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'Supercharging' Office to Housing Conversions: New Federal Resources Available to Speed Conversion of Downtown Buildings

The future of office space and office to housing conversions have been hot topics for some time now, as municipal governments are embracing the idea of office to housing conversions by offering tax incentives to developers to help subsidize the often-prohibitive costs and expanding by-right zoning policies to ease the burden of entitlement processes.

In October 2023, the federal government also entered the game in a big way. The Biden administration launched a multi-agency effort to encourage states and cities to convert more empty office buildings into housing units, with billions of dollars now available to help spur such transitions. They even released a White House guidebook on commercial to residential federal resources, with over 20 federal programs across six federal agencies that can be used to support conversions, including low-interest loans, loan guarantees, grants and tax incentives for developers.

This new federal initiative involves the Department of Housing and Urban Development, the Department of Transportation, the Department of Energy, the Department of Treasury, the General Services Administration and the Office of Management and Budget in a multi-pronged effort to address the national shortage of affordable housing and the post-pandemic surplus of vacant office buildings. The $35 billion in lending capacity from federal agencies is intended to provide below-market rate loans to finance new housing construction and office conversions near transportation hubs. This year the Department of Transportation in particular will issue new guidance to states and municipalities on how to access funding through a pair of new federal programs – the Transportation Infrastructure Finance and Innovation Act (TIFIA) and the Railroad Rehabilitation & Improvement Financing (RRIF) programs. The GSA will also work with the Office of Management and Budget to identify surplus federal properties that could similarly be transferred for development into affordable housing units.

In summary, the federal government's new package of initiatives includes:

Department of Housing and Urban Development (HUD) – Community Development Block Grants (CDBG)

HUD has made conversions eligible for direct funding under the Community Development Block Grants program. To show how significant this is, this HUD guidance represents the first update to the CDBG program in 15 years, and HUD has also increased outreach efforts to support municipalities and developers seeking to use HUD tools to finance conversions. States and localities can access up to five times their annual CDBG allocation in low-cost loan guarantees to fund conversion projects. HUD is also accepting applications for the $85 million Pathways to Removing Obstacles to Housing Program, which includes the development of adaptive reuse strategies and the financing of eligible conversions. In addition to directly offering lower than market rate interest loans, CDBG funds may also be used as loan guarantees to encourage lending institutions to offer more favorable rates and boost markets facing disinvestment.

Department of Transportation (DOT) – TIFIA and RRIF Loan Programs

As noted above, the Department of Transportation has two new federal programs, the Transportation Infrastructure and Finance Innovation Act (TIFIA) and Railroad Rehabilitation & Improvement Financing (RRIF) programs, which combined have over $35 billion in lending capacity for transit-oriented development projects at below market interest rates that can be used to finance housing development near transportation, including conversion projects. This year, the DOT is expected to release guidance making it easier for transit agencies to repurpose properties for transit-oriented development and affordable housing projects, including conversions near transit. Under the new guidance, transit agencies may transfer properties to local governments, non-profit and for-profit developers of affordable housing at no cost. The new policy has the potential to turn property no longer needed for transit into affordable housing development, particularly when combined with loans from TIFIA or RRIF programs. The DOT will also launch technical assistance to support municipalities and developers seeking to use DOT tools to finance conversions.

The push to place housing near transit aims to, among other things, 1) decrease single-occupancy vehicle travel, 2) increase affordability, 3) limit construction of wasteful parking infrastructure, etc. and 4) to align the goals of affordability and sustainability that urban municipalities have been avidly pursuing in recent years. The financial support of the federal government in achieving these aims is a heartening step toward true transit-oriented development and redevelopment.

Department of Energy (DOE)

The Department of Energy's Better Buildings Initiative includes a toolkit with technical and financial guidance on how to achieve zero emissions on commercial to residential conversions. The DOE's loan and guarantee programs and tax incentives through the Inflation Reduction Act, such as the new energy efficient home tax credit (45L), the energy efficient commercial buildings tax deduction(179D), and the clean energy investment tax credit (48), will help to pay for more sustainable (and often more costly) "green" building system upgrades in aging office buildings in office to residential conversion.

General Services Administration and Office of Management and Budget

The General Services Administration (GSA) is expanding on its Good Neighbor Program to promote the sale of surplus federal properties that buyers can potentially redevelop for residential use. The GSA will work with the Office of Management and Budget (OMB) to identify current and upcoming sale opportunities and will maintain a list of current opportunities. Such programs may have additional positive externalities like relieving the pressure caused by land shortages (particularly in urban centers) and lowering government costs of maintaining surplus or unused property.

Department of Treasury

In October 2023, the Treasury launched a blog that describes tax incentives available through the Inflation Reduction Act that can be used for conversions.

PROS AND CONS

Should the federal government be encouraging conversions despite often-prohibitive costs and the proven design and underwriting challenges?

PRO #1: Converting Underused Commercial Buildings to Residential Can Reduce Carbon Emissions

Nearly 30 percent of carbon emissions come from the building sector. According to an Arup report released in early December, as an example, if New York City expanded zoning eligibility for office to housing conversions, this could result in up to a 54 percent reduction in whole life carbon emissions by 2050. The Arup study concluded that the significant carbon savings attainable from office to residential conversions should urge policymakers to expand eligibility for conversions. Office to housing conversions could contribute to decarbonization goals and to greener, more inclusive cities for everyone.

PRO #2: Conversions Could Help Solve the Affordable Housing Crisis

While office vacancies have reached a 30-year high, housing supply is constrained and rents in most major cities are at a record high. Conversions could create more housing affordability by increasing supply.

CON #1: Conversions Are as Expensive as Ground-Up Construction

Even with the new federal programs outlined above, many critics say office to residential conversions are not practical or economically feasible even with subsidies. Discussions about the desirability of office to residential conversions are therefore ongoing. The Brookings Institution has even created a calculator to estimate the feasibility of a conversion in selected major metro areas. The interactive calculator was launched in November 2023 and can help determine which conversions are viable without a subsidy, and, if not viable without a subsidy, how big the subsidy needs to be to make a conversion viable. The calculator also helps policymakers assess the financial cost to investors of requiring a greater share of affordable housing in the conversion.

CON #2: Design Challenges

Many office buildings are not physically suited for conversion. Since most office buildings are laid out differently from residential spaces, some developers estimate that only about one in 20 office buildings is actually a good candidate for conversion to housing. Because of this, a common criticism of office to residential conversion is that while they seem promising theoretically, they are difficult to execute and unlikely to turn a profit. Underwriting generally takes twice as long. One of the biggest costs in such conversions is the conversion of the façade. Many conversions attempt to minimize the façade work to make it more economically feasible, but this is problematic due to the minimum window requirements for natural light in the converted units. Allowing for smaller windows would make conversions easier and more attractive. Elevators and related infrastructure are another issue. Conversions typically require elevator shafts to be upsized, necessitating structural modifications with significant costs making conversions infeasible. Requirements for additional staircases are yet another design issue with conversions.

Furthermore, often, local zoning regulations pose challenges to office to residential conversion. Density restrictions in "as of right" zoning can limit the number of units in a given building, resulting in unused or underutilized space. Parking requirements and restrictions on ground floor uses are also barriers to redevelopment. However, amending such regulations requires engaging in lengthy entitlement processes, which can impose costly affordability, sustainability and wage-related requirements to already expensive conversions.

As municipalities adjust their policies in these areas, there is hope that local and federal requirements could align so that developers can avail themselves of multiple tiers of incentives and credits simultaneously to help projects make financial sense.

Conclusion

This new year, it remains to be seen how much federal subsidy and the technical assistance and outreach provided by federal agencies, coupled with new tools like the Brookings Institution's new interactive calculator, will help developers determine what an office-to-apartment conversion will actually cost, and if including affordable units is feasible. The new federal subsidies available are a step in the right direction in getting conversions to "pencil out," and more outreach and technical assistance could accelerate conversions, which would contribute to the creation of greener and more affordable housing. Fostering adaptive reuse across the country will require concentrated efforts and collaboration at all levels of the private sector and government.

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