Could Office Conversions Solve the Housing Shortage?

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It's no secret that the United States is suffering from a historic housing shortage and it's only getting worse. With at least 3.2 million housing units (equal to 2.5% of the entire housing stock as of 2022) fewer than necessary, there does not seem to be a simple solution in sight. Several recent federal programs created by the Inflation Reduction Act of 2022 or recently refocused by federal agencies, along with a new proposed bipartisan tax bill commonly referred to as The Tax Relief for American Families and Workers Act of 2024 (the "Bill"), could spur housing unit production and development by incentivizing the conversion of existing office space to residential apartments and condominiums (an "Office Conversion"). The Bill passed in the House of Representatives by a 357 to 70 vote on January 31, 2024, and now moves to the Senate floor. Keep reading for a discussion of current Office Conversion activity as well as how these new and revised federal programs and the Bill may increase Office Conversions in the near future.

Continue reading the article below or watch this short video for key points and takeaways.

An article in *Time* notes that Office Conversions are projected to add 55,300 new housing units ("New Units") to the market in 2024, which is more than quadruple the number of New Units added in

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2021. The Bill would incentivize the adaptive reuse of existing office buildings and increase the number of New Units coming to market each year by way of Office Conversion, which investors and developers alike have traditionally viewed as cost prohibitive.

Currently, more office space is sitting empty in the United States than at any point since 1979. Commercial Edge estimated that the nationwide commercial office vacancy rate is currently 18.3% and surging to 25% in some of the most distressed markets. It also noted that the office market logged $33.8 billion in sales for 2023, down from $83.6 billion in 2022 sales, and that construction of new office space was down 35% in 2023 from 2022. As remote and hybrid work policies become the new norm, the demand for office space has decreased; according to *60 Minutes*, New York City alone currently has more than 95 million square feet of vacant office space. As firms prioritize the construction of new office space with modern, efficient designs, a large swath of vacant, or likely to become vacant, office space could be adapted to new uses to help remain viable – especially in commercial business districts in large cities.

With low or no demand for antiquated office space in the post-pandemic economy, the demand for residential space has surged and developers have begun targeting existing, outdated office buildings for rehabilitation and conversions. Office Conversions represent 38% of the 147,000 new housing units generated by adaptive reuse projects this year according to RentCafe. The U.S. Department of Housing and Urban Development (HUD) recently identified several key obstacles for real estate developers underwriting an Office Conversion. Among such concerns, HUD specifically flagged non-conforming uses under local zoning codes, potential building code violations, and materially different parking requirements; logistical concerns posed by building layouts and the centralized nature of plumbing and HVAC systems in high-rise buildings; financial challenges; and whether a local market's rents can support the relocation, rehabilitation, and conversion of a building for residential use.

Despite these potential challenges, many larger metropolitan areas are seeing drastic year-over-year rises in Office Conversion

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projects, with RentCafe noting that the Washington, D.C. metro area leads the nation with 5,820 projected New Units this year, which is an 88% year-over-year increase from 2023. The New York metro area, furthermore, is projected to build 5,215 New Units, which is an 18% year-over-year increase from 2023. The buildings to be converted this year are on average 72 years old – 20 years younger than the average existing Office Conversion building. This could lead to lower costs in the conversion process and alleviate some common concerns with Office Conversions, but it also potentially opens the door for developers to take advantage of Historic Tax Credit programs in building their capital stack.

Agencies are retooling existing government programs to support Office Conversion initiatives, with HUD allocating $10 billion of Community Development Block Grant (CDBG) Program funding to support pre-development, acquisition, and rehabilitation costs and empowering states and localities to access up to five times their CDBG allocation in low-cost loans to support Office Conversions. Along with HUD funding, the Department of Transportation (DOT) is offering $35 billion in below-market loans for qualifying, transit-adjacent development projects. DOT plans to release new guidance simplifying the process by which transit agencies can transfer government properties to cities, non-profit developers and for-profit developers to encourage the development of affordable New Units. Developers taking advantage of these no-cost land transfers can also obtain below-market loans from DOT to bolster their capital stacks, while also using existing subsidies programs potentially applicable to Office Conversions under the Inflation Reduction Act of 2022, including the New Energy Efficient Home Credit and Energy Efficient Commercial Buildings Deduction.

The Bill aims to, among other things, stimulate similarly successful Office Conversion projects by lowering the bond-financed threshold for any 4% Low Income Housing Tax Credit ("LIHTC") developments placed in service after December 31, 2023. Increasing capitalization rates on office buildings make them prime targets for adaptive reuse projects since their acquisition and conversion could be less expensive than land acquisitions and ground-up residential construction.

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As the housing shortage deepens and commercial office space vacancy rates concurrently grow worse, developers and investors could see a significant rise in Office Conversions. The Bill, and other government initiatives, seek to increase Office Conversion projects despite the challenges they face. Having already passed in the House by a wide margin, the Bill is now headed to the Senate for further consideration and another potential vote. Check back in for periodic updates on our Multifamily Matters Blog as the Bill progresses through Congress.

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