

## **“Can You Make a Killing in Condo Conversions?”**

**~ Look Before You Leap~**

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Condo conversions have become a hotly debated issue within the broader discussion of affordable housing in San Diego County. Condo conversion is the process by which existing apartment rental units are sold off individually as condominium units. Some argue that the conversion of thousands of units in recent years (1,449 in the city of San Diego alone since 1999) has had a negative impact on affordable housing because the converted units have been removed from rental inventory. Others contend that the reduction in rental units is offset by a corresponding reduction in renter demand, under the theory that the newly converted condos are purchased by buyers who would otherwise be renting apartments somewhere in the county. Moreover, the proponents state, overall housing affordability is enhanced by a greater supply of condominiums, which creates more opportunity for homeownership at the more affordable levels.

As evidenced repeatedly at public hearings, and by increasing limitations in the conversion approval process within the City of San Diego, the controversy has escalated and conversion proposals are receiving forceful opposition from community groups and heightened scrutiny from city planners.

What does this mean for the owners of rental units? If you own apartments and are considering converting them to condominiums, there are several risks that should be carefully evaluated before undertaking a conversion. The risks of condo conversion for the apartment owner include the following:

**Regulatory approvals** may prove unobtainable, even after significant investment of time, money and general wear and tear on the applicant. Few communities in the county are “conversion friendly,” meaning that without an existing condo map, most jurisdictions will not grant new subdivision maps without extracting conditions and/or fees that render the project unfeasible. If a property already has a recorded condo subdivision map, the owner must submit CC&Rs, organization articles and bylaws and the homeowner association budget to the DRE in order to obtain a Final Subdivision Public Report, commonly known as the “white report.” Dealing with the DRE can be daunting; if documents are not compiled in a manner to minimize the likelihood of revision (this is a recipe that is closely guarded by successful converters), the resulting delays can penalize the anticipated profit margins.

**Tax consequences**, resulting from treatment of gains on condo conversions as ordinary income, can take a huge bite of the benefit. When you convert apartments into condos, the IRS will consider you a dealer, and *your profits will not be eligible for capital gain treatment or deferral in a 1031 exchange.* Given the tax consequences, owners of mapped property are often better off selling apartments and deferring capital gain in an exchange.

**Construction liability** is perhaps the single greatest unknown (read “risk”) factor for experienced and novice converters alike. Our litigious society guarantees full employment for developers’ defense attorneys. The statute of limitations on defect claims for all new construction, including renovations and building code compliance runs for 10 years. Attorney Lorne Polger, who heads the real estate practice group at Procopio, Cory, Hargreaves and Savitch, stresses that condo converters must carefully address aspects of seller disclosures, warranties, defect liability insurance, as well as the legal structure of the converter entity in order to layer in liability protection to the extent possible.

**Tenant notification** of the conversion must occur 6 months in advance, and tenants must have the right of first refusal on the purchase of condo units.

**Financial assistance** to displaced tenants may be required depending on the local jurisdiction. Some municipalities in the county, such as Carlsbad, discourage condo conversion by requiring relocation assistance of up to a year’s rent for each tenant. This practice is likely to spread, not for the purpose of denying conversion per se, but in response to concerns from tenants’ rights and affordable housing activists.

In other parts of the country, where the condo conversion phenomena has preceded the current level in San Diego County, most municipalities have required converters to fund relocation expenses, including moving costs and several months rent expense, for displaced tenants. This has increased the cost of conversion significantly. Bob Szolomayer, a local engineer who has managed conversions of more than 500 units in the past 3 years before joining Maisel-Presley, Inc., projects it is only a matter of time before the same regulations are imposed here. Indeed, the San Diego City Council is currently considering a proposal requiring compensation to displaced tenants if their income is below the area median income, and when the average vacancy is below 7%.

**Project management** of a condo conversion project (essentially the transitioning of a cash flow asset into a for-sale asset) requires multi-tasking extraordinaire. Two key areas which must be juggled simultaneously include:

**Tenant relationships:** During the conversion process, which often occurs in phases, the property continues to be operated as apartments in order to generate cash flow that defrays the costs of conversion. If your tenants panic and vacate ahead of schedule, the interim cash flow you were counting on can evaporate. Compliance with detailed regulations and lengthy time requirements for advance tenant notification of their rights with respect to conversion, combined with the need to manage occupancy, requires active management of tenant relationships and communication.

**Construction management:** Phasing of the conversion process to (a) preserve the living environment for continuing tenants (thus protecting cash flow), and (b) maximize construction efficiencies (thus controlling conversion costs) is a critical balancing act required to achieve projected profit margins. Converters must evaluate which improvements will have the greatest economic benefit, and where expenditure can be cut back without sacrificing the overall outcome. For example, if the apartment units have "popcorn" ceilings, the converter must evaluate the most cost-effective remedy. Removal of the coating is expensive due to the asbestos hazard. Less expensive alternatives such as painting and sealing, or applying drywall over the popcorn surface, will improve the appearance but the converter will still have to disclose the presence of asbestos.

**Financing and insurance** conventions fall outside the typical structure for apartment properties. Traditional apartment lenders do not finance condo conversion projects. A typical conversion loan, similar to a development loan, has release clauses so that the loan gets paid off in phases as the units are sold. It is very difficult to obtain conversion financing without a successful conversion track record. Often first-time converters must use equity funds only or borrow against other personal assets. Construction liability insurance, which protects the converter as well as contractors, is also difficult to obtain without conversion experience. If insurance cannot be obtained, contractor availability becomes limited, as many require the developer to provide such insurance, known as wrap coverage.

## **Conclusion**

Many owners of rental property, both with and without an existing condo map, have been seduced by the prospect of reaping huge profits from selling off individual units as condos at prices up to 70% above their value as rental units. Anyone who has even started the process has learned that the conversion process is not for the faint of heart. Those who have completed the process know that anticipated profit margins can prove elusive once the actual costs of construction, engineering, insurance, money and management are tallied. The ultimate profit is further eroded by taxation at ordinary income tax rates and the unknown future cost of construction defect claims. Before embarking on a condo conversion, apartment owners are well advised to consult their real estate advisors who can refer them to engineering, tax and legal professionals experienced in condo conversions in order to minimize the risks inherent in the process.

**LANGSTON & LOW**, Real Estate Advisors, specialize in condo conversions, as well as alternative 1031 strategies that allow rental owners to sell appreciated property without paying capital gains tax or buying more units. They are part of ACI Commercial, and their combined

*backgrounds include public accounting, law, property management, banking and real estate sales and consulting. Contact them at (619) 725-3660.*