

# The Case for Governmental Action to Retard Condominium Conversion Activity

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The conversion of rental apartment buildings into individually-owned condominiums has emerged as a common real estate practice in recent years.<sup>1</sup> Since 1970, over one-half million apartments have been converted to condominiums.<sup>2</sup> The pace of conversion activity accelerated throughout the 1970's<sup>3</sup> and remains strong despite high interest rates.<sup>4</sup> Conversion, moreover, is spreading from the nation's largest met-

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1. A condominium is a "housing unit in a multi-family building or complex owned by an individual, who also owns a partial interest in the common areas of the building or complex." U.S. DEP'T OF HOUS. AND URBAN DEV., *THE CONVERSION OF RENTAL HOUSING TO CONDOMINIUMS AND COOPERATIVES I-4* (1980) [hereinafter cited as HUD 1980 STUDY]. For the purposes of this paper, reference to condominiums also includes cooperative apartments. A cooperative is "a nonprofit housing corporation in which individual households own shares entitling them to live in a particular unit in a multi-family building or complex and to use the common areas and facilities of the building or complex." *Id.* at I-5. See generally, P. ROHAN, M. RESKIN, *I CONDOMINIUM LAW AND PRACTICE* Ch. 1 (1981). The main difference between the cooperative and condominium schemes of ownership is their financial structure. In condominiums, each unit is a separate piece of real estate and thus purchased with a separate mortgage. The cooperative purchasers, by contrast, own a share of stock in a corporation that takes out a blanket mortgage for the entire housing project. A practical effect of this difference is that the cooperative's owners are liable should any stockholder default in the obligation to pay a share of the monthly mortgage payment. Condominium owners, as owners of separate parcels of real estate, are not liable for each other's default.

The differences between condominiums and cooperatives are immaterial for the purposes of this paper since rental units are transformed into ownership units in both condominium and cooperative conversions. Thus, the benefits and costs of condominium and cooperative conversion are nearly identical.

2. See HUD 1980 STUDY, *supra* note 1, at IV-5, IV-9 (approximately 366,000 rental units were converted between 1970 and 1979); ADVANCE MORTGAGE CORPORATION, U.S. HOUSING MARKETS I (Subscribers' Special Report, April 24, 1981) (conversion papers were filed for an estimated 160,000 units in 1980). The 526,000 rental units converted by 1980 represent over 5% of all units in rental buildings with 5 or more units and about 2% of all occupied rental units including single family homes and units in buildings with less than five units. See HUD 1980 STUDY, *supra* note 1, at IV-9.

3. HUD 1980 STUDY, *supra* note 1, at IV-5. Seventy-one percent of the decade's total occurred in 1977-1979. *Id.* at i.

4. The rate of condominium conversion continued to accelerate in 1980 and 1981 despite the high interest rates that have crippled the rest of the housing industry. ADVANCE MORTGAGE CORPORATION, *supra* note 2, at 1. An even greater surge in conversion activity is anticipated once mortgage interest rates fall. *Id.* at 2. HUD 1980 STUDY, *supra* note 1, at VII-43 (projecting between 1,056,000 and 1,140,000 units will be converted between 1980 and 1985); *Condos Take Over the Real-Estate Market*, 89 U.S. NEWS AND WORLD REPORT 78 (November 10, 1980) (reporting a nationwide condominium craze).

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ropolitan areas into smaller cities.<sup>5</sup>

Many commentators have viewed condominium conversion as a constructive force. They contend that it provides additional homeownership opportunities and reduces urban decay.<sup>6</sup> The primary drawback of conversion, according to these analysts, is the displacement of poor and elderly tenants from the converted buildings.<sup>7</sup> To retain the benefits of conversion while reducing its harms, these commentators urge that conversion be permitted to continue but that the process be regulated to mitigate the effects of displacement.<sup>8</sup> They advocate measures that provide tenants a reasonable opportunity to purchase their residences and that reduce the difficulties encountered by those forced to move.<sup>9</sup> This standard view of condominium conversion miscalculates the social benefits and costs of conversion, however, and therefore underestimates the need for governmental action to curb conversion activity.

This analysis of conversion activity begins by discussing the forces that generate condominium conversion and identifies the preferential federal income tax treatment of homeownership properties as the most important single factor fueling the conversion boom. The article then examines the costs and benefits of condominium conversion. Since the attractiveness of condominium conversion is largely a product of federal tax policy, the social benefits of conversion activity have been exaggerated. By contrast, conversion's costs have been underestimated because its adverse effect on the lower-income housing stock has been misperceived. After evaluating various ways of addressing the problems associated with conversion, the article concludes by proposing denial of preferential tax treatment to owners of newly converted condominiums.

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5. Condominium conversion had remained a limited phenomenon nationally until recently as much of the nation's conversion activity had been concentrated in the largest metropolitan areas. HUD 1980 STUDY, *supra* note 1, at IV-8 (76% of all conversion between 1970 and 1979 occurred in the largest 37 Standard Metropolitan Statistical Areas (SMSA's) and 59% of all conversions took place in 12 of the 37 SMSA's); ADVANCE MORTGAGE CORPORATION, *supra* note 2, at 1. For example, conversion doubled in 1980 in the medium and smaller markets of the five states that keep full conversion records. *Id.* at 1.

6. *See, e.g.*, NATIONAL ASSOCIATION OF REALTORS, DISPLACEMENT DUE TO CONDOMINIUM CONVERSION: SOME EVIDENCE 12 (1979); Comment, *The Condominium Conversion Problem: Causes and Solutions*, 1980 DUKE L.J. 306, 307.

7. *See, e.g.*, UNITED STATES DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, Condominium Cooperative Study V-34 (1975) (hereinafter cited as HUD 1975 STUDY); Comment, *The Regulation of Rental Apartment Conversions*, 8 FORDHAM URBAN L.J. 507, 513 (1980).

8. Note, *Condominium Conversion—Balancing Tenants' Rights and Property Owners' Interests*, 27 WAYNE L. REV. 349, 365 (1980).

9. *See, e.g.*, DIVISION OF FLORIDA LAND SALES AND CONDOMINIUMS, DEPARTMENT OF BUSINESS REGULATION, STATE OF FLORIDA, CONDOMINIUM CONVERSION IN FLORIDA: A REPORT TO GOVERNOR BOB GRAHAM 39 (1980). The report also recommends actions to encourage new rental apartment construction.

This proposal would decrease the rate of condominium conversion and its accompanying harms by removing governmentally created incentives to convert. This would allow conversion to continue in those markets where the other benefits of conversion outweigh its costs. It would also avoid the need for complex and costly regulation of conversion activity.

### I. *The Causes of Condominium Conversion*

The main force behind the surge in condominium conversion is the shortage of homeownership opportunities that has developed in recent years. In large part, the demand for homeownership has grown due to an array of federal income tax incentives which provide a tremendous subsidy to homeowners.<sup>10</sup> The ability of homeowners to deduct mortgage interest<sup>11</sup> and property taxes<sup>12</sup> while not reporting any imputed income<sup>13</sup> from ownership creates a tax shelter of considerable value.<sup>14</sup> In addition, the capital gains provisions of the Internal Revenue Code make any appreciation in home value nearly tax-free.<sup>15</sup> Taken together, these tax subsidies transform homeownership into a superior investment opportunity.<sup>16</sup>

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10. E. BOURDON, CONDOMINIUM CONVERSIONS: POSSIBLE CHANGES IN FEDERAL TAX LAWS TO DISCOURAGE CONDOMINIUM CONVERSIONS AND ASSIST RENTAL HOUSING CRS-2-CRS-3 (Congressional Research Service Report No. 80-71E, 1980) (tax laws provide strong incentives for middle and upper income households to purchase housing).

11. I.R.C. § 163 (1982).

12. I.R.C. § 164(a)(1) (1982).

13. E. BOURDON, *supra* note 10, at CRS-3 (owners of homes who in effect rent to themselves are not required to pay tax on this derived value). *See generally*, B. BITTKER, L. STONE, FEDERAL INCOME TAXATION 80-85 (5th ed., 1980).

14. This tax shelter is estimated to have saved homeowners over \$16 billion in federal income taxes in 1979, an amount that was expected to increase to over \$22 billion by 1981. E. BOURDON, *supra* note 10, at CRS-3 (estimates are adjusted downward to reflect the effect of the standard deduction). For the family that purchased an average priced new home in 1981, the value of these deductions would total about \$3100 annually. This figure is based on the median sales price for a new single family home in April 1981 which was \$69,300. N.Y. Times, June 3, 1981, at D7, col. 1.

15. Taxpayers are able to defer capital gains by purchasing a new residence within 24 months of the sale of their previous home. I.R.C. § 1034 (1982). Taxpayers are also entitled to a one-time, non-recognition of capital gain up to \$125,000 once they reach age 55. I.R.C. § 121 (1982). Even the portion of the gain subject to taxation usually will be taxed at a low rate since taxpayers exercising the one-time non-recognition feature are elderly and usually in low tax brackets.

16. Downs, *Too Much Capital for Housing?*, 17 THE BROOKINGS BULLETIN 2 (The Bookings Institution, Summer, 1980) (housing as an investment offers extraordinary tax advantages compared to all other investment alternatives); Goetze, *The Housing Bubble*, 8 WORKING PAPERS FOR A NEW SOCIETY 44, 45 (January-February, 1981) (federal tax code strongly favors investment in housing); Sahling, Stern, *Co-op Fever in New York City*, 5 FEDERAL RESERVE BANK OF NEW YORK QUARTERLY REVIEW 17 (Spring, 1980) (co-op, condominium, and home ownership provide a practical, increasingly valuable tax shelter).

A number of other factors are usually cited along with the tax laws as contributing to the economic attractiveness of homeownership. These factors include the appreciation in the home's value due to the inflation in home prices, the leveraged nature of a home purchase in

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Although most of these tax preferences have existed for decades, their attractiveness has increased in recent years as inflation has pushed households into higher federal income tax brackets.<sup>17</sup> As individuals creep into higher marginal brackets, the value of tax deductions and other tax avoidance devices increases proportionally.<sup>18</sup> As a result, more middle income households are finding that homeownership offers them substantial economic benefits.<sup>19</sup>

This increased demand for homeownership has developed during a period when the expansion of homeownership opportunities has slowed. Due to high interest rates<sup>20</sup> and inflation in construction costs,<sup>21</sup> the construction of single-family residences and newly-built condominium units has slowed since the early 1970's.<sup>22</sup> The housing stock increased only 23% over the decade of the seventies.<sup>23</sup> The number of households in

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which the homeowner receives all the appreciation although only a 20% downpayment was made, and the ability to freeze housing costs at the same monthly payment for the next thirty years. See Downs, *supra* at 2.

Although these factors do contribute to the economic value of homeownership, the preeminent factor is the tax treatment of homeownership. The critical importance of the tax factor can be seen by comparing household A which purchases its home and household B which continues to rent an apartment but purchases a house as an investment. The only difference between real estate investors A and B is that household A lives in its investment and B does not. Both A and B will benefit from property appreciation and will be able to purchase on a leveraged basis. Because B's own rental payments will increase at approximately the same pace as its rental income from its investment property, both A and B will be able to freeze their housing costs. Since household B can obtain an investment with comparable benefit to homeownership except for the favorable tax treatment afforded homeowners, tax incentives are the crucial factor in the family's decision to invest in their home instead of in other real estate or, for that matter, in a range of other alternatives.

17. E. BOURDON, *supra* note 10, at CRS-4. In 1967, 5.5 million of 58.9 million taxpayers or 9.3% of all taxpayers were taxed at a 25% or higher marginal rate. INTERNAL REVENUE SERVICE, STATISTICS OF INCOME—1967, INDIVIDUAL INCOME TAX RETURNS 76 (1969). By 1977, 26.4 million of 81.7 million taxpayers or 32.3% of all taxpayers were taxed at a 25% or higher marginal rate, an increase of 480%. INTERNAL REVENUE SERVICE, STATISTICS OF INCOME—1977, INDIVIDUAL INCOME TAX RETURNS 94 (1979). See also D. HAIDER, ECONOMICS, HOUSING, AND CONDOMINIUM DEVELOPMENT 60 (Center for Urban Affairs, Northwestern University, 1980) (a family with the average income was taxed at the 27% marginal rate in 1976 and at the 29% marginal rate in 1977 although purchasing power did not increase).

18. NATIONAL ASSOCIATION OF REALTORS, *supra* note 6, at 6.

19. EMERGENCY CONDOMINIUM AND COOPERATIVE CONVERSION COMM'N, DISTRICT OF COLUMBIA, FINAL REPORT 23 (1979) (tax and investment incentives have interested increasing numbers of renters in homeownership).

20. DEPT OF HOUS., STATE OF CONNECTICUT, CONDOMINIUM CONVERSION: AN INTERIM RESPONSE 19, (1980) (Federal Reserve Board restrictions on the money supply increase interest rates and thereby inhibit new construction).

21. D. HAIDER, *supra* note 17, at 7 (citing statistics on the increased cost of residential construction).

22. Construction of single unit structures has proceeded at sub-par levels in four of the past eight years. BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, HOUSING STARTS: JULY 1981 2, 3 (Construction Report C20-81-7, September 1981). This pattern has been even more pronounced in structures with five or more units. *Id.* at 2, 3.

23. Overall, between the 1970 Census and October 1979, 18,636,000 new units were built

the U.S. jumped by 27%.<sup>24</sup> With a growing number of households demanding homeownership and only minor increases in the supply, a shortage of homeownership opportunities has developed, increasing the value of those opportunities that do come onto the market and pricing housing ownership beyond the reach of many families.<sup>25</sup>

The conversion of apartment buildings into condominiums is able to alleviate this shortage of homeownership opportunities.<sup>26</sup> The converted units are attractive to potential home buyers for several reasons. The households who purchase and reside in these individually owned apartments receive the same tax and investment benefits as the owners of single-family homes. They are also affordable to many households that would otherwise be closed off from ownership by spiraling single-family home prices.<sup>27</sup> Additionally, converted condominiums are appealing because the apartment buildings that have been converted have usually been high-quality structures in prime locations.<sup>28</sup>

The conversion option is also attractive to the owners of rental apartment buildings. By converting to condominiums, the building owner is able to charge 60%-100% more for each condominium unit than its market value as a rental apartment.<sup>29</sup> The prime reason for the increased

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and 6,742,000 existing units were lost due to abandonment or demolition. This 12 million increase in dwelling units represents a 17% increase in the housing stock. Adding 4,296,000 "unspecified additions" to the housing stock caused by subdivision of existing units and conversion of non-residential structures, the housing stock increased by 16.2 million units or 23.1%. U.S. DEP'T OF COMMERCE, U.S. DEP'T OF HOUS. AND URBAN DEV., ANNUAL HOUSING SURVEY: 1979 pt. A, XV-XVI (Current Housing Reports Series H-150-79, 1981).

24. N.Y. Times, May 26, 1981, at A1, col. 2.

25. COMPTROLLER GENERAL OF THE U.S., RENTAL HOUSING: A NATIONAL PROBLEM THAT NEEDS IMMEDIATE ATTENTION 8 (General Accounting Office Report No. CED-80-11, 1979) (the cost of homeownership has priced an increasing number of families out of the new home market).

High home prices have made it increasingly difficult to accumulate a downpayment for first-time home buyers. In addition, the combination of high prices and high interest rates has increased the monthly mortgage payment beyond the capacity of many families. PRESIDENT'S COMM'N. ON HOUSING, INTERIM REPORT, October 30, 1981, p. 2.

26. J. SILVER, C. SHREVE, CONDOMINIUM CONVERSION CONTROLS 9 (U.S. Dep't of Hous. and Urban Dev., 1979).

27. B. HEUDORFER, CONDOMINIUM DEVELOPMENT IN BOSTON 61 (BOSTON REDEVELOPMENT AUTHORITY, 1980) ("in many parts of the country condominium conversions do expand ownership opportunities for those priced out of the detached single family housing market"); E. BOURDON, *supra* note 10, at CRS-8 (conversion provides a new supply of homes for young people, divorced individuals, one income households, and other groups who can not afford or do not want a \$100,000 detached house).

28. HUD 1980 STUDY, *supra* note 1, at vii-viii. *See, e.g.*, Sahling, Stern, *supra* note 16, at 13 (co-op conversions in Manhattan have been concentrated in relatively well-to-do neighborhoods in newer and more desirable buildings). *See generally*, NATIONAL ASSOCIATION OF REALTORS, *supra* note 7, at 4-9.

29. D. HAIDER, *supra* note 17, at 8 (units worth sixty times monthly rents as rental units are worth 110 times monthly rents as condominiums); Goetze, *supra* note 16, at 50 (rental apartments worth four to six times the annual rent roll start at ten times annual gross rent as condominiums); E. BOURDON, *supra* note 10, at CRS-11 (a unit worth \$25,000 as an invest-

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price of the units as condominiums is the disparate tax treatment of homeownership and investor-owned properties.<sup>30</sup> In contrast with the substantial benefits that the Internal Revenue Code extends to homeowners, the federal tax treatment of investor-owned rental properties is not favorable. For an investor, mortgage interest and property tax payment deductions may merely offset the building's reported rental income and do not create a tax shelter. The building's operating expenses may also be deducted, however.<sup>31</sup> The deduction for the building's depreciation does create a tax subsidy for the investor,<sup>32</sup> but this deduction is comparatively small and is recaptured upon sale of the building.<sup>33</sup> Finally, the investor is subject to a capital gains tax on any appreciation in the value of the property without the deferral and non-recognition provisions that are available to homeowners.<sup>34</sup>

This disparity in the tax treatment of investor-owned and resident-owned properties creates an opportunity for an apartment building owner to increase the building's tax subsidy by shifting ownership to a

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ment may sell for between \$50,000-\$60,000 as a condominium); CITY DEV. DEP'T, KANSAS CITY, MISSOURI, CONDOMINIUM CONVERSION IN KANSAS CITY 33 (Technical Bulletin No. 5, 1979) (converted condominiums commonly sell for 2 1/2 times their value as investor-owned apartments).

30. Many commentators claim that apartment building owners are interested in conversion because of the deteriorating profit margins that are plaguing the rental housing industry. *E.g.*, Comment, *supra* note 6, at 311. Those buildings that are converted to condominiums are not typical rental buildings, however; they are prime buildings with residents of some means. *See* note 28, *supra*. Thus, the key factor that has held rents down and reduced landlord profits—the inability of lower income renters to pay market rents—is not present in those buildings undergoing conversion. Stanfield, *Caught in the Squeeze of the Rental Housing Market*, 11 NATIONAL JOURNAL 262, 264 (February 17, 1979) (landlords have been unable to raise rents sufficiently because the lower income families that increasingly compose the renter class cannot absorb the higher rents).

Other commentators have argued that rent control has spurred conversion activity by diminishing the profitability of rental housing. *See, e.g.*, Harter, *Rent Controls Forcing Condo Conversions*, 39 MORTGAGE BANKER 46 (July, 1979). However, the HUD 1980 study concluded that rent controls were not a leading cause of condominium conversion because so few of the jurisdictions with conversions have enacted such measures. HUD 1980 STUDY, *supra* note 1, at V-17. In fact, if the source of landlords' interest in condominium conversion was the avoidance of rent regulation, one would wonder why renters would be interested in purchasing condominium units since the conversion would permit the owner to increase her profits at their expense.

31. I.R.C. §§ 162-164 (1982). Operating expense deductions also only offset rental income.

32. I.R.C. §§ 167 (1982). *See* D. HAIDER, *supra* note 17, at 13 (depreciation is a tax break for real estate investors since it does not reflect the property's actual expenses or economic depreciation).

33. *See* NATIONAL ASSOCIATION OF REALTORS, *supra* note 6, at 10; I.R.C. § 1016 (1982). Amendments to the Internal Revenue Code in 1969 reduced the depreciation subsidy by altering the method by which a used rental building can be depreciated. NATIONAL ASSOCIATION OF REALTORS, *supra* note 6, at 10. Depreciation is recaptured at the lower capital gains rate, however.

34. I.R.C. § 1001 (1982). *See* note 16, *supra*.

group of residents.<sup>35</sup> Even though the tax subsidy is channeled initially to the condominium buyer, the apartment building owner is able to share in the increased value of the property because the homeownership subsidy increases the sum households are willing to pay for the condominium unit.

Apartment building owners are often reluctant to convert, however, for fear of losing capital gains treatment of their investment<sup>36</sup> or because of inexperience with conversion and its risks.<sup>37</sup> In these instances, a condominium converter with expertise in the creation and marketing of condominiums may purchase the property from the owner at a price in excess of its value as a rental building and sell the units as condominiums.<sup>38</sup> In the process of negotiating the sale to the converter, the original building owner and the converter divide the financial benefits of transferring the building from the rental market to the ownership market.<sup>39</sup>

The logic of conversion, then, is clear: by altering the ownership structure of a building to improve its tax treatment, the property gains in value. This increase is then apportioned among the transaction's participants.<sup>40</sup> Apartment building owners are able to sell their buildings

35. Tamarkin, *Condomania in Chicago*, 122 FORBES 54, 56 (November 13, 1978) (tax policy has encouraged conversion by subsidizing owners rather than renters); B. HEUDORFER, *supra* note 27, at 46, 101 (explicit federal tax policy is in large part responsible for conversion's proliferation).

36. A building owner who converts an apartment building herself begins to take on the markings of a dealer and risks being taxed at ordinary income rates on the building's entire appreciation. In most instances, an owner is better off selling at a lesser price to a converter but retaining capital gains treatment. For a discussion of the difficulties in acquiring capital gains treatment of a conversion by an apartment building investor, see Miller, *Can A Straight Condominium Conversion Produce A Capital Gain*, 54 J. OF TAXATION 8 (January, 1981); Livsey, *Minimizing the Tax Consequences of Condominium Conversions and Other Real Property Developments*, I N.Y.U. 39TH ANNUAL INSTITUTE ON FEDERAL TAXATION 28-1 (1981); ADVANCE MORTGAGE CORPORATION, *supra* note 2, at 3.

37. D. HAIDER, *supra* note 17, at 19 (apartment building owners without expertise may not wish to risk proceeding with a conversion).

38. HUD 1980 STUDY, *supra* note 1, at iii (converters are willing to pay prices for rental properties far in excess of their value as rentals).

39. See D. HAIDER, *supra* note 17, at 20 (the price paid by the converter for the building, conversion expenses, and the condominium market determine the converter's profit). As conversion has become more common, owners of rental buildings have understood the potential value of their buildings to converters and have insisted on higher prices. Chicago Tribune, June 21, 1981, at 1, col. 5; ADVANCE MORTGAGE CORPORATION, *supra* note 2, at 3. Although estimates vary, converters are able to make a substantial profit. D. HAIDER, *supra* note 17, at 20-21 (converter profits equal 10% to 20% of gross condominium sales); CITY DEV. DEP'T, *supra* note 30, at 37 (25%-30% net profit); TAMARKIN, *supra* note 35, at 59 (returns on investment of from 6% to 500%). Because converters contribute only a small portion of the capital needed to purchase the building and borrow the remainder, the profits gained by converters are even larger when compared to their equity participation in the transaction. Comment, *supra* note 6, at 313.

40. D. HAIDER, *supra* note 17, at 9 (apartment building owners, converters, and condominium buyers all obtain financial benefits from conversion).

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at a greater price than they would receive from a rental building investor. Converters receive a healthy profit for their participation in the transaction as middlemen. And the condominium unit buyers gain the tax and investment advantages of homeownership that were unavailable to them due to the price and short supply of single family homes.

### II. *The Benefits Created by Condominium Conversion*

#### A. *The Benefits For Participants In Conversion Activity*

The major beneficiaries of the conversion of an apartment building into condominiums are the participants in the transaction: the real estate investor who owns the building, the condominium converter who purchases the building from the investor and sells the apartments as individual units, and the condominium buyers who purchase and reside in the apartments.<sup>41</sup> The financial benefits to participants are described in the previous section.<sup>42</sup>

#### B. *Conversion's Effect on Urban Conditions*

The other important benefit commonly attributed to conversion is its contribution to urban revitalization. The general notion of conversion activity underlying these claims is that conversion is an element of the broader urban revitalization movement in which deteriorating buildings in marginal neighborhoods are rehabilitated for middle class "urban pioneers."<sup>43</sup> The perceived benefits of this activity are the renovation of the urban housing stock, the improvement of the center city tax base, and the return of the middle classes to the cities.<sup>44</sup>

In reality, conversion has had at best a modest impact on urban conditions. Conversion activity has been divided evenly between urban

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41. See text and notes accompanying notes 27-40, *infra*.

42. These "benefits" arise from the favorable tax treatment of converted units, and are thus offset by the loss of tax revenues.

43. See, e.g., Comment, *supra* note 6, at 316 (conversion helps revitalize blighted and decaying neighborhoods by saving many dwelling units from abandonment and demolition and by increasing resident stability).

44. The HUD 1980 STUDY reported that condominium purchasers are mostly white, relatively young, small households with higher than average incomes and managerial and professional jobs. See HUD 1980 STUDY, *supra* note 1, at Ch. VI (condominium buyers are 90% white; 48% are under 36 years old; 57% are one person and 35% are two person households; 39% earn over \$30,000; 65% hold managerial or professional positions). Local studies generally confirm the HUD conclusions. See, e.g., J. DINKELSPIEL, J. UCHENICK, H. SELESNICK, CONDOMINIUMS: THE EFFECTS OF CONVERSION ON A COMMUNITY 76-81 (1981) (of condominium buyers in Brookline, Massachusetts, 57% were under 40 years old; households averaged 1.95 persons including .35 children per household; 44% were married; the mean income was \$27,830; 71% were employed in professional, technical or managerial positions). See also note 83 *infra* for income data on condominium buyers.



centers and suburban jurisdictions.<sup>45</sup> The activity that has occurred in the inner cities has centered on prime urban neighborhoods and involved high quality structures.<sup>46</sup> Because only cosmetic improvements have typically been made to these buildings, conversion has had a relatively minor effect on the quality of the urban housing.<sup>47</sup> In the long run, conversion may protect the housing stock because condominium owners may maintain their buildings better than rental building investors.

The immediate effect of conversion on the real estate tax base of inner cities has also been minimal. Although converted buildings have not received substantial renovation, their tax assessments have risen to reflect the increase in their market values as condominiums.<sup>48</sup> Nevertheless, when compared to the total assessed value of a city's real property, these increases are very insignificant.<sup>49</sup>

Perhaps the most valuable contribution of conversion to the urban environment is its role in encouraging middle class households to remain in or return to the cities. Conversion may begin to reverse the long-term process of economic segregation that has left high concentrations of poor households in the cities while wealthier households have fled to the suburbs.<sup>50</sup> By creating homeownership opportunities for the middle classes in the cities,<sup>51</sup> conversion might assist in the rejuvenation of urban economies. Middle class households may in some cases spur the local economy and spin off job opportunities and similar benefits for other city residents. Whether these benefits will in fact develop remains uncertain; the middle class residents may merely create an economic life that is separate from and yields few benefits to the city's less affluent residents.<sup>52</sup> In any case, the scope of the benefits that are received by poor,

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45. HUD 1980 STUDY, *supra* note 1, at IV-8. While 76% of conversion activity between 1970 and 1979 occurred in the largest 37 SMSA's, *see* note 2 *supra*, only 49% of these conversions were in center city areas; the other 51% occurred in suburbs.

46. *See* note 28, *supra*.

47. HUD 1980 STUDY, *supra* note 1, at III-4, III-5, VIII-27, VIII-28 (75% of inner city and 85% of suburban conversion involve only cosmetic improvements or are sold "as is"); Tamarkin, *supra* note 36, at 59 (only 25% of converted buildings receive more than cosmetic changes).

48. HUD 1980 STUDY, *supra* note 1, at VIII-5, VIII-11 (increases in valuation found not to be caused by building improvements); B. HEUDORFER, *supra* note 27, at 63 (assessments of apartment buildings increased 40% on the average after conversion).

49. HUD 1980 STUDY, *supra* note 1, at VIII-9 (San Francisco experienced a .0002% increase in total assessments due to conversion, the largest increase among SMSA's with major conversion activity).

50. Comment, *supra* note 6, at 314-316.

51. J. KAIN, H. LEONARD, K. CASE, CONDOMINIUM CONVERSION IN MASSACHUSETTS 3 (Greater Boston Real Estate Board, 1980) (condominiums provide the only form of homeownership suitable for most of the existing housing stock in the central cities).

52. The return of middle class families may merely add to the economic diversity of a

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inner city residents must be contrasted with the costs that conversion places upon them.

### III. *The Harms of Conversion Activity*

#### A. *The Effect of Conversion On A Building's Tenants*

Those individuals most obviously affected by conversion are the apartment building tenants who must choose either to buy their apartments or move elsewhere. On the average, over 70% of the tenants who reside in a building undergoing conversion are displaced.<sup>53</sup> Approximately 20% of the tenants purchase their apartment and the rest remain as renters in their apartments which have been bought by investors.<sup>54</sup>

Some purchasers, however, decide to buy their units for negative reasons. These households purchase reluctantly because they wish to avoid a disturbing move or because they are concerned with their ability to locate suitable replacement housing. The number of defensive purchases by tenants is quite significant.<sup>55</sup>

Considerable public attention has been focused on the effects of conversion on those households who are displaced from their residences.<sup>56</sup>

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city's population, but not create an economic renewal with benefits for all urban residents. Cf. Hartmann, *Displacement—A Not So New Problem*, in URBAN HOUSING 296 (Federal Home Loan Bank of San Francisco, 1978) (a city's problems may be ameliorated when the middle class replace the poor, but the return of the middle class does not address the plight of the poor).

53. The percentage of tenants forced to move by conversion varies by building and by city. Not surprisingly, the studies of conversion-induced displacement report inconsistent findings regarding the extent of displacement. Few studies, however, report less than 70% displacement. HUMAN RELATIONS COMM'N, CITY OF EVANSTON, ILL., CONDOMINIUM CONVERSION IN THE CITY OF EVANSTON 19 (1978) (80% of tenants plan not to buy); HUD 1975 STUDY, *supra* note 7 at V-35 (75-85% displacement); HUD 1980 STUDY, *supra* note 1, at VI-2 (58% displacement); SAN FRANCISCO DEP'T OF CITY PLANNING, MEMBERS OF THE REAL ESTATE INDUSTRY, CONDOMINIUM CONVERSIONS IN SAN FRANCISCO iii (1978) (75% of pre-conversion tenants had to relocate) (hereinafter cited as San Francisco Study); Lauber, *Condominium Conversions—The Number Prompts Controls To Protect The Poor and Elderly*, 37 J. OF HOUSING 209 (1980) (citing a variety of studies reporting between 75% and 95% displacement).

54. HUMAN RELATIONS COMM'N, *supra* note 53, at 30 (20% of tenants purchase their unit); B. Heudorfer, *supra* note 28, at 57 (25% of tenants purchase); CITY OF CAMBRIDGE, CONDOMINIUM CONVERSIONS IN CAMBRIDGE 2 (1978) (20% of tenants purchase); DEVELOPMENT ECONOMICS GROUP, CONDOMINIUM AND COOPERATIVE CONVERSIONS IN THE DISTRICT OF COLUMBIA 1 (October 1978) (24% of tenants purchase); HUD 1980 STUDY, *supra* note 1, at VI-2, VI-11 (22% of tenants purchase units and investors purchase 19% of converted units); Tamarkin, *supra* note 35, at 57 (8-15% of converted units are investor-owned); SAN FRANCISCO STUDY, *supra* note 53, at 54 (11% of converted units are investor-owned).

55. HUD 1980 STUDY, *supra* note 1, at VI-10 (23% of tenant purchasers buy their unit to avoid a move); BALTIMORE STUDY, *infra* note 62, at 33 (43% of tenant purchasers consider themselves reluctant purchasers); Lauber, *supra* note 53, at 204 (75% of tenant buyers in Palo Alto did so reluctantly); G. LONGHINI, D. LAUBER, CONDOMINIUM CONVERSION REGULATIONS: PROTECTING TENANTS 3, 4 (American Planning Association, PAS Report No. 343, 1979).

56. *E.g.*, J. SILVER, C. SHREVE, *supra* note 26, at 1.

The central concern is that those tenants who are forced to move are predominantly poor or elderly and experience trauma in losing their home and difficulty in locating a satisfactory substitute.<sup>57</sup>

The data available from a variety of case studies runs counter to these common perceptions of the effects of displacement.<sup>58</sup> Displaced households fare surprisingly well in their search for substitute housing. Most of those displaced are able to locate housing of comparable cost and size within three months of receiving notice of conversion.<sup>59</sup> Most remain in the same city and many find apartments in the same neighborhood.<sup>60</sup>

The evidence on displacement underlines the misperception that pervades much of the study concerning the nature of conversion. Conversion activity is often thought to focus on distressed rental properties. Because conversion typically involves higher-grade buildings, however, those who are displaced do not resemble the populations of ethnic poor that were uprooted by the urban renewal and highway construction programs of the 1960's.<sup>61</sup> Only twenty-eight percent of the displaced tenants are poor or elderly.<sup>62</sup> Since the converted buildings are strong

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57. *E.g.*, TENANT ADVOCACY TECHNICAL AD HOC TASK FORCE IN EMERGENCY CONDOMINIUM AND COOPERATIVE CONVERSION COMMISSION, *supra* note 19, at 38.

58. NATIONAL ASSOCIATION OF REALTORS, *supra* note 6, at 2; J. KAIN, H. LEONARD, K. CASE, *supra* note 51, at 71.

59. The HUD 1980 Study reported a startling degree of success for those displaced tenants searching for housing. Rents typically increase by less than 10% after displacement. Less than 20% of the displaced rate their new residence as inferior in quality to their previous home. Ninety percent indicate satisfaction with their new housing. HUD 1980 STUDY, *supra* note 1, at vi. Studies of conversion activity in particular cities are in general agreement with the HUD results. SAN FRANCISCO STUDY, *supra* note 53, at 44, 47 (rents for displaced households went down slightly, an average housing search took three months); DEVELOPMENT ECONOMICS GROUP, *supra* note 54, at 2, 25 (in the District of Columbia rents went up 17.9%, but apartment size increased an average of .22 bedrooms, average housing search took two months); CITY OF CAMBRIDGE, *supra* note 54, at 23, 24, 29 (most tenants able to relocate within two months, 71% paid higher rents, but 87% were satisfied with their new housing); EMERGENCY CONDOMINIUM AND COOPERATIVE CONVERSION COMM'N, *supra* note 19, at 41 (53% of displaced tenants in the District of Columbia paid higher rents, 15% paid less rent).

60. DEVELOPMENT ECONOMICS GROUP, *supra* note 54, at 23-24 (45% of the displaced relocated in the same neighborhood and 75% within the District of Columbia); HUD 1980 STUDY, *supra* note 1, at IX-18-IX-20 (72% moved out of their neighborhood, 85% considered their new neighborhood as good if not better than their preconversion neighborhood, and 80% lived as close if not closer to friends and relatives); SAN FRANCISCO STUDY, *supra* note 53, at 46 (only a slight dispersal of displaced households from their former neighborhoods).

61. HARTMANN, *supra* note 52, at 298.

62. HUD 1980 STUDY, *supra* note 1, at IX-14 (poor is defined as under \$12,500, elderly as over 65 years of age). The HUD 1980 STUDY reports that twenty percent of displaced tenants are poor and about 20% are elderly. Because 60% of the elderly who are displaced are also poor, a total of 28% of the displaced population is poor and/or elderly. *Id.* at VI-18. Similar results were found in the majority of case studies. DEVELOPMENT ECONOMICS GROUP, *supra* note 54, at 22, 23 (21% of displaced households had members over 65, 14% had an annual income less than \$10,000); SAN FRANCISCO STUDY, *supra* note 53, at 37, 40 (18% of displaced tenants over 61, 13% had incomes less than \$10,000); CITY OF CAMBRIDGE, *supra* note 54, at 19, 20 (24% over age 61, 30.8% earned less than \$10,000); HUMAN RELATIONS COMM'N, *supra*

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rental properties, the tenants who are displaced generally have some economic resources at their disposal.<sup>63</sup> With these resources, they are able to re-enter the housing market and, on the whole, obtain satisfactory substitutes to their current apartments without great difficulty.<sup>64</sup>

Although most displaced tenants are able to shoulder a move without severe repercussions, displacement is a difficult experience for those that are poor or elderly. The poor lack the resources to compete effectively in a tight rental market and their search for housing is less successful than that of the rest of the displaced population.<sup>65</sup> For the elderly, a forced move can be emotionally and physically traumatic.<sup>66</sup> In addition, their new homes may isolate them from their traditional communities.<sup>67</sup>

Despite the fact that the effects of conversion on the tenants of the converted building are not so drastic as commonly perceived, the burdens that conversion imposes on all tenants, especially poor and elderly tenants, are not insignificant.<sup>68</sup> It is likely, moreover, that in the future the problems of displacement will become more severe as conversions exhaust the higher quality housing stock and spread to other neighborhoods forcing greater numbers of the poor and elderly into an increasingly tight rental market.<sup>69</sup>

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note 53, at 7 (18% over age 65, 9.8% earned less than \$10,000); DEP'T OF HOUS. AND COMMUNITY DEV., CITY OF BALTIMORE, CONDOMINIUMS: BALTIMORE CITY 37, 38 (1980) (hereinafter cited as BALTIMORE STUDY) (69.1% over age 62, 19.6% earned less than \$10,000).

63. SAN FRANCISCO STUDY, *supra* note 53, at 40 (displaced tenants had a median income of \$22,800); BALTIMORE STUDY, *supra* note 62, at 38 (the median income of the displaced households was \$17,800); HUMAN RELATIONS COMM'N, *supra* note 53, at 6 (median income between \$15,000 and \$20,000); CITY OF CAMBRIDGE, *supra* note 54, at 20 (50% earned between \$10,000 and 20,000).

64. NATIONAL ASSOCIATION OF REALTORS, *supra* note 6, at 39. See notes 58, 59, *supra*.

65. DEP'T OF HOUSING, *supra* note 20, at 21 (few equivalent vacancies exist for displaced low and moderate income families); HUD 1980 STUDY, *supra* note 1, at IX-20 (31% of displaced poor families or three times as many as in the general displaced population, assess their new neighborhood as worse than their pre-conversion neighborhood).

66. N.Y. Times, May 31, 1981, at 47, col. 1 (reporting a study showing that elderly tenants experienced serious emotional and physical disturbance when advised that their homes were being converted); D. Marlin in EMERGENCY CONDOMINIUM AND COOPERATIVE CONVERSION COMM'N, *supra* note 19, at App. B, 7 (partial dissent).

67. Hartmann, *supra* note 52, at 294.

68. Displaced tenants must spend time and energy in order to find and move to substitute housing. Half of the displaced reported difficulties in locating a new residence. HUD 1980 STUDY, *supra* note 1, at IX-17. In addition to this inconvenience, tenants must absorb an average rent increase of 8% and moving costs that average \$145. *Id.* at IX-11, IX-21. Many commentators try to minimize these burdens by pointing out that 38% of all tenants move each year. NATIONAL ASSOCIATION OF REALTORS, *supra* note 6, at 17. Voluntary and forced moves differ significantly in the trauma they engender, however. Also, conversion has generally occurred in prime rental structures whose tenants are most likely to be long-term residents who do not move each year. See note 110, *infra*.

69. EMERGENCY CONDOMINIUM AND COOPERATIVE CONVERSION COMM'N, *supra* note 19, at 34, 47; B. HEUDORFER, *supra* note 27, at 93.

B. *The Effects of Conversion on the Adequacy of The Lower Income Housing Stock*

Because most evaluations of conversion's effects have focused on the highly visible problem of tenant displacement, the less direct effects of conversion on the adequacy of the lower income housing stock have remained unexamined.<sup>70</sup> Conversion is a method by which wealthier households are able to appropriate a larger segment of the housing stock for their use, reducing the housing available to lower income groups.<sup>71</sup> The focus in the literature on the harms of tenant displacement obscures the fact that when a stagnant supply of housing exists, any increase in housing opportunities for the middle classes must come at the expense of the lower classes.

The need of the middle classes for a larger share of the housing stock has prompted this phenomenon.<sup>72</sup> The number of households in the U.S. increased by 27% in the past decade.<sup>73</sup> Yet, construction of new housing failed to keep pace with this increase.<sup>74</sup> Without a sufficient number of newly built units to satisfy the increased demand for homeownership opportunities, the middle classes have needed to capture a

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70. Several studies have focused on the problem of diminishing rental housing stock caused by the conversion of apartment buildings. *E.g.*, Comment, *supra* note 6, at 317. Loss of rental housing is significant because certain groups, such as the young and the elderly, are not interested in or are unable to make a commitment to an extended tenure in a particular location. *Id.* at 318. Many observers use an analysis of rental stock losses as a proxy for the loss of lower income housing, however. *E.g.*, Dreier, Atlas, *Condomania*, 45 THE PROGRESSIVE 19, 20 (March, 1981). The focus on the loss of rental stock does not adequately assess the impact of conversion on poor households. See text and notes accompanying notes 73-84, *infra*.

71. EMERGENCY CONDOMINIUM AND COOPERATIVE CONVERSION COMM'N, *supra* note 19, at 19, 24 (conversion provides higher income households with housing at the expense of the elderly, poor, and female-headed households); Goetze, *supra* note 16, at 52 (conversion allows the "haves" to take over housing from the "have-nots"). See text and notes accompanying notes 83, 84 *infra*.

72. See text and notes accompanying notes 19-26, *supra*. HUD found that the 366,000 units converted in the 1970's reduced the rental housing supply by only 18,000 available units. HUD 1980 STUDY, *supra* note 1, at iii. Although the supply of rental units was reduced by conversion, HUD recognized that the demand for rental units was also diminished since many of the condominium buyers were former renters. For a discussion of their complex calculations, see *Id.* at Ch. 7. The implicit conclusion, therefore, is that conversion does not significantly harm the renter populations, i.e., the poor. The problem with the HUD analysis is that in order to focus on ownership status, it creates a model with a static population of households. *Id.* at VII-5, n.2. The model thus ignores the growth in the number of middle class households and their resulting need for a greater share of the existing housing stock. As conversion has met this need, it has reduced the housing available to poorer populations. See text and notes accompanying notes 73-84 *infra*.

73. N.Y. Times, *supra* note 24, at A1, col. 2. This data reports the rate of new household formation for the entire population and is not broken down by income group. The factors leading to this increase (e.g., divorce, delayed child rearing, later marriages) are middle class phenomenon, which would indicate that the increase in middle class households is at least proportional to the general increase.

74. See notes 22 & 23, *supra*.

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greater share of the existing housing stock. Conversion has been able to satisfy this need in a manner that has great appeal for these households.<sup>75</sup> As conversion has created access to a larger portion of the rental stock, it has also provided these households with the tax and investment advantages that accompany homeownership.

As the middle classes extend their grasp over a larger share of the housing stock, the housing opportunities for the growing number of lower income households are diminished. This ramification of conversion is hidden, since the converted condominiums that middle class households purchase are not typically located in lower income neighborhoods and those displaced are not typically poor.<sup>76</sup> Instead, the effects of the conversion of the better rental stock to condominiums ripple through the housing market and affect the poor through a filtering process.

The filtering process allocates the supply of housing through a dynamic that resembles a chain reaction.<sup>77</sup> One family's move creates a vacancy that will become the new home of a second family. Similarly, the move of this second family from its old residence creates a vacancy that will be available to other families.<sup>78</sup>

Historically, this filtering process has created housing opportunities for low and moderate income families.<sup>79</sup> New houses have traditionally been built for the middle classes. When these families moved into new homes, their previous residences became available for occupancy by other families. Because the pace of new home construction exceeded the growth in the number of middle class households, these vacated residences were not needed by other middle class families and became available to less affluent households.<sup>80</sup> The new occupants of these residences had moderate incomes. Their previous residences, however, became available to households with less resources. As this chain reaction continued, a series of families were able to move into better accommodations.<sup>81</sup>

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75. See text and notes accompanying notes 26-28, *supra*.

76. See note 63, *supra*.

77. For an extended discussion of the filtering process, see W. GRIGSBY, *HOUSING MARKETS AND PUBLIC POLICY* (1963).

78. J. LANSING, C. CLIFTON, J. MORGAN, *NEW HOMES AND POOR PEOPLE: A STUDY OF CHAINS OF MOVES 2* (1969).

79. *Id.* at 65, 66.

80. *Id.* at 2; D. GORDON, *PROBLEMS IN POLITICAL ECONOMY* 357, n.17 (1971).

81. J. LANSING, C. CLIFTON, J. MORGAN, *supra* note 78, at 65. In essence, by building a new home, a middle class family created a new rung near the top of the ladder of housing quality. When the middle class family moved up to this rung, its old rung became vacant. Through the chain of moves that followed, a number of less affluent families were each able to take a step up the housing quality ladder. Black families, however, have not benefited

The benefits that accrued to poorer households from this filtering process have nearly ceased in recent years. With the decline in new home construction, relatively few middle class households have moved from their current residences into newly built homes. Because middle class households have created only a small number of new rungs at the top of the ladder, only a limited number of additional housing opportunities have filtered down to lower income families.<sup>82</sup>

In fact, the filtering process has begun to reverse direction and to reduce the housing available to lower income households. Because the growth in the number of middle class households has outstripped the rate of new construction, many middle class households have been forced to seek housing formerly occupied by other income groups. They have gained access to this housing through condominium conversion and have displaced other households. The households displaced by conversion, although not as wealthy as the condominium purchasers, still possess some economic resources which they use to obtain units that would otherwise be available to less affluent households.<sup>83</sup> These less affluent households, in turn, must seek housing previously occupied by those with even less resources. Thus, because the growing number of middle class households have needed additional housing units and have been unable to move up to new rungs at the top of the ladder, they have obtained housing on lower rungs through condominium conversion and prompted a chain reaction that reduces the housing available to those households with the least economic resources.<sup>84</sup>

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from filtering to the extent that white families have due to racial discrimination and income differences. *Id.* at 67. In addition, these chains of moves are interrupted by a variety of factors. Only one poor family is able to move to a better residence for every three units of new housing constructed for higher income families. *Id.* at 66. Therefore, the filtering caused by new construction cannot fully meet the housing needs of lower income and minority families.

82. Note, *supra* note 8, at 352 n.31.

83. SAN FRANCISCO STUDY, *supra* note 53, at 40 (median income of condominium buyers was \$32,325 contrasted to \$22,800 for displaced tenants); BALTIMORE STUDY, *supra* note 62, at 35, 38, 40 (median income for purchasers was over \$30,000, displaced tenant median income equalled \$17,800); HUMAN RELATIONS COMM'N, *supra* note 53, at 31 (median owner income totalled between \$20,000 and \$30,000, displaced tenant income averaged between \$15,000 and \$20,000); City of Cambridge, *supra* note 54, at 5, 20 (median income of new owners was over \$25,000 compared to displaced tenant median income of \$10,000-\$15,000). The HUD 1980 STUDY found a less significant difference. HUD 1980 STUDY, *supra* note 1, at VI-18 (39% of owners had income over \$30,000 compared to 30% of the displaced).

84. J. SOLOWAY, CONDOS, CO-OPS, AND CONVERSIONS: A GUIDE ON RENTAL CONVERSIONS FOR LOCAL OFFICIALS 6 (Office of Planning and Research, State of California, 1979) (conversion, even in high rent buildings, increases the competition for the remaining units and hurts the poor the most); J. SILVER, G. SHREVE, *supra* note 26, at 25 (reference to the indirect displacement of lower income households through a chain reaction).

Some observers have noted that condominium conversion merely re-shuffles the existing housing supply because the condominium buyers vacate their previous residences which become available for occupancy by other families. *Condominium and Cooperative Conversion: The*

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If a housing surplus existed, the problems caused by this reduction in the housing available to lower income families might not be as extensive.<sup>85</sup> The nation is experiencing its worst housing shortage in decades,<sup>86</sup> however, and with the retarded pace of housing construction, no relief is in sight.<sup>87</sup> By transferring existing housing to wealthier households, conversion places the burden of the shortage on those with the least capacity to resolve the underlying crisis.<sup>88</sup> Faced with an extremely tight housing market, poor families must either live in substandard housing, double up, or pay more for housing.<sup>89</sup>

Those commentators who focus on the effect of conversion on the displaced ignore this problem because they examine only the first stage of a chain reaction. An examination of the manner in which conversion's effects ripple through the housing market demonstrates that the benefits of conversion for the middle classes are linked to the reduction in housing opportunities for the poor.

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*Federal Response: Hearings Before a Subcomm. of the Comm. on Government Operations, House of Representatives, 97th Cong., 1st Sess., Pt. 2, p. 101 (1981) (statement of Patrick J. Rohan). Nevertheless, one cannot conclude that the housing stock available to lower income families remains stable simply because middle class households leave behind a vacant unit for every condominium that they occupy. But see Id. at Pt. 3, p. 140 (statement of Philip D. Winn). In a static housing market, conversion would merely re-shuffle the housing stock: the middle class would retain the same share of the available housing, but simply occupy different units. However, the housing market is not static. Instead, the number of middle class households is expanding rapidly and the middle classes require a greater share of the existing housing stock. The conversion process is able to assist the middle classes in capturing this added portion. Because of the tax advantages of conversion, middle income households can "bid up" the price of available housing at each step in the chain far beyond what they could afford to pay for rental housing. This provides them with an additional advantage over low income groups, who are unable to utilize the tax advantages of homeownership and who are often unable to obtain the necessary downpayment to purchase an apartment. Thus middle income households can successfully compete for available housing by paying higher prices without an actual increase in the costs to them because of the tax subsidy.*

85. The existence of an oversupply of units might diminish the harms to the poor because they might still have access to a reasonable, though reduced, number of minimum-quality housing units.

86. COMPTROLLER GENERAL OF THE U.S., *supra* note 25, at 5 (the rental vacancy rate declined to 4.8% in the first quarter of 1979, the lowest since tabulations began in 1956); Koeppel, *For Rent, Cheap, No Heat*, 45 THE PROGRESSIVE 23, 24 (March, 1981) (vacancy rates of 2% or less exist in many cities).

87. *See* notes 22, 23, *supra*.

88. Since conversion in most instances does not reduce the number of dwelling units, it is clear that conversion does not create the housing shortage. Conversion's effect is to satisfy the needs of middle class households and thus to insure that the burdens of the shortage fall on those with lower incomes. Historically, however, housing has only been built for higher income groups because of the inability of lower income households to support new construction. *See* note 80, *supra*.

89. J. SOLOWAY, *supra* note 84, at 6 (38% of California's lower income renters pay a disproportionate share of their income for housing; many are forced to double up or to locate far from work or city services); COMPTROLLER GENERAL OF THE U.S., *supra* note 25, at 9-10 (poor families are paying increasing portions of their income for housing and live in substandard conditions).



IV. *A Comparison of the Benefits and Harms of Conversion*

A comparison of the benefits and costs associated with condominium conversion indicates that on balance conversion is not a constructive social force.

The main benefits of conversion accrue to the participants in the transaction: the apartment building owner, the condominium converter, and the condominium unit buyers. Conversion is able to benefit each participant because it improves the federal tax treatment of a rental property by transforming it into homeownership units. The purpose of the tax provisions that subsidize homeownership is to encourage the construction of new homes.<sup>90</sup> By stimulating home construction, the tax law intends to improve the nation's housing stock and the general economic health of the country. With the growth in conversion as a means to satisfy the demand for homeownership, however, the federal tax subsidy of homeownership has increasingly been utilized to redistribute the nation's housing stock rather than to increase it.<sup>91</sup> Because the subsidy fails in these circumstances to stimulate housing production or any significant housing reclamation, it creates little social benefit. Instead, the tax subsidy merely represents a transfer payment of substantial proportions to the participants in the conversion transaction. Although conversion is able to benefit those parties involved in conversion activity, these benefits are directly offset by a governmental tax expenditure that accomplishes little of its intended social purposes.

The other benefit attributed to conversion is its contribution to urban revitalization. As shown previously, this benefit, too, is overstated. The gains to urban centers from conversion activity are in reality quite modest.

By contrast, the drawbacks to conversion are substantial and greatly outweigh its benefits. Conversion burdens lower income households by reducing their housing options. In addition, the poor and elderly resi-

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90. It is generally believed that this provision and the other portions of the code that favor homeownership are intended to stimulate the housing industry and the economy. *See, e.g.*, 2 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS 31-3 (1981) (the provision's perpetuation may reflect a legislative desire to stimulate the nation's economy by encouraging the use of credit to purchase homes, autos, and other consumer goods). Congress has never made explicit its reasons for the personal interest deduction that lies at the core of the homeownership preference, however, even though this deduction has been part of the tax code since 1913. *Id.* at 31-3; Goetze, *supra* note 16, at 44, 50-51, 52 (tax reductions for homeowners are received to promote new housing construction).

91. *See* Goetze, *supra* note 16, at 44 (tax favoritism for homeowners no longer adds to the housing supply; instead it merely induces affluent households to overconsume while the needy are left out).

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dents of converted buildings experience severe difficulties when forced to move.

Conversion also diminishes the pressure for new construction, the only long-term answer to the nation's housing troubles. New housing is usually built for the middle classes since they possess the resources to pay for new high-quality units.<sup>92</sup> But conversion reduces the interest of these households in new construction since they are able to qualify for the homeownership subsidy as condominium owners. As conversion satisfies the homeownership demands of the middle classes and places the burdens of the housing shortage on lower income families, the pressure for additional housing comes from those least able to support new construction.

Consideration should thus be given to measures that would reshape governmental policy to protect the lower income housing stock, minimize the effects of displacement, and insure that the effect of the government's homeownership subsidy more closely adheres to its original purpose of encouraging new home construction.

### V. *The Regulation of Condominium Conversion*

A number of strategies have been proposed to address the problems posed by condominium conversion. This section will present these options, analyze their impact, and propose a preferred policy in this area.

#### A. *Strategy of Governmental Non-Intervention*

One approach to the regulation of condominium conversion is a policy of non-interference. This approach presumes that conversion is a natural response to the market pressures created by the consumers and suppliers of housing. As a market force created by thousands of independent actors pursuing their own best interests, it is suggested that conversion should receive special deference and be immune from governmental interference. This view concludes that governmental intervention would reduce the effectiveness of the marketplace in satisfying the public's housing needs and produce serious unanticipated consequences due to the inexact nature of intervention strategies.

Whatever the merit of governmental non-intervention in other sectors of the economy, the application of this philosophy to the condominium conversion market is unwise. The assumption that conversion is a free market force is inaccurate. As indicated earlier, conversion is a product of the federal tax law, not of the free market. Although thousands of

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92. See note 80, *supra*.

independent actors have demanded converted condominiums in the housing marketplace, these parties are in fact seeking the federal tax benefits that attach to homeownership properties. As the product of governmental tax policies, condominium conversion does not deserve any special protection from governmental regulation that might be provided true market forces. Therefore, to the extent that conversion is an undesirable phenomenon, government should adjust its intervention in the housing market to diminish conversion's harms.

### B. *Regulation of The Process of Condominium Conversion*

A variety of regulations have been proposed to alter the process of conversion so that tenants are provided with a reasonable opportunity to purchase their units and are treated fairly if they are unable to buy. Provisions that provide tenants prior notice of conversion and the first option to purchase their units are widely supported and have been adopted in many jurisdictions.<sup>93</sup> Some observers have also advocated relocation assistance for displaced households and prohibiting or delaying eviction of elderly and handicapped tenants.<sup>94</sup>

These proposals are aimed only at the immediate displacement problem and will only address the predicament of tenants in the apartment buildings undergoing conversion. Even with regulations of this nature, conversion activity will continue and will appropriate the lower income housing stock for the middle classes.<sup>95</sup> Unless the level of conversion

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93. See, e.g., Comment, *supra* note 6, at 331, 332. The Uniform Condominium Act and Model Condominium Code contain these protections. *Id.* at 328, 329. Eighteen states have adopted the notice requirement; fourteen create a tenant right of first refusal. HUD 1980 STUDY, *supra* note 1, at XI-5. Several localities have passed similar provisions. *Id.* at XII-8, XII-14.

94. E.g., Comment, *supra* note 6, at 331, 332. Five states require relocation assistance be provided to displaced tenants and three provide extended tenancies for elderly or handicapped tenants. HUD 1980 STUDY, *supra* note 1, at XI-5, XI-20. One-fourth of municipalities with conversion ordinances require relocation assistance for tenants and several have adopted additional protections for the elderly or handicapped. *Id.* at XII-9, XII-16.

A related category of proposals attempts to preserve particular dwelling units or buildings for lower income households. Such measures require a certain percentage of units in each converted building to be set aside for lower income renters, provide financial assistance for households to purchase their units, or facilitate tenants' purchase their buildings to create low income cooperatives. HUD 1980 STUDY, *supra* note 1, at XI-20, XII-15, XII-30. These measures will protect the residents of the targeted apartments from displacement. Because these measures do not reduce the demand for conversion, however, they will in all likelihood merely shift conversion to other buildings, rather than retard the overall level of activity. Note, *Regulatory Responses to the Condominium Conversion Crisis*, 59 WASH. U. L. Q. 513, 533 (1981). Thus displacement will simply occur elsewhere and conversion's role in reducing the lower income housing stock will not be altered.

95. Regulations that protect existing tenants might create sufficient administrative costs to developers that they may decide to forego conversion. Regulations of this nature have not seemed to have significantly affected converters thus far, however. These regulations are

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activity is restricted, conversion's negative effect on the housing opportunities of lower income households will continue unabated.

### C. *Restrictions on the Level of Conversion Activity*

Conversion can also be regulated by direct governmental restrictions on the number of condominium conversions. One such proposal is contained in a federal bill submitted by U.S. Representative Benjamin Rosenthal. It would create a three-year nationwide moratorium on condominium conversion.<sup>96</sup> Other proposals would restrict conversion at the municipal level through local ordinance. Measures of this type that have been adopted include: prohibitions on conversion when rental vacancy rates fall below a designated percentage;<sup>97</sup> quotas restricting conversion to a limited number of units<sup>98</sup> or to a percentage of the locality's new rental construction;<sup>99</sup> and systems of discretionary approval by a local board<sup>100</sup> or the building's tenants.<sup>101</sup>

By restricting the rate of condominium conversion, these proposals minimize both the harms of displacement and conversion's role in reducing the housing opportunities of lower income households.<sup>102</sup> The difficulty with these efforts is to insure that they are both adapted to local conditions and comprehensive. Though comprehensive in scope, a national moratorium would be totally insensitive to local housing markets. Conversion would be proscribed even in areas with high vacancy rates where the reduction in the housing stock of lower income groups is less harmful due to the general oversupply of housing.<sup>103</sup> In these regions, regulations that minimize the effects of displacement may be suffi-

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common in areas with significant conversion activity. See HUD 1980 STUDY, *supra* note 1, at IV-7, XI-5; ADVANCE MORTGAGE CORPORATION, *supra* note 2, at 4-12.

96. 125 CONG. REC. H7346 (daily ed. September 5, 1979) (statement of Rep. Rosenthal).

97. See Lauber, *supra* note 53, at 204. For a discussion of the administrative problems associated with such ordinances, see Note, *Municipal Regulation of Condominium Conversions in California*, 53 S. CALIFORNIA L. R. 225, 267-268 (1979).

98. See Note, *supra* note 97, at 237 (citing a San Francisco ordinance that permits only 1000 conversions annually).

99. J. SOLOWAY, *supra* note 84, at 14 (citing a La Mesa, California, measure that restricts conversion to an amount equal to 50% of the average new rental units constructed in the past two years).

100. Comment, *Conversion of Apartments to Condominiums: Social and Economic Regulations Under the California Subdivision Map Act*, 16 CALIFORNIA W. L. R. 466, 491-492 (1980) (citing a Vallejo, California, ordinance placing discretionary approval power with the City Planning Commission).

101. Note, *supra* note 97, at 235, 266, 268-273.

102. As these ordinances halt conversion, they protect the lower income housing stock. See text and notes accompanying notes 109-114, *infra*.

103. Snyderman, Morrison, *Rental Market Protection Through the Conversion Moratorium: Legal Limits and Alternatives*, 29 DEPAUL L. R. 973, 1006 (1980) (federal and even statewide actions do not adequately recognize that housing markets are predominantly local). See also note 85, *supra*.

cient, but a nationwide prohibition would prevent conversion in every locale. Statewide prohibitions would have similar problems.<sup>104</sup>

In contrast, local measures would be more sensitive to housing market conditions in each community. Yet, these measures are not likely to be sufficiently comprehensive. Since most housing markets encompass several cities, municipal prohibitions might merely shift conversion activity among cities within a region. This problem would be remedied only if several adjacent municipalities simultaneously enact ordinances of a similar nature. The practical difficulties in securing such regional cooperation might be insurmountable.

#### D. *Improving the Economics of Rental Housing*

Many commentators have suggested that the best way to discourage condominium conversion and prompt badly-needed new construction is to improve the profitability of rental housing through governmental actions. One proposal of this nature would increase the federal subsidy of rental buildings through tax breaks for housing investors.<sup>105</sup> Another measure calls for the government to improve the ability of the renter population to pay for housing by additional transfer payments to lower income households.<sup>106</sup>

The political feasibility of these alternatives is very low, however, because of the enormous costs of such proposals. In order to diminish conversion activity, not only must these efforts increase the profitability of

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104. See note 103, *supra*.

105. See, e.g., Rosenthal, *The Legality and Practicality of Condominium Conversion Moratoriums*, 34 U. MIAMI L. R. 1199, 1226 (1980).

106. See, e.g., Koepfel, *supra* note 86, at 25. Even if transfer payments to the poor were increased, poor families are likely to spend these additional resources on items other than housing. M. BENDICK, JR., J. ZAIS, *INCOMES AND HOUSING: LESSONS FROM EXPERIMENTS WITH HOUSING ALLOWANCES* 3 (1978). Housing subsidy programs may be able to increase housing expenditures by altering the flexible character of the transfer payment, however. The federal Lower Income Housing Assistance Program (Section 8) pays poor families the difference between the cost of standard housing in their locality and 25% of their adjusted family income and has had the effect of increasing housing expenditures. M. DRURY, O. LEE, M. SPRINGER AND L. YAP, *LOWER INCOME HOUSING ASSISTANCE PROGRAM (SECTION 8): NATIONWIDE EVALUATION OF THE EXISTING HOUSING PROGRAM 70-72* (United States Dep't of Hous. and Urban Dev., 1978).

Other proposals related to these efforts to improve the economics of rental housing seek to tax condominium conversion to raise money for lower income housing programs. Comment, *supra* note 6, at 321 (a transfer tax of 5% on the first sale of a converted condominium, the proceeds of which would be used for rent subsidies, and relocation assistance); HUD 1980 STUDY, *supra* note 1, at XII-31. These proposals would either slow the pace of conversion by raising the price of converted units or provide some financial resources to assist low income families. The rate of tax in most proposals is low enough so that conversion would continue, but some revenue would be raised. For example, a Los Angeles ordinance that requires a \$500 payment for each unit converted will halt few conversions. See *Id.* at XII-31. The revenue raised by such measures will in all likelihood not be sufficient to construct new low income units or provide much long-range assistance to poor families, however.

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rental ownership to an acceptable level, the subsidies must be large enough to counteract the windfalls available to an investor who converts to condominiums.<sup>107</sup> Similarly, new rental construction would not be undertaken unless a substantial subsidy is available.<sup>108</sup> Thus, although additional subsidies for housing may represent a constructive approach to the nation's housing problems, these measures would be tremendously expensive and are unlikely to be adopted given the current political climate.

### E. *The Refusal of Homeownership Tax Status to Owners of Converted Condominiums*

The final regulatory option and the recommended alternative is to refuse preferential tax treatment to owners of condominiums that have been converted from apartments. Owners of condominiums converted after enactment of this legislation would be treated as though they owned an investment property and would be required to impute rental income. In turn they would be able to deduct operating expenses and depreciation as well as mortgage interest and property tax payments, and would be subject to capital gains tax on the unit's appreciation. For administrative simplicity, the Internal Revenue Service may prefer a proposal that simply removes the deduction for mortgage interest and property tax payments. This change would free the I.R.S. of the burden of calculating imputed rents, but would have essentially the same economic effect. Owners of newly built condominiums and purchasers of previously converted condominiums would continue to receive preferential homeownership treatment.

The object of this tax amendment is to steer those demanding homeownership units away from existing rental structures. The amendment would substantially slow the pace of conversion activity by denying governmental tax benefits to the owners of converted condominiums. The amendment, however, would not prohibit conversion. If the conversion of an apartment building is able to create economic value independent of the transaction's tax consequences, it would be able to proceed, but

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107. Although only the best of the rental stock has been the focus of conversion activity to date, it would not be possible to target a tax measure designed to prevent conversion on these buildings. Every rental building would receive a tax subsidy so that the highest quality rental units would not be converted. It is obvious that the cost of this sort of measure would be extraordinarily high.

108. At current rent levels, privately financed rental units are not economically feasible. COMPTROLLER GENERAL OF THE U.S., *supra* note 25, at 11. Rents must rise by 25% in order to stimulate new construction. *Id.* at 13. Regardless of whether these increases in a building's income come from tenants who are able to pay higher rents due to an additional transfer payment or from tax expenditures, the cost to the federal treasury would be enormous.

would simply not receive any federal income tax benefits. Thus, the amendment to the Internal Revenue Code would be sensitive to local conditions, but comprehensive in scope.

The amendment would also be sensitive to the expectations of households who have already purchased converted condominiums. They would continue to receive homeowner's tax status and would be able to pass that status on to future purchasers, thereby protecting the market value of their investment. In all future conversions, it would be clear at the time of initial purchase whether the units will receive homeowner's tax treatment and presumably the condominiums would be priced accordingly.

The key question is whether the reduction in conversion activity created by these changes would achieve the objective of protecting the housing stock of lower income groups. The effectiveness of the proposal would depend on the response of the middle classes. The middle classes are seeking both access to additional portions of the housing stock and ownership units that qualify for preferential tax treatment. In the absence of conversion, the middle classes would have two main options: creating new ownership units through the construction of homes or new condominiums or entering the rental market.<sup>109</sup>

To the extent that middle class households enter the rental market, the housing available to lower income groups would continue to diminish. The middle classes would be able to outbid those with fewer resources for the better rental units, thereby reducing the housing for lower income families through the filtering process.

There is good reason to believe that the rental option would not be preferred, however. Without the high turnover created by conversion in prime rental buildings, the middle classes would have difficulty gaining access to top-quality rental units which characteristically have low turnover rates.<sup>110</sup> Additionally, rental choice fails to confer the benefits of

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109. A third option is to reduce the number of households through shared arrangements. The merger of households is a common occurrence in tight housing markets. Downs, *supra* note 16, at 3. By restricting conversion's use by the middle class as a means to gain access to additional housing units, unrelated individuals who are currently living alone may decide to join together to rent or purchase housing in order to share the increasing costs of housing. Already the number of households composed of unrelated individuals is rising. BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, POPULATION PROFILE OF THE UNITED STATES: 1980 22 (Current Population Reports Series P-20, No. 363, 1981) (the number of non-family households of two or more persons increased by 162% between 1970 and 1980 from 1.8 million to 2.9 million households). And many homes are being purchased jointly by unrelated parties. Wall Street J., April 17, 1981, at 1, col. 6; Chicago Tribune, November 9, 1980, § 14, at 2E, col. 1.

110. Lauber, *supra* note 53, at 206 (residents in buildings undergoing conversion in Evanston and Oak Park (Ill.) had lived in their apartments for an average of 7.2 and 5.5 years respectively).

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homeownership demanded by the middle classes. In contrast, new home construction presents the middle classes with access to additional high quality units and to homeownership and its benefits. The problem usually identified with newly constructed units is their exceptionally high price.<sup>111</sup> But a comparison of the sales prices of converted condominiums and newly built condominiums reveals that the new units are only slightly more expensive and that the difference is diminishing.<sup>112</sup> Thus, if converted condominiums were no longer an attractive or available alternative, middle class households might increasingly choose to buy newly built units. New construction adds units to the housing supply, thereby lessening the need of the middle classes for a greater share of the existing housing stock. In shifting the attention of the middle classes from conversion to new construction, this tax amendment would protect the housing stock of the poor from the threat posed by the expanding number of middle class households.

### VI. Conclusion

A major weakness of the policy debate on condominium conversion has been a failure to appreciate the central role of the federal tax law in encouraging conversion activity. Even when the importance of federal tax policy is noticed, these statutes are viewed as though they were an unchangeable element of the real estate environment. This unquestioning acceptance of the current tax law may be based on political judgment; the homeownership preferences in the tax code have a large and powerful constituency. Rather than abolishing all homeownership benefits, however, the proposed changes in homeowner tax treatment would be made at the margins and prospectively only. The political obstacles to change would be significantly less than for proposals affecting real estate transactions generally, yet conversion would be significantly affected.

In addition to assessing the political feasibility of amending the tax laws, the merits of the policy of granting homeownership benefits to owners of converted condominiums must be evaluated. The assessment conducted in this paper reveals that beyond the immediate financial

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111. An additional problem that may detract from the attractiveness of new construction is the shortage of land available for construction near the center cities. This problem is more pronounced in major metropolitan centers like New York City. In such areas, some middle class families may prefer to rent in central locations rather than buy residences in areas that require a longer commute to the center city. To the extent that middle class families remain in the rental market, they will continue to reduce the housing available to lower income groups.

112. ADVANCE MORTGAGE CORPORATION, *supra* note 2, at 2, 3.



benefits for conversion's participants, conversion's benefits are quite limited. Conversion, however, does seriously reduce the housing available to lower income groups and harms the poor and the elderly who are displaced by conversion. Because this portion of the tax code encourages an activity that creates more harm than benefit, the law should be amended to refuse homeownership benefits to owners of newly converted condominiums. This amendment would reduce conversion levels and the costs associated with conversion. It would also create additional pressure for the expansion of the nation's housing stock during a period of housing shortage. This tax amendment would permit the federal government to shift its tax expenditure from conversion activity that merely redistributes the existing housing stock to new construction activity that increases the total supply of housing.