

# A PACIFIC NORTHWEST VIEW OF OFFICE-TO-RESIDENTIAL CONVERSIONS



**MAREN CALVERT** is a shareholder at Schwabe, Williamson & Wyatt, PC, in the firm’s Real Estate & Construction Industry Group. Her practice provides comprehensive land use legal advice to commercial and industrial developers throughout Oregon and Washington. Maren’s background in public policy, government relations, commercial litigation, and administrative law equips her to counsel her clients on how to think strategically and engage government in regulatory, legislative, and judicial settings. She is a member of the American Bar Association Section of Dispute Resolution and a board member of the Association of Washington Business (AWB). She currently serves as Chair of the Governments Affairs Council, Board Member, and Executive Board Member for AWB.



**JULIE WILSON-MCNERNEY** is of counsel at Schwabe, Williamson & Wyatt, PC, serving the firm’s Real Estate & Construction; Natural Resources; and Consumer Products, Manufacturing & Retail Industry groups. She represents private and public owners and developers of large retail, office, sports and entertainment, industrial, energy, multifamily residential, and other commercial projects. These projects often entail navigating complex regulatory requirements; appropriately scaled environmental review; and thoughtful negotiations with agencies, Native American tribes, and project neighbors. Julie is a member of the Transportation Research Board, AJL20 Standing

Committee on Transit and Intermodal Transportation Law, Urban Land Institute (ULI), and ULI’s Transportation-Oriented Development Product Council. She’s currently serving as co-chair of the AJL50 Standing Committee on Environmental Issues in Transportation Law. In 2023, Julie was selected to the Washington Super Lawyers Rising Star List in Land Use and Zoning and has received two honorable mentions for Best Paper from the American Bar Association.

Oregon and Washington are not alone in their desperate need for 550,000<sup>1</sup> and 1,100,000 new housing units<sup>2</sup> within the next 20 years, respectively. The entire nation continues to struggle with a lack of housing supply.<sup>3</sup>

Meanwhile, many states—including Washington and Oregon—have hundreds of thousands of square feet of empty office space. Perhaps the solution is to convert empty post-COVID office space to residential flats. The Washington State Legislature, and various other states, including New Jersey and New York, seem to think so.

In 2023, the Washington State Legislature passed several bills to increase housing density and streamline permitting, including a bill that allows underutilized commercial office space to be converted to residential units, regardless of zoning classifications and land use and permitting barriers.<sup>4</sup>

Even cities are getting into the action. Seattle City Council unanimously passed legislation earlier this year that exempts conversions from design development standards and the city’s Mandatory Housing Affordability requirements.<sup>5</sup>

These state and local laws and incentives pair nicely with recent federal legislation that establishes and revises grant and preferential loan programs to help fund such office-to-residential conversions. This article will discuss those federal grant and loan programs that are open to nonprofit and private entities, analyze the need for change, and consider whether the proposed changes will be sufficient to provide the housing these communities so desperately need.

## FEDERAL PROGRAMS

In October 2023, the White House released a guidebook of available federal resources for commercial-to-residential conversions.<sup>6</sup> The

guidebook identifies 19 federal programs from the Department of Energy (DOE), the Department of the Interior, the Department of Transportation (USDOT), the Environmental Protection Agency (EPA), Housing and Urban Development (HUD), the Department of Agriculture, and the Department of the Treasury (Treasury). These programs are divided into two groups: (i) those that increase project affordability; and (ii) those that assist with the creation of zero-emissions buildings. This article focuses on the former. New federal opportunities to increase project affordability are as follows:

- Grants to cover pre-development, acquisition, construction, and other costs (HUD's Community Development Block Program);
- Below-market loans for office-to-residential conversions near transportation (USDOT's Transportation Infrastructure Finance and Innovation Act (TIFIA) and Railroad Rehabilitation and Improvement Financing (RRIF));
- Land dispositions that can reduce development costs (USDOT regulations that allow transit agencies to transfer surplus property to local governments, nonprofit, and for-profit developers of affordable housing);
- Tax incentives that fund conversions of historic buildings (Rehabilitation Tax Credit); and
- Tax incentives that fund energy-efficiency improvements (Section 45L New Energy Efficient Home Credit).

### **HUD Programs**

The HUD office administers the Community Development Block Grants (CDBG) program. CDBG provides funds to state and local governments who distribute money to CDBG applicants as either loans or grants. The money can be used to acquire, rehab, reconstruct, and convert commercial properties to residential and mixed-use properties. CDBG funds are not restricted to any particular locality. However, they are allocated to local or state governments who apply for the funds and distribute them using HUD's formulas to developers, nonprofits, or

smaller units of government. To be eligible for this program, states or metropolitan cities must have populations of at least 50,000. Qualified urban counties with populations of at least 200,000 may also apply. CDBG funds are expended to further the national objective of the project: to provide low-to-moderate-income benefits, to eliminate slums and blight, or to respond to a qualified urgent need. CDBG funds include an affordability requirement. If the grantees are creating rental units, they must provide affordable rates.

Similarly, if a unit is sold for purchase, the purchase price must represent a reasonable cost for low-to-moderate income households. Funding requires that the government entity that receives the funding comply with the National Environmental Policy Act (NEPA), the Davis-Bacon Act, the Build America, Buy America Act, and the Uniform Relocation Assistance and Real Property Acquisition Policy Act (Uniform Act).<sup>7</sup> Most states have received CDGB grants. A list of CDBG grantees can be found on the HUD Exchange website.<sup>8</sup>

### **USDOT Programs**

The USDOT administers two location-restricted programs. Both programs are designed to encourage residential development—including office-to-residential conversions if the resulting residential units are close to public transportation. Restricting or incentivizing residential development near public transportation is called Transit-Oriented Development (TOD).

As stated above, the USDOT administers funds available under TIFIA. TIFIA provides preferential loans and loan guarantees for TOD projects that: (i) improve or construct public infrastructure within walking distance (i.e., 0.5 miles) of, and accessible to, a fixed guideway transit, intercity or passenger rail, intercity bus station, or intermodal facility; (ii) projects for economic development, including residential housing, that are physically or functionally related to a passenger rail or multimodal station which includes rail service, and that improves or adds public infrastructure; and (iii) TOD projects

that qualify as joint development projects between a public transit agency and a non-transit private developer in the form of residential, commercial, and mixed-use projects.<sup>9</sup>

Project Types 1 and 2 must incorporate private investment, be shovel-ready, and generate revenue that exceeds costs for the related transit station or service. Project Type 3 requires that the development: (i) create an economic benefit; (ii) create a transit benefit; (iii) provide a fair share of the revenue for transit; (iv) entail occupants who pay a fair share of the costs to operate/maintain; and (v) include collection of fees by the sponsor for use of ZEV fueling equipment, if installed.

The minimum project cost for this program is \$10 million; there is no maximum loan size or project cost. A TIFIA loan can finance up to 49 percent of project costs (if eligible). Eligible project costs include development phase activities; construction, reconstruction, rehab, replacement, and acquisition of real property; and capitalized interest needed to meet market requirements, reasonably required reserve funds, capital issuance expenses, and other carrying costs during construction. The rate on the TIFIA loan is fixed and roughly equal to the yield on US Treasury securities with comparable maturity. TIFIA funds come with requirements to comply with the following federal laws: NEPA; Build America, Buy America; the Davis-Bacon Act; and the Uniform Act. TIFIA funds may be lent directly to a private entity with a public sponsor. The average time from application to financial closing is 12 months. Loans can have up to a 35-year repayment period. TIFIA currently has more than \$70 billion in lending capacity.

The USDOT also administers the RRIF program, which provides below-market direct loans and loan guarantees for commercial and residential development near commuter rail or intercity rail stations.<sup>10</sup> These funds are slightly more restricted than TIFIA money. The costs that are eligible for RRIF loan financing must: (i) incorporate more than 20 percent private investment in total project costs; and (ii) be physically connected to or inside one-half

mile of a fixed guideway transit station, an intercity bus station, a passenger rail station, or multimodal station—provided the station includes service by a railroad.<sup>11</sup>

The applicant must demonstrate an ability to begin contracting within 90 days of RRIF funds becoming obligated and must demonstrate the project will generate new revenue for the relevant passenger rail station. Loans can have up to a 35-year repayment period. Unlike TIFIA, there is no maximum or minimum project cost, and up to 75 percent of eligible costs can be financed by an RRIF loan. The average time from application to financial closing is 12 to 18 months. RRIF currently has more than \$30 billion it can lend.

As of April 18, 2024, both the TIFIA and RRIF programs had a 3.48 percent interest rate. These federal funds are encouraging and may allow a project to be financially feasible (or to “pencil”).

### **USDOT Asset Disposition**

The National Defense Authorization Act for Fiscal Year 2022 added a new disposition option for assets acquired with federal funds that are no longer needed for the originally authorized purpose.<sup>12</sup> The Federal Transit Authority can now authorize the transfer of surplus property purchased with federal funds to local government authorities, a nonprofit organization, or private developer—if, among other factors, it will be a necessary component of a TOD project that includes affordable housing and will increase transit ridership. This program requires that: (i) at least 40 percent of the housing units in the TOD are legally binding affordable housing units restricted to tenants or owners with incomes less than 60 percent of the area median income (AMI); and (ii) at least 20 percent of these units must be reserved for tenants or owners with incomes less than 30 percent AMI. The residential property must also remain in use for at least 30 years after the date the property is transferred. The transfer of real property acquired with federal assistance under this statute incurs no further obligation to the government.<sup>13</sup>

## Tax Credit Programs

The National Park Service (NPS) offers a Historic Rehabilitation Tax Credit for the rehab of historic buildings. A 20 percent federal income tax credit is available for qualified expenses related to the certified rehabilitation of historic buildings that are determined by the Secretary of the Interior, through the NPS, to be “certified historic structures.”<sup>14</sup> A “certified historic structure” is a building that is listed individually in the National Register of Historic Places (NRHP) or a building located in a registered historic district and certified by the NPS as contributing to the historic significance of that district.

The application process involves three parts. In Part 1, the property owner submits an application to the State Historic Preservation Office (SHPO) that includes a request for the property to be listed on the NRHP, unless it is already listed.

In Part 2, the property owner applies for certification of the rehab work. The SHPO reviews and provides a recommendation to the NPS, which reviews the project for conformance with the Secretary of the Interior’s Standards for Rehabilitation. The entire project is reviewed, including related demolition and new construction; and is certified, or approved, only if the overall rehabilitation project meets the standards. The SHPO and the NPS may require changes to the construction methods or project design to preserve the historic character of the building.

In Part 3, the NPS evaluates the constructed project against the proposed project to confirm that the project was built as approved. Qualified rehabilitation expenditures include costs of the work on the historic building, as well as architectural and engineering fees, site survey fees, legal expenses, development fees, and other construction-related costs, if they are added to the property basis and are reasonable and related to the services performed. As much as 20 percent of these costs may be claimed as a tax credit. The tax credit is typically claimed the year the building goes back into service; or, if it remains in service during the rehab, the tax credit is claimed when Part 3 is completed. Tax credits lower

the amount of tax owed; therefore, in general, one dollar of tax credit reduces the amount of income tax owed by one dollar. Tax credits may be carried back one year and carried forward for up to 20 years. The Part 1 and 2 processes can take a year or more, with the Part 3 approval granted only after construction is finished.

The Section 45L New Energy Efficient Home Credit provides a tax credit for new and substantial reconstruction and rehab of existing energy-efficient homes that meet either EPA’s Energy Star certification or DOE’s Zero Energy Ready Homes certification.<sup>15</sup> Commercial-to-residential conversions that are eligible to participate in the Energy Star Multifamily New Construction program may be eligible for this tax credit. The section 45L New Energy Efficient Home Credit provides up to \$2,500 for multifamily dwelling units certified to an eligible version of the EPA’s Energy Star Multifamily New Construction Program, and up to \$5,000 for units certified to the applicable Zero Energy Ready Homes program. The tax credit is available to the “eligible contractor.”<sup>16</sup> An eligible contractor is the individual or entity that: (i) constructed or substantially reconstructed and rehabilitated the qualified home; and (ii) owned and had a basis in the qualified home during its construction or substantial reconstruction and rehabilitation. Multifamily projects that receive this tax credit must meet prevailing wage requirements.

The Section 179D Energy Efficient Commercial Buildings Deduction provides a tax deduction of up to five dollars per square foot for energy-efficiency improvements to commercial buildings and multifamily buildings greater than three stories.<sup>17</sup> This deduction is available to owners and long-term lessees of commercial buildings and multifamily buildings greater than three stories. A tax credit differs from an income tax deduction. An income tax deduction lowers the amount of income subject to taxation, whereas a tax credit reduces the amount of tax owed. A project is eligible if it is a retrofit of a building at least five years old or new construction. The amount of tax deduction is based on whether the project meets prevailing wage and registered apprentice requirements.

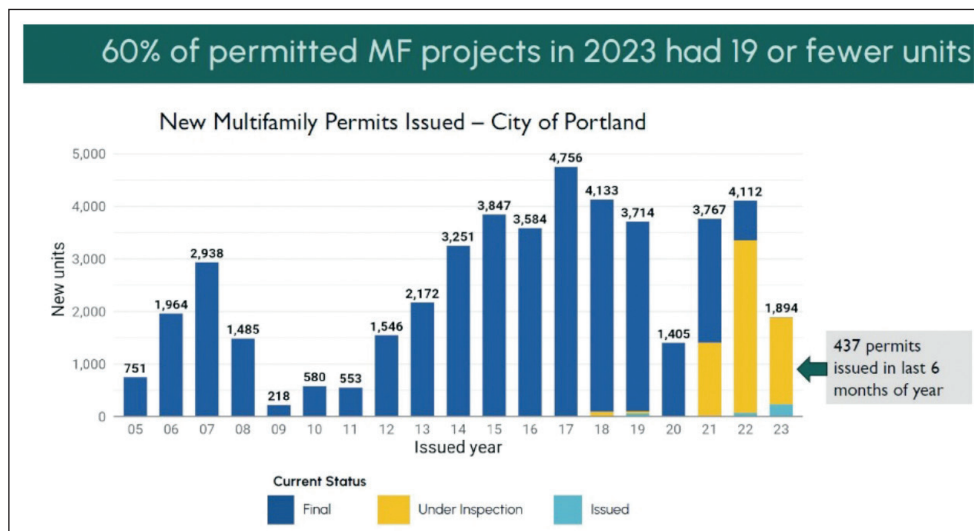


## WHY IS THE NEED SO GREAT?

The housing crisis in 2008 compelled the US residential development market to slow down significantly. Meanwhile, short-term rental units increased across the nation, which reduced the availability of housing units for non-vacation use. The market started to recover, but COVID dealt another deadly blow, halting all construction in many states and causing a supply-chain crisis of

previously unknown proportions. Construction costs skyrocketed.

In the post-COVID era, residential construction has resumed, but not quick enough to satisfy demand. Last year, the number of multifamily permit applications in the Portland, Oregon, was less than *half* the number of permit applications filed the year before. Even then, 60 percent of those applications were for 19 units or fewer.<sup>18</sup>



Admittedly, Portland is not necessarily representative of the nation as a whole. Portland received a fair amount of negative press during the COVID and post-COVID years. Oregon lost more than 1,000,000 residents between 2010 and 2024 and had negative population growth in 2022 and 2023.<sup>19</sup> These are the first population losses in Oregon in 40 years and would be only the fourth and fifth losses since World War II.

Portland's political scene has gone through significant turmoil and the city is struggling to recover. In February 2024, Portland was ranked 51 out of the top 80 cities for development opportunity. That number is an improvement from 2021, when

only 20 percent of those surveyed reported a favorable view of developing in Portland, but it still illustrates that developers would choose 50 other cities before choosing to develop in Portland.<sup>20</sup>

Portland is not alone. Apartments under construction in the Puget Sound Region near Seattle are also down 17 percent, even though Seattle remains in the top 10 favorite cities for development opportunities.<sup>21</sup> In 2023, Seattle set a new record for housing production, with 12,835 new homes constructed, a 21 percent increase over 2022 and the most homes built since at least 2005.<sup>22</sup> However, as in Portland, Seattle's permit applications for housing have dropped by 71 percent from their 2020 peak.<sup>23</sup>

Meanwhile, the central city region of Portland has more than double the amount of vacant office space it had pre-pandemic.<sup>24</sup> Leasing volume is also down to less than half the pre-pandemic rate.<sup>25</sup> Given that the shift to hybrid or remote work is here to stay, downtown office buildings will either thrive or struggle based on their newness and amenities. Newly constructed Class A office space is projected to remain competitive while the older, less attractive Class B or C office buildings will struggle to find or keep tenants.<sup>26</sup>

The office space exists, and it is not being used. It likely will not ever be occupied at pre-pandemic rates seen. If the bones are there, why not simply convert office space structures to residential uses?

### WILL IT BE ENOUGH?

In February 2024, ECONorthwest reported a “nearly daily stream” of news articles related to office-to-residential conversion projects. We have seen similarly frequent publication rates.<sup>27</sup> The pipeline of these conversions has more than doubled in the past four years. The most activity has occurred in Washington DC.

**Planned Office-to-Apartment Conversions by Metro Area**

	Metro Area	2024 Office-to-Apartments Pipeline	Office-to-Apartments Pipeline Y-o-Y % Change	Share of Office-to-Apartments 2024	Total Future Conversions
1	Washington, D.C.	5,820	88%	65%	9,021
2	New York, NY	5,215	18%	45%	11,485
3	Dallas, TX	3,163	58%	83%	3,833
4	Chicago, IL	2,822	-9%	55%	5,140
5	Los Angeles, CA	2,442	6%	37%	6,660
6	Cleveland, OH	2,012	-10%	63%	3,210
7	Cincinnati, OH	1,563	-6%	81%	1,919
8	Kansas City, MO	1,510	84%	50%	3,033
9	Atlanta, GA	1,422	40%	52%	2,713
10	Phoenix, AZ	1,377	114%	63%	2,172
11	Minneapolis, MN	1,334	13%	59%	2,244
12	Detroit, MI	1,070	40%	27%	3,905
13	Columbus, OH	1,006	35%	58%	1,740
14	Philadelphia, PA	975	136%	19%	5,092
15	Seattle, WA	973	5%	46%	2,138
16	Birmingham, AL	942	41%	50%	1,875
17	Hartford, CT	930	61%	37%	2,523
18	Milwaukee, WI	911	-8%	41%	2,217
19	Denver, CO	902	0%	36%	2,528
20	Charlotte, NC	864	8%	45%	1,925

The data shows office-to-apartments currently under conversion, planned or prospective. Data is subject to change.  
Table: RentCafe • Source: Yardi Matrix • [Get the data](#) • [Embed](#) • [Download image](#) • Created with [Datawrapper](#)

Seattle's first proposed office-to-residential conversion since the pandemic appears to be moving forward without federal funding.<sup>28</sup> The city of Philadelphia recently *completed* an office-to-residential conversion without federal funding.<sup>29</sup> Further north, two office-to-residential projects are underway in Calgary.<sup>30</sup>

Although these projects are promising, the number of buildings suitable for conversion and the units that have been created by office-to-residential conversions are not enough to make a noticeable difference. In 2021, there were 12,100 units of office-to-residential conversions, and in 2024, those applications jumped to 55,300. Unfortunately, that averages to just over 1,100 apartment units per state. There is only one proposed project in the Seattle area: a 618-apartment-unit project as part of the Renton City Hall Redevelopment project. Portland has zero office-to-residential conversions.

## WHY ARE DEVELOPERS SO RESISTANT?

Office-to-residential conversions are not easy, cheap, or the right fit for each vacant or semi-vacant downtown office building. Additionally, economic conditions are making financing office-to-residential conversions challenging and are reducing the return on investment (ROI) for projects that require new construction. According to ECONorthwest, investors are more likely to put their money toward the purchase of an existing apartment building than they are to incur the high construction costs associated with conversions. Put differently, high construction costs are making it difficult for developers to make the business case to lenders and investors that they should invest their money in new construction when they can invest in existing construction that could have a higher ROI. The federal funds rate remains stubbornly high at between 5.25 and 5.5 percent, which is more than double pre-pandemic interest rates, while construction costs across the nation continued to rise. The cost of construction is up 2.2 percent over the past year nationwide, but the cost varies by region. For example, in 2023, Seattle construction costs increased 2.7 percent, while Portland's construction costs remained relatively

flat with a 0.1 percent increase.<sup>31</sup> With interest rates so high and construction costs volatile, investors see existing construction as a better bet.

An additional reason for the stilted growth is logistical. The plumbing needs for residential units (e.g., multiple bathrooms and multiple kitchens per floor) are significantly different from those for typical offices. Plumbing infrastructure costs money. Internal office spaces used for large storage rooms or servers and data storage typically have no windows or outside walls. Few apartment dwellers desire an apartment unit with those features. The floors often have to be reconfigured. Developers, however, have gotten creative in addressing these challenges. The Franklin Tower in Philadelphia placed building amenities in the core of the building and spread them throughout multiple floors, instead of building a single amenity floor, which has been more typical.<sup>32</sup>

Another reason is the cost of conversion. Given the logistical challenges, costs to convert office buildings to residential can be high. A recent study of the San Francisco market found that conversions there cost between \$472,000 and \$633,000 per unit due to seismic upgrades required by code.<sup>33</sup> Some experts believe that conversions cannot be successfully used to provide affordable housing, given the costs involved.<sup>34</sup> Even for conversions to market-rate housing, some experts believe the costs to convert would be too high without significant public funding.<sup>35</sup>

A fifth reason is a lack of supply of suitable office buildings. Studies of urban downtowns have found that the amount of convertible space is not enough to make significant strides to solve the housing crisis. For example, in Denver, potentially convertible office buildings offer 1.5 million square feet of space, or 1,500 apartments at an average of 1,000 square feet in size. This would be enough to meet only 11 percent of Denver's housing needs.<sup>36</sup> In San Francisco, only 12 office structures have been identified as convertible.<sup>37</sup> The buildings could provide 2,700 housing units, which will barely exceed three percent of San Francisco's housing needs by 2030.<sup>38</sup> In Boston, architecture firm Gensler

has identified just 10 of 84 buildings that merit consideration for conversion.<sup>39</sup> Although Gensler acknowledges the number is low, the firm remains bullish about conversions, stating even a small percentage of converted underutilized office space could make a dent in the housing crisis.

A sixth reason is systemic. Experience has shown that current and impending building and fire code requirements can render a conversion project infeasible. In March 2024, the Washington State Building Code Council adopted their version of the 2021 International Energy Conservation Code, which increases green building requirements to make the most environmentally restrictive building code in the nation even more restrictive.<sup>40</sup> In addition, the Washington legislature enacted other bills in 2023 that require municipalities to revise their land use planning processes for affordable housing and climate change impacts.<sup>41</sup> Though these requirements are not objectionable on their own, the increased requirements were not accompanied by increased funding.<sup>42</sup> At least one city in Washington reports that their efforts to comply over the past year have exceeded \$1 million in additional cost.<sup>43</sup>

### **CAN FEDERAL AND STATE LEGISLATION HELP?**

Think tanks argue that financial incentives and a streamlined entitlements process are likely to be most helpful in encouraging office-to-residential conversions.<sup>44</sup> Not all financial incentive programs are equal, however.

In the four months after the White House expanded the RRIF program described above, no TOD loans closed, but three are in the active underwriting phase.<sup>45</sup> Developers have criticized the RRIF program for taking too long to close on loans—roughly 18 to 24 months, compared to 60 to 90 days for a traditional real estate financing deal. The RRIF program also subjects the project to NEPA review, which could increase time to close by another two to four years and could tack on hundreds of thousands or millions of dollars to the project's price tag. RRIF financing may also require the borrower to obtain a national credit rating to avoid a credit risk premium

of up to 15 percent of the total loan cost. Various municipalities have called on the White House to change the RRIF program for TOD developments by reducing the closing period to six months and eliminating NEPA review.<sup>46</sup> Pittsburgh currently has \$300 million in shovel-ready conversions within its downtown core, but there could be potentially \$1 billion more if developers can obtain the right type of funding.

Historic rehabilitation tax credits can make projects pencil that otherwise would not, given the generous nature of the one dollar to one dollar reduction in income tax owed. However, these credits require that the building at issue be designated a historic building eligible for the National or State Register of Historic Places. This designation can limit a developer's ability to alter the property without obtaining approval from the NPS or the SHPO. In the case of federal tax credits, the NPS reviews the project's design and might request changes to the design to better preserve the historic elements. Some developers may not appreciate such oversight and development restrictions on their property.

The Washington legislature enacted statutes that authorize municipalities to share staff and resources.<sup>47</sup> The legislature required the Department of Commerce to develop land use and permitting software to support local, smaller communities in their efforts to comply.<sup>48</sup> The legislature prohibited municipalities from requiring a new State Environmental Policy Act (SEPA) analysis for commercial-to-residential conversions;<sup>49</sup> excluded middle housing from SEPA review;<sup>50</sup> and imposed permit processing deadlines on local governments.<sup>51</sup>

The Washington state legislature's changes are a good start, but additional legislative and administrative code changes may be necessary—or at least advisable—before office-to-residential conversions can become a fiscal and logistical reality. 📌



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## Notes

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- 9 23 U.S.C. § 601 et seq.
- 10 US Dep't of Treas., Railroad Rehabilitation & Improvement Financing (RRIF), available at <https://www.transportation.gov/buildamerica/financing/rrif>.
- 11 49 C.F.R. pts. 80 and 260.
- 12 49 U.S.C. § 5334(h); see also Federal Transit Administration, Interim Asset Disposition Guidance (2024), available at <https://www.transit.dot.gov/funding/funding-finance-resources/interim-asset-disposition-guidance>.
- 13 States may have their own provisions. Washington State allows a regional transit authority to transfer surplus property if a minimum of 80 percent of the surplus property to be disposed or transferred, including air rights, is suitable for development as housing. The property must first be offered for either transfer at no cost, sale, or long-term lease to qualified entities that agree to develop affordable housing on the property, consistent with local land use and zoning laws. RCW 81.112.350.
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