects have seen developers hollow out the middle of the building to create a courtyard or blind shaft so as to avoid leaving an unusable middle portion of the building that lacks access to natural light. Many conversion projects also require the developer to update heating and cooling units to accommodate separate controls for each individual unit. Also, plumbing often has to be overhauled to serve kitchens and bathrooms in each new residential unit, as most large office buildings have central kitchens and bathrooms that serve an entire floor.

- **Regulatory issues**. It can be very costly and time-consuming to deal with zoning laws, which, in some cities, prohibit or limit housing in office districts. Most cities also maintain building codes that are different for offices than they are for residential buildings, so additional work may be necessary in order to ensure compliance with those codes.

- **Highest and best use**. Even with the decline in demand for downtown office space, office rents remain substantially higher than residential rents per square foot. Couple that with the cost to acquire and renovate a property for conversion, and it's easy to see why only a few conversion projects appear attractive to developers.

In light of these obstacles, many state and local governments are offering incentives intended to promote office-to-residential conversions. Additionally, the federal government has released a guidebook explaining several new programs designed to promote these conversions, especially where they are near public transit centers and/or where they would reduce emissions.

New federal programs that could enable developers to undertake an otherwise infeasible conversion project include:

- **HUD**. Office-to-residential conversions are now eligible for direct funding under HUD's CDBG program, and state and local governments are now able to access up to five times their annual CDBG allocation in low-cost loan guarantees to fund conversion projects.
- **DOT**. Two new programs, the Transportation Infrastructure and Finance Innovation Act (**TIFIA**) and Railroad Rehabilitation & Improvement Financing (**RRIF**) programs, offer financing at below-market interest rates for housing development near transportation, including conversion projects. Also, per the aforementioned guidebook, transit agencies may transfer properties to local governments, nonprofits, and for-profit affordable housing developers at no cost.

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- **DOE**. The DOE offers loan and guaranty programs, as well as tax incentives, that will help pay for renovations to reduce emissions and make "green" upgrades to existing commercial buildings. Many of these items are listed in this October 2023 blog from the U.S. Treasury.
- **Technical assistance**. All of the agencies listed above are offering technical assistance intended to aid developers seeking to take advantage of these tools. In some instances, the technical assistance funds may even be used to cover legal expenses**.**

These programs are in addition to state and local programs available in certain locations, as well as other longtime federal programs that might be available in certain conversion projects (such as LIHTC, opportunity zones, historic tax credits, and so on). Developers who are interested in pursuing an office-to-residential conversion should contact their legal counsel and determine which of these different incentives could be available to facilitate the project.