Cash, Condos, and Crisis: What about North Carolina?

The conversion of rental housing units to single ownership or condominiums has become an increasingly significant component of the American housing market. Between 1970 and 1979, 346,476 rental units were converted to condominiums, and the Department of Housing and Urban Development (HUD) projects that an additional 1.1 million units will be converted between 1979 and 1985 (HUD, 1980, pp. IV-6, ii). A great deal of controversy and speculation has been generated regarding the effect these conversions will have on the housing market.

The Southeast, with the exception of resort areas in Florida, has not experienced the same rate of conversions that other sections of the country have. Continued growth and industrialization, accompanied by the continual high cost of new construction, indicate that Southern states can expect to see increased conversion activity in the 1980s. Instead of responding to conversions reactively, North Carolina state and local governments need to take steps to limit the negative impacts that other regions have experienced. A study of national conversion trends, consideration of local situations and needs and analyses of existing and proposed state legislation would enable North Carolina to formulate a framework that is suitable to address conversions both today and in five years.

NATIONAL TRENDS

A combination of circumstances leads to the conversion of rental units to condominiums, including growing numbers of small households, increasing housing costs for all types of housing, the federal tax structure and the limited return on rental property that is perceived by investors.

MORE AND SMALLER HOUSEHOLDS

More conversions are occurring in metropolitan areas where there are growing numbers of households, a large percentage of which have only one or two persons. Approximately 50% of all condominium purchasers are two-person households (*U.S. News and World Report*, November 13, 1978). Very little market demand for condominiums is created by households of four or more people. Many of the households buying condominiums are single people or couples beginning to invest in housing, and converted units are seen as an affordable mechanism for home purchase. Households that cannot afford, or do not desire, the responsibility of a single-family unit are buying converted units instead of renting. Rather than redirecting potential single-family unit sales, condominium buyers may be moving toward such a purchase in the future by building equity in a condominium.

COST

Condominiums are less costly than single-family units, and ones which have been converted are less expensive than new ones. In addition, tax deductions on mortgage interest and property taxes for unit-owners can represent a significant savings. Upon resale, if the gain from the sale is reinvested in another primary residence within eighteen months that gain is not taxable. Condominiums are appreciating at 14% to 15% annually compared to 12% appreciation on single-family houses (*TIME*, March 5, 1979). This rapid appreciation creates a situation in which condominiums represent a good housing investment for people who might not be able to own in other circumstances. It is still the case, however, that there are segments of the population that simply cannot afford a home, regardless of the attractive appreciation rates and the additional tax deductions offered to homeowners.

Even though converted units tend to be less expensive than new condominiums or single-family houses, these lower prices may well be due to the fact that they are smaller in terms of square feet of living space and number of bedrooms. Converted units usually have 8% to 16% less square feet of living area than new condominiums (Metropolitan Washington COG, 1976, p. 55). It would appear, then, that in terms of the quantity

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Condominiums are sometimes bought by investors and remain in the rental stock. Rents go up.
Photo by John Gaadt

of space being purchased, converted units are not necessarily a better buy than other forms of housing.

TAX ADVANTAGES IN CONVERSIONS

When rental units are converted to condominiums the process is usually performed by a professional conversion developer rather than by the original owner. Direct owner-conversions are atypical, as they would not be able to apply capital gains provisions to the profit if they converted directly. By selling the entire building to a converter, the profit will be treated as capital gains rather than ordinary income, resulting in a significant tax benefit to the original owner.

The converter is willing to buy a potential condominium building at a higher sales price than a rental building because profits from the sales of individual units are high and generated fairly quickly. These higher sales prices and capital gains benefits make it very attractive for rental owners to sell after the depreciation value of a building has been extracted.

In January 1979, taxes on real estate investment changed from taxing 50% of gain at ordinary rates to 40% at these rates. This creates an even stronger incentive for the owners of rental property to sell to converters. Rather than recognizing and addressing the adverse effects the federal tax structure has on rental stock and conversion activity, the federal government has instead acted to intensify these impacts.

FINANCIAL RETURN ON RENTAL PROPERTIES

Escalating development costs have contributed to the growth of the condominium market. Many developers feel that rent levels have not kept pace with rising costs. While operating costs have increased, it is not always possible to pass these increases on to tenants. Renters' incomes have not kept pace with the rest of the economy, and usually cannot sustain the rents necessary to maintain operating costs. Between 1970 and 1976, median rent rose by 55% while median income for renters rose by 29% (Urban Consortium 1979, p. 9). It would be difficult for many population groups -- the elderly and low- and moderate-income households -- to pay substantial rent increases. This also means that they most likely cannot afford to buy a converted unit.

Income, depreciation allowances, property appreciation and tax sheltering on rental property may not keep pace with inflation and match the return from sale to a converter, but interest costs on mortgages, which make up one-half to one-third of landlords' total costs, are fixed and, therefore, not tied to subsequent inflation.

LOCAL CIRCUMSTANCES

Certain local markets have experienced a great deal of conversion activity while others have had none. These high conversion areas share several characteristics listed in Figure 1. Localities experiencing these characteristics should expect conversions and analyze their local rental markets to ascertain what effect conversions might have.

CONVERSION STIMULI

1. Scarce land for new development
2. High prices for available land
3. High prices for single-family units
4. Supply of good-quality rental stock
5. No conversion regulation legislation
6. Low rental vacancies

Figure 1

(Daniel Lauber, *Planning*, September 1977)

The rental market is extremely complex. Vacancies are declining, making it very difficult to find rental housing; utility costs and overall inflation factors are causing operating costs to rise; and there is very little new rental construction. At the same time, rents are not rising as quickly as other cost-of-living components. Whether this is because the market either will not or cannot respond, is unclear. If it cannot respond, because of the low incomes of renters, then conversion will only exacerbate an already difficult situation.

WHO IS AFFECTED BY CONVERSIONS

There are two groups of people who are directly affected by condominium conversions: those who buy and those who are displaced.

CONVERTED UNIT BUYERS

Annual income less than $30,000	39%
Managerial or professional jobs	66%
Single-person household	57%
Black	10%
Hispanic	2%
35 years of age or less	50%
Over 55 years of age	20%
Over 65 years of age	9%

Figure 2

(Department of Housing and Urban Development, 1980)

People who buy converted units tend to be young and white, with relatively high incomes from professional and managerial jobs, and with small households. Single persons and blacks typically represent greater proportions of converted-unit owners than of single-family unit owners, and it would appear that for these groups, conversions open up ownership opportunities that previously did not exist. Elderly and low-income households represent a smaller proportion of condominium owners than of single-family homeowners, and for these groups, conversion does not enhance their ownership options. It may, in fact, intensify their housing difficulties through displacement and increased rents as a result of fewer rental vacancies.

People who are tenants prior to conversion represent another affected group and usually have lower incomes than tenant-buyers. Twenty percent of those displaced are over sixty-five. Twelve percent are elderly and have annual incomes of under $12,500. Eleven percent are black and 1% are Hispanic (HUD, 1980, p. vi).

It appears that those benefitting from conversions are relatively young, white, middle-income people, and those who suffer from conversions are more likely to be older and poorer. Conversion policy needs to account for both these groups' relative needs.

THE IMPACTS OF CONDOMINIUM CONVERSION

Condominium conversions can have an impact on a variety of community concerns. Local tax bases, neighborhood stability, displacement, the supply of rental housing and its cost are areas that are influenced by the growing rate of conversion.

It is possible that the reassessment of property after conversion can lead to greater revenues from local property taxes depending on how local jurisdictions assess property. If owner-occupied property is assessed at a lower rate than income-producing rental property, the higher value of the individual owner-occupied property will not have a significant effect. When considering total property tax revenues in relation to conversions to date, the ramifications have been small (HUD, 1980, p. vii).

Originally it was thought that conversions would help stabilize and revitalize neighborhoods. Conversions that have occurred so far have been in already-stable areas. They appear to result from, rather than generate, revitalization and stability (HUD, 1980, p. vii).

Conversions occur in order to provide housing for the middle-income and a quick, high rate of return for developers. Stabilizing neighborhoods and providing improved housing are risky ventures. They do not provide safe investment opportunities and therefore conversions have not been an integral part of the gentrification process. Conversions do little in the way of creating additional local revenues through property taxes and do not significantly improve the nature of the neighborhoods in which they take place.

Displacement caused by condominium conversions is perhaps the most hotly disputed side-effect of the conversion process. The Department of Housing and Urban Development estimates that in buildings converted after January 1977, 58% of the resident households moved by January 1980; but it classifies only 10% of the residents who live in converted buildings as displaced. This is based on a definition of displacement as a move to rental housing of similar or lower quality at a higher price or of lower quality at an equivalent cost. Displacement can be viewed, however, as any involuntary move. If that perspective is used, then a larger proportion of the 58% of households that moved after conversion could be considered displaced. Estimates made in the U.S. Senate hearings of 1979 cite average displacement following conversions at 75%.

The extent of displacement is still unclear despite the controversy around it. Differences in definition and the difficulty in contacting tenants who have moved contribute to the problem.

It appears that some converters take steps to minimize apparent displacement by raising rents prior to conversion so that many tenants are forced to move. This tactic reduces the apparent displacement rate, although the effect is the same. Tenants forced out in this manner will not be able to benefit from any displacement or relocation allowances that certain localities may require.

The extent of displacement may be disputed, but it is clear that the elderly and low- and moderate-income families are the ones who suffer most. Low vacancy rates, limited incomes, and the difficulties experienced in readjustment make these segments of the population vulnerable to the adverse consequences of displacement and relocation. These people bear the burden of conversion's negative effects and can least afford to.

While rental units are being removed from the market, it is assumed that unit-buyers will be drawn partially from former renters, thereby reducing the rental market demand. The net decrease in the rental market when accounting for this reduced rental demand, assuming that some condominiums are bought by investors and remain rental, is five units from the rental stock for every 100 converted units. It is also true, however, that the reduction of rental units by conversion accounted for 17% of the excess rental demand over supply in 1977 (HUD, 1980, pp. iii-iv). Even relatively small reductions can have a critical effect on local markets with very low rental vacancies.

As long as little new rental housing is being added and the vacancy rates remain low, conversions harm the rental market. In the first quarter of 1979 the national rental vacancy rate was 4.8% (U.S. Senate hearings, 1979, p. 40), which does not allow a great deal of choice or fluidity in the rental market. Conversions, even when not affecting large numbers of units, can be devastating in such a situation.

Condominium conversions can influence housing costs in three ways. First, tenant buyers in converted buildings will pay more for housing. The monthly costs of purchasing a unit, which include debt service, insurance and property taxes, are usually 30-50% higher than rent for the same space (U.S. Senate hearings, 1979, p. 260). Tax deductions for property taxes and interest payments may help mitigate these increased costs.

Some converted units are bought by investors and remain in the rental market. This process is beneficial in that it does not reduce the rental stock or the already-low vacancy rate. These investors, however, must cover the same increased costs that any other unit-purchaser must. Rents on investor-owned units are usually substantially higher than rents on units in rental buildings. Once units are investor-owned, rents are, on the average, 75% higher than pre-conversion rents (Lauber, 1980, p. 205). Increases of this magnitude often contribute to the displacement of low- and moderate-income households which simply cannot afford this increase in housing expenditure.

Converters want tenants to vacate quickly so that they can get rapid sales turnover.
Photo by John Gaadt

Finally, conversion can influence housing cost through secondary market impacts. As units are removed from the rental stock and vacancy rates remain low, competition for the remaining units forces rent levels up. The middle-income households who may not choose to buy their units when conversions occur compete with low- and moderate-income households for a decreasing number of rental units. There is a strong demand and because the middle-income households can pay more, landlords can raise rents beyond previous levels and still fill their units. This impact on housing costs is perhaps more critical than the others as it can affect people who are not directly involved in conversions. Its repercussions can be felt all through the rental market. The combination of increasing rents and decreasing vacancies that can result from the conversion process influences people who are not able to mitigate these impacts and are unable to benefit from the advantages of increased homeownership that conversions provide.

CONVERSIONS IN NORTH CAROLINA

EXISTING AND PROPOSED LEGISLATION

The right to sell condominiums is provided for in the North Carolina Unit Ownership Act. This provision allows for condominium units to be bought and sold, but does not address tenants' rights, consumer protection or impacts on local housing markets. In order for local jurisdictions to be able to mitigate the effects of conversions, it is necessary to have enabling legislation on the state level. It is unclear whether the North Carolina Unit Ownership Act permits such local intervention. The Act states that planning and zoning commissions may enact supplemental laws governing condominium projects. Some legal experts believe that this provision grants municipalities the authority to adopt conversion regulations as long as they are not expressly inconsistent with other sections of existing state condominium law (Rhyne, Rhyne and Asch, 1975, p. 21). There is debate over this provision and municipalities have been reluctant to test the extent of authority provided for in the Act.

The ambiguity of the existing North Carolina condominium legislation will be resolved when new legislation is adopted. The state has appointed a Condominium Statutes Drafting Committee to develop new enabling legislation for condominium ownership. The committee's proposals are drafts that will be reviewed and presented to the General Statutes Commission, possibly in the spring or summer of 1981. The Attorney General's office hopes to introduce the legislation to the state legislature in 1981, but action may not be taken until the 1982 session.[1]

Condominium conversions are only one aspect of condominium law and to date the committee has released two drafts on the subject. The first provides for moratoria on conversions by municipal ordinance, which may be enacted when city or county governing bodies ascertain that conversions would cause critical financial and relocation problems for existing tenants, and reduce the supply of rental housing available to elderly and low- and middle-income households. Such a moratorium has a six-month time limit, but may be readopted for an indefinite number of additional six-month periods. If a specific conversion is approved by two-thirds of the tenants or found not to result in the situations described above, a governing body may allow the conversion. The draft on moratoria explicitly states that this provision is to be the exclusive procedure for prohibiting conversions.

This proposed intervention is only a temporary response to conversions. Should conversion activity cause either severe problems for tenants or a reduction in rental stock for the elderly and low- and middle-income populations, a more comprehensive and finely-tuned response would be called for. Moratoria are temporary measures to provide localities with the time to formulate an appropriate long-range response to conversion. It is questionable whether repeated moratoria, without any effort to address the conversion problem itself, would withstand court challenge.

In order to provide an equitable response to conversion, municipalities must seek ways to regulate and limit conversion activity when the rental market is inadequate to meet demand, yet allow conversions when clearly-stated standards pertaining to local market conditions are met. A balanced approach is not provided for under the draft legislation.

"NORTH CAROLINA HAS THE OPPORTUNITY TO BENEFIT FROM NATIONAL EXPERIENCE IN THE AREA OF CONVERSION."

The second draft released by the committee deals with provisions for tenants in buildings that are being converted. The draft gives tenants the exclusive right to purchase their units up to forty-five days after the required notice of conversion is received; puts some restrictions on when the unit can be shown to non-tenant buyers; and states that tenants will not be required to vacate until the expiration of their leases or before seventy-five days after notice of conversion, whichever is later. Tenants may also terminate leases with thirty days' notice and no penalty. In addition, tenant-buyers must receive the following information within the last fifteen days of the period in which they have first-purchase rights:

1. articles of incorporation, bylaws, declaration of condominium and purchase agreement;

2. a statement of all improvements to be made and an estimated completion schedule;

3. a financial analysis that includes a proposed budget for the homeowners association, showing maintenance operation estimates and either a statement of capital reserves expenditures or a statement that there will be no such reserve; and

4. a copy of the warranty or a statement that no warranty will be given.

These provisions give tenants protections that were previously unavailable on a widespread basis in North Carolina. Some localities requested limited tenant protections, but the legal basis for these varied from city to city, and in some cases was non-existent. The forty-five day period during which tenants have exclusive right to buy their units is useful, but somewhat shorter than provisions made by other states. The period for exclusive purchase-rights ranges from thirty to 120 days, though sixty and ninety days are the most frequently used (HUD, 1980, Appendix 2-X). The tenants' rights to terminate leases with notice at no penalty included in this draft is particularly helpful. The draft also specifies that no rent increases may occur after the notice to convert is given.

The information that must be given to tenant-buyers represents an improvement over the existing situation of no mandatory disclosures, but additional items would also be helpful to prospective buyers. A building code inspection report citing any violations, a property report disclosing the age and condition of the building and its components, and the right to rescind the contract within specified limits would enable prospective buyers to make more knowledgeable decisions.

The drafts relating to conversions that have been released by the Condominium Statutes Drafting Committee represent an improvement over the existing enabling legislation. The primary weakness of the draft legislation is its failure to allow for adequate and appropriate local response to conversions. The proposals made reflect concern about conversion impacts, but it is necessary to formulate legislation that will not only meet the demands of conversion circumstances today, but allow localities to address their changing situations within the next several years. National trends have demonstrated that as conversions increase, their negative consequences intensify. Southern states, with current patterns of growth and expansion, should expect to see rising conversion rates. By adopting legislation that allows localities more discretion in dealing with conversion, North Carolina will reduce the likelihood that the proposed legislation will be outdated in the near future. A more far-sighted legislative provision would also allow localities to work with conversion activity on an ongoing basis rather than resorting to emergency measures that are inadequate for continued use.

SEVEN NORTH CAROLINA CITIES

Conversions in seven cities in Piedmont North Carolina were reviewed. These are: Chapel Hill, Charlotte, Durham, High Point, Greensboro, Raleigh and Winston-Salem. The information available reflects a range of activity and governmental involvement in conversions.

Chapel Hill has had one conversion of 124 units in January 1981. Another attempted conversion is presently involved in court action. A rental vacancy rate is not currently available, but it is considered to be significantly less than 4%. The town also has a high transient population due to the University of North Carolina. The Town Council has expressed concern about conversions and in February 1981 an information report on condominium conversions was submitted to the Council.

Charlotte has had 604 units converted to condominiums since 1980. Between 1971 and 1979 3,747 units were converted. Charlotte does not have a shortage of rental housing now, but one is anticipated by the spring of 1982. The City Council requested information on conversions a year ago but the prevailing attitude is that conversions are not yet a problem.

Repairs on condominiums are often only of an exterior, cosmetic nature. Photo by John Gaadt

Six units have been converted in Durham. Several conversions were attempted in 1973, but failed because of market conditions. These failures apparently dampened conversion activity in Durham. Presently conversions must be approved through the subdivision regulations. At this point no study or action pertaining to conversions has taken place in Durham.

No conversions have taken place in High Point. A study is planned to determine the likelihood and possible impacts of conversions in that city.

Greensboro has had approximately 352 units converted to condominiums within the past two years. Any apartment building can be converted if it meets local fire and building codes and state codes. No study of conversion and its possible effects has been done, nor is one planned.

Approximately 200 units have been converted in the city of Raleigh. A condominium conversion study was done in November of 1980 and recommendations were made to the City Council. No action has been taken. Since conversions have tapered off, perhaps due to market conditions, no Council response is likely until conversions again become an active concern.

Two hundred-forty-six units in Winston-Salem were converted to condominiums as of September 1980. The rental vacancy rate there is about 4%. A condominium conversion study for Winston-Salem and Forsyth County was put out in October 1980, but no recommendations were made to the Board of Aldermen. The study reflects the desire to wait for the work of the Condominium Statutes Drafting Committee before recommendations and possible action are advocated.

CONCLUSION

This overview of conversions in seven North Carolina cities shows a variety of local situations. Differing degrees of conversion activity are taking place in North Carolina cities and concern varies. It is clear, however, that the diversity of local experiences calls for a range of possible responses to meet local needs. Municipalities should be able to address conversion concerns in an appropriate manner. While conversion is moderate in North Carolina, anticipated rental shortages, limited new rental unit construction and a growing demand for housing all point to increased future activity.

In order to prevent the problems that other areas of the country have experienced, North Carolina must take steps to ensure that adequate responses to conversion-associated problems are possible before local situations become critical. North Carolina has the opportunity to benefit from national experience in the area of conversion legislation. By creating a legislative framework that encompasses present and future needs, the state can increase legislative effectiveness and provide preventive measures to a potential problem.

NOTES

[1] Telephone conversation with Charlie Murray, Assistant Attorney General of North Carolina.

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