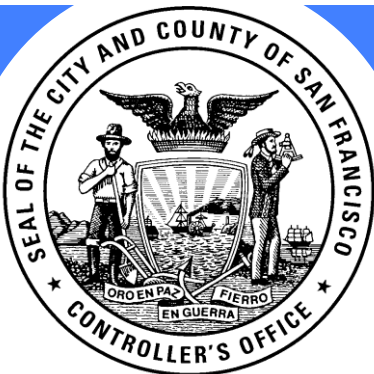


# Real Estate Transfer Tax Exemption and Office Space Allocation: Economic Impact Report



**CITY & COUNTY OF SAN FRANCISCO**

Office of the Controller  
Office of Economic Analysis

February 23, 2024

- Proposition C on the March 2024 San Francisco ballot is a proposed exemption of certain transactions from the City's Real Property Transfer Tax ("Transfer Tax"). The tax is levied on sellers of real estate when properties are sold.
- The proposed measure would exempt certain sellers of residential property from the tax, if the property was converted from commercial to residential use prior to 2030. Only the first sale after such conversion would be eligible for the tax exemption. Up to 5 million square feet of residential estate, converted from office space, would be eligible for the exemption.
- Since the pandemic, office attendance in the city has declined, and commercial office vacancy rates have reached a record high. Some commentators have suggested that converting downtown office buildings to housing would further the city's economic recovery.
- New office development in the city is subject to an annual limit. The measure would additionally increase that limit in proportion to the amount of office space lost under this measure.
- The Office of Economic Analysis (OEA) has prepared this report because the proposed measure may have a material impact on the city's economy.

# Transfer Tax Rates

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- The transfer tax is paid by property sellers upon sale. The rates are shown in the table below:

<b>Sale Price</b>	<b>Transfer Tax Rate</b>
\$250,000 or less	0.500%
\$250,000 - \$1 million	0.680%
\$1 million - \$5 million	0.750%
\$5 million - \$10 million	2.250%
\$10 million - \$25 million	5.500%
\$25 million or more	6.000%

- Office buildings that are converted to condominiums are sold individually, since condominiums are separate legal properties. Given the current market, most of these properties would be subject to the lower 0.680% or 0.750% rate. Apartments, on the other hand, are sold as an entire building, and would most likely pay the higher 5.5% or 6.0% rates.

# Remote Work and the Downtown Economy

- The persistence of working-from-home after the pandemic has led to a significant change in office demand across the U.S., with important implications for downtown office districts and city economies.
- According to JLL, San Francisco's office vacancy rate has risen from 5.2% to 32.1% from 2019 to the end of 2023<sup>1</sup>. Office rents have fallen by 22% since that time, though recent sales of office buildings suggest a significantly greater drop in value<sup>2</sup>.
- With a smaller daytime population of office workers, the rest of the downtown economy has also suffered:
  - Sales tax from the Financial District/South Beach area dropped 29% from the third quarter of 2019 to the third quarter of 2023<sup>3</sup>.
  - MUNI metro ridership has hovered between 50-60% of normal since early 2023, and BART's ridership to downtown has averaged 30-35% of normal<sup>4</sup>.

# Background: Office Space Conversion

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- While this change to downtown has been particularly notable and pronounced in San Francisco, it is part of a national phenomenon. Office attendance has declined by 40-60% across the largest metro areas in the country<sup>5</sup>, and office vacancy has risen since 2019 in every major market in the country<sup>6</sup>.
- This reduction in office attendance and leasing has led to speculation that the U.S. has an over-supply of office space, and large-scale conversion to other uses, especially housing, will have to occur.
- However, thus far, office-to-residential conversions have been slow to proceed. As of September 2023, planned or in-progress office conversions accounted for only 1.4% of total office space in the U.S.<sup>7</sup>. According to the office brokerage CBRE, 48% of converted office space has been turned into multi-family housing.
- In San Francisco, the economics of conversion of office space to housing are made particularly challenging by the weakness in the city's housing market. According to data from Zillow, San Francisco has seen the third-steepest drop in housing prices of any large county in the U.S. from December 2019-2023, behind only the Bronx and Manhattan in New York City<sup>8</sup>.

# Moody's Report on Conversion Candidates

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- In December 2023 the economic consulting firm Moody's Analytics published a study of potential office-to-residential conversion candidates in San Francisco<sup>9</sup>.
- Moody's studied past conversion efforts in other cities and found that the best candidates were older, lower-quality Class B and C buildings, with small floorplates (to maximize natural light) but big enough to be efficient in construction (at least 25,000 square feet in building size).
- Other, non-structural, factors include permissive zoning – such as the C-3 and C-2 districts in San Francisco where most office space is located – and high levels of vacancy.
- Using these criteria, the study determined that 13% of office buildings in the city were viable candidates for conversion.
- According to Moody's, the best conversion candidates were concentrated in the North Financial District, South Financial District, and Union Square office sub-markets.
- The report did not study the financial feasibility of conversions.

- A November, 2023 working paper by three academics from New York and Columbia Universities studied the financial feasibility of office conversions across the U.S., including in the San Francisco metropolitan area<sup>10</sup>.
- Like the Moody's report, the authors screen properties as candidates for conversion based on their location, age, class, size, and vacancy, along with energy use. They found 9% of buildings were promising candidates, including 295 in the San Francisco metropolitan area.
- In terms of the financial feasibility of conversions, the authors found that "conversions can be financially viable if the developer can purchase the office building significantly below pre-pandemic valuation levels."
- The study further determined that the typical conversion of a class B office building is financially feasible in the San Francisco metro area without any subsidy<sup>11</sup>.
- In the San Francisco area, the authors estimated that the current average value of a Class B office building was \$88/square foot, which according to the authors is 74% below pre-pandemic levels. It is, however, higher than recent sale prices for office buildings in downtown San Francisco (see Appendix D).

# SPUR Report on the Feasibility of Conversions

- In late 2023 the San Francisco think tank SPUR released a report on the financial feasibility of office-to-residential conversions in San Francisco<sup>12</sup>.
- Based on its financial modeling, the SPUR report determined that conversions are not currently financially feasible in San Francisco.
- The finding was based on, among other things, an average acquisition cost for office buildings of \$183 per square foot. The average feasibility gap was \$267,000 per residential unit.
- The SPUR report's estimate for the acquisition cost of office buildings is higher than the \$88 per square foot price in the Gupta, Martinez, and Van Nieuwerburgh report, but still lower than most of the prices paid in recent office building transactions in the city (summarized in Appendix D).



# The Proposed Incentive and the Feasibility Gap

- Condos in downtown San Francisco have recently sold at an average of \$1.2 million per unit, or \$902 per square foot<sup>13</sup>. For a developer who converted an office property to condos, the incentive would be worth \$9,000 per unit or \$6.77 per residential square foot, at these average prices and the 0.75% transfer tax rate applicable at that price range.
- Although the market is currently more favorable to condos development than apartments<sup>14</sup>, the proposed incentive is larger for rental projects. Since apartments are sold as entire buildings, the higher 6% transfer tax rate would likely apply, and the incentive would be worth \$33,360 per unit or \$41/square foot, based on the report's numbers.
- Considering the development costs assumed in the SPUR report, the proposed incentive would represent a 2% reduction in development costs for condos, or a 6% reduction costs for apartments, excluding the cost of the office building.
- Given the size of the incentive relative to the feasibility gap indicated in the SPUR report, and the fact that office buildings are currently trading for more than that report assumes, it is unlikely that the proposed incentive will stimulate conversions unless and until market conditions improve.

# Potential Impacts if Market Conditions Change

- If market conditions change, office-to-residential conversions may become financially feasible. For example, housing prices may recover, construction costs could decline, or office building prices could fall further from the current levels.
- As noted earlier, the Gupta, Martinez, and Van Nieuwerburgh report determined that conversions would be broadly feasible when Class B office properties were valued at \$88 per square foot in the San Francisco area.
- In a situation where conversions were actively occurring, the economic and fiscal impact of the proposed tax incentive would depend on its effectiveness in stimulating additional conversions, and the conversions' impacts on the broader economy and the City's finances.
- Because there have been so few conversions, it is not possible to statistically estimate how the number of conversions would change in response to a 2% or 6% reduction in development costs. But, by way of illustration, if that level of subsidy led to a three-fold percentage in the number of conversions (6% or 18%), that would represent a highly effective incentive<sup>15</sup>.
- We will use that benchmark to explore the economic and fiscal impact of the proposed incentive on the following pages. The results are intended to be illustrative, because they depend on hypothetical future market conditions.

- When office buildings are converted to housing units, the City's tax revenues change. In general, the City can expect to see higher property and sales taxes from a converted building, since the refurbished building will have new investment, and lower business taxes, because office building tenants pay business taxes, and residents do not.
- Appendix A details our estimate of the fiscal impact of converting to apartments and condos, under assumptions of higher future housing prices and lower office buildings prices that would make conversion feasible. We estimate that the City would gain \$2,287 per year from each converted apartment unit, and \$4,260 per year for each condo.
- However, these ongoing gains need to be considered against the costs of the transfer tax exemption, for both the conversions that are stimulated by the incentive, and those that would have happened anyway. The estimates for those are detailed in Appendix B.
- Overall, the cost of the foregone revenue would outweigh the annual gain by a factor of 29:1 for condos, and 102:1 for apartments. Since the foregone revenue occurs at the time of sale, and the tax gain accrues over time, these ratios can be understood as a payback period. Under these assumptions, the City would recoup the foregone revenue from condo conversions in 29 years, and from apartment conversion in 102 years.

- Conversions also change structure of the city's economy, by reducing employment that needs office space (in a stabilized office market) and increasing the city's population. Both the loss of office jobs and the gain in population create multiplier effects in the local economy, which can be examined with the OEA's REMI model.
- Using REMI, we modeled the impact of reducing office employment (in a stabilized office market where Class B buildings have a 25% vacancy rate) and increasing the city's population, along with the fiscal impacts discussed on the previous page.
- In general, office-to-residential conversion would reduce the number of jobs in the city and the city's GDP over a 20-year forecast period, while increasing the city's population and labor force. For every 100,000 square feet of office space converted, total employment in San Francisco would decline by 155, population would grow by 462, and the city's GDP would decline by \$49 million. Per capita disposable income of residents would decline by \$45.
- On a sectoral basis, most of the job losses would be concentrated in office-using industries (which are major contributors to the city's GDP), while gains would be recorded in construction, government, and local-serving industries.
- Detailed assumptions and results are shown in Appendix C.

- Aside from the economic and fiscal issues covered in this report, several commentators have suggested that cities should prioritize office-to-residential conversions as a matter of policy.
- Arguments in favor of encouraging downtown housing include improved housing affordability, improving foot traffic and stabilizing demand for downtown businesses, and promoting economic diversification.
- Without attempting to evaluate those claims in the context of this report, there are obvious economic benefits to increasing the downtown population through new housing. The City should, however, consider the opportunity cost of alternative approaches.
- Office-to-housing conversion cannot occur, at present, without a substantial public sector subsidy, and the opportunity cost – in the form of lost office space – is likely to lead to a net loss to the city's economy.
- On the other hand, zoning controls currently limit the height, and in some cases the permissibility, of new housing in several areas in and around downtown. Relaxing these restrictions could lead to more housing with a lower opportunity cost.

- The continuing prevalence of remote work and San Francisco's record-high levels of office vacancy have raised concerns about the future of a downtown district that was among the most vibrant in the country a few years ago.
- The city's office market is slowly adjusting, however, and in time this is likely to lead to some recovery of both the daytime population downtown, and the downtown housing market. Despite some decline, effective office rents in downtown San Francisco remain among the highest in the country.<sup>16</sup>
- Conversion of office space to housing does not appear to be financially feasible at the moment, and the proposed incentive is likely too small to close the feasibility gap.
- If market conditions change in the future, and conversions do become feasible, the proposed incentive is likely to lead to a negative economic impact, and an extended period before foregone transfer tax revenue is recouped by higher property tax revenue for the City.
- Broader goals of revitalizing downtown and increasing housing opportunities are certainly important, but might better be pursued through zoning changes that could be economically and financially beneficial to the city.

1. JLL San Francisco Research (2024) *Pulse of the Market Q4 2023 San Francisco*, p. 13.
2. Klearman, S (2023, December 4) San Francisco's postpandemic office reset is starting to take shape. *San Francisco Business Times* <https://www.bizjournals.com/sanfrancisco/news/2023/12/04/downtown-office-postpandemic-reset.html>
3. Office of Economic and Workforce Development (2024) *San Francisco Sales Tax*, <https://www.sf.gov/data/san-francisco-sales-tax>
4. San Francisco Controller's Office (2024) *Status of the San Francisco Economy: January 2024* <https://openbook.sfgov.org/webreports/details3.aspx?id=3347>
5. Kastle Systems (2024) Kastle Back-to-Work Barometer 2.4.24. <https://www.kastle.com/safety-wellness/getting-america-back-to-work/>
6. JLL (2024), p. 35.
7. CBRE (2023) *Rise in Office Conversions May Help to Reinvigorate Cities*. <https://www.cbre.com/insights/briefs/rise-in-office-conversions-may-help-to-reinvigorate-cities>
8. Zillow.
9. Spinelli, A. and L. Chen (2023) *San Francisco Office Conversion*, Moody's Analytics CRE <https://ma.moody's.com/rs/961-KCJ-308/images/San%20Francisco%20Office%20Conversion%20Report.pdf>
10. Gupta, A., Martinez, C., and Van Niewerburgh, S. (2023) *Converting Brown Offices to Green Apartments*. The Hamilton Project [https://www.hamiltonproject.org/wp-content/uploads/2023/11/20231103\\_THP\\_Conversions\\_Proposal.pdf](https://www.hamiltonproject.org/wp-content/uploads/2023/11/20231103_THP_Conversions_Proposal.pdf)
11. Ibid, p. 7.

12. SPUR (2023) *From Workspace to Homebase*. [https://www.spur.org/sites/default/files/2023-10/SPUR\\_From\\_Workspace\\_to\\_Homebase.pdf](https://www.spur.org/sites/default/files/2023-10/SPUR_From_Workspace_to_Homebase.pdf)
13. Zillow sales data from October 2023 – January 2024.
14. San Francisco Controller’s Office (2023). Inclusionary Housing: Triennial Review of Economic Feasibility <https://www.sf.gov/sites/default/files/2023-06/Triennial%20Economic%20Feasibility%20Report%202023.pdf>
15. By way of comparison, past OEA research has found that a 1% change to housing costs has a less than 1% increase in new construction in San Francisco. See, for our example, our [2015 report](#) on the proposed Mission housing moratorium. New housing supply is constrained by zoning, and these constraints generally don’t apply to downtown conversions in San Francisco, so it’s reasonable to assume that conversions will be more responsive to price changes and tax incentives. However, conversions are still complex, capital-intensive, and impractical in many cases, so they likely won’t have a comparable supply elasticity to new construction in supply-unconstrained housing markets, and our assumption is likely generous to the effectiveness of the incentive. For a recent review of housing supply elasticities across the U.S. see Aastveit, K., Albuquerque, B., & Anundsen, A. K. (2020). [The declining elasticity of US housing supply](#). VoxEU. org, 25.
16. CBRE (2024). Negative Office Demand Continues to Ease. <https://mktgdocs.cbre.com/2299/c85eda05-a80d-4156-8958-13c3bd7fab6c-2009844453.pdf> Average asking rents in San Francisco for the 4<sup>th</sup> quarter of 2023 were above every major market except midtown Manhattan & the San Francisco Peninsula.



# Appendix A: Per-Unit Impacts - Apartments

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	Office	Residential	Notes
Property value / SF	\$100	\$591	Sources: SPUR report, increased by 15% to account for a presumed stronger housing market and adjusted for a 75% residential efficiency factor and an 812 SF average unit size. For offices, assume \$100/sf market value and assessed value for Class B candidate buildings.
Annual property tax / SF	\$1.00	\$5.91	Tax rate is 1% of value.
Business tax / SF	\$2.28	\$0.00	Based on 2022 tax filing data, average business tax/SF for (Gross Receipts, Homelessness Gross Receipts, Commercial Rents, and Overpaid Executives Tax) from a sample of Class B office buildings. Residential does not generate business tax.
Sales tax / SF	\$0.04	\$0.44	For office, based on sales tax from office equipment and supplies for 2022Q4-2023Q3 (\$3.7 million) divided by 87 million sf of office inventory. For residential, we assume (favorably) that residents generate all sales tax except from business and industry categories (i.e. visitors, commuters, and tourists pay nothing), and divide that by the number of households in the city.
Total per SF	\$3.32	\$6.35	
Net Gain from Conversion/SF-year	\$3.03		
Average Unit Size	812		SPUR report
Net Gain from Conversion/Unit-year	\$2,457		

# Appendix A: Per Unit Impacts - Condos

	Office	Residential	Notes
Property value / SF	\$100	\$778	Sources: Zillow recent sales, increased by 15% to account for a presumed stronger market, and adjusted for a 75% residential efficiency factor per the SPUR report. For offices, assume \$100/sf market value and assessed value for Class B candidate buildings.
Annual property tax / SF	\$1.00	\$7.78	Tax rate is 1% of value.
Business tax / SF	\$2.28	\$0.00	Same as apartments
Sales tax / SF	\$0.04	\$0.33	Same as apartments
Total per SF	\$3.32	\$8.11	
Net Gain (Loss) from Conversion/SF	\$4.79		
Average Unit Size	812		SPUR report
Net Gain (Loss) from Conversion/Unit-year	\$3,889		

# Appendix B: Fiscal Impacts - Apartments

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	Conversions That Would Occur Without Tax Incentive	Conversions Caused by the Tax Incentive	Total
Number of Apartment Units	100	18	118
Value per Unit	\$639,400	\$639,400	
Transfer Tax Rate	6%	6%	
Transfer Tax Foregone	\$3,836,400	\$690,552	\$4,526,952
Annual Tax Impact of Conversions Caused by the Incentive	\$0	\$44,225	\$44,225
Ratio of foregone revenue to annual revenue gained	102		

# Appendix B: Fiscal Impacts - Condos

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	Conversions That Would Occur Without Tax Incentive	Conversions Stimulated by the Tax Incentive	Total
Number of Condo Units	100	6	106
Value per Unit	\$842,288	\$842,288	
Transfer Tax Rate	0.75%	0.75%	0.75%
Transfer Tax Foregone	\$631,716	\$37,903	\$669,619
Annual Property, Business, and Sales Tax Impact	\$0	\$23,336	\$23,336
Ratio of Foregone revenue to annual revenue gained	29		

# Appendix B – Fiscal Impact - Notes

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- Number of Condo/Apartment Units - based on the assumed effectiveness of the incentive, its 2% or 6% decrease in development costs would lead to a 6% or 18% increase in the number of units converted.
- Value per Unit - based on Zillow (for condos) and SPUR's report (for apartments), raised by 15% to account for a presumed improved market.
- Transfer Tax Foregone - the applicable rate times the Value per Unit
- Annual Tax Impact - Conversions Caused by the Tax Incentive times the Net Gain from Conversion per Unit-Year

# Appendix C: Economic Assumptions

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	Office	Residential	Notes
Office Square Feet	100,000		
Residential Efficiency Factor		75%	Per the examples in the SPUR report, assume 75% of office space is usable for housing units.
Residential Square Feet		75,000	
Square feet per employee or resident	400	369	Residential density based on an average household size of 2.2 persons per unit, and an average unit size of 812 sf. Pre-pandemic office employment density was 250-300 sf/employee; we assume it falls to 400 sf/employee in a stable post-pandemic market.
Stabilized vacancy rate	25%	5%	Assuming that Class B office stabilizes at a higher vacancy rate than housing (and higher than its pre-pandemic level).
Number of new residents, for residential		193	Equal to residential square feet * (1-stabilized vacancy rate) / square feet per resident
Working age as a share of total population		70%	SF average, based on 2022 American Communities Survey
Office employees / working age population	188	135	
One-time saved transfer tax revenue	\$583,481		Derived, for condos, from Appendix A, based on 812/SF average size.
Ongoing gained other tax revenue		\$20,334	Derived, for condos, from Appendix A, based on 812/SF average size.

# Appendix C: Economic Impacts

	Economic Impact per 100,000 feet of office space converted
Total Employment	-155
Private Non-Farm Employment	-161
Residence Adjusted Employment	110
Population	462
Labor Force	295
Gross Domestic Product (Million 2023 \$)	-\$49
Real Disposable Personal Income per Capita (2023 \$)	-\$45

# Appendix D: Recent Office Transactions

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Address	Property Class	Recent Price Per SF	Prior Price Per SF	Prior Sale Year	Price Change
115 Sansome	A	\$281.12	\$666.67	2016	-58%
550 California	BC	\$114.08	\$304.23	2005	-63%
350 California	A	\$203.33	\$833.33	2020	-76%
180 Howard (CA State Bar)	BC	\$255.92	\$106.64	1998	140%
60 Spear	A	\$261.15	\$681.53	2014	-62%
201 Spear	A	\$269.23	\$465.38	2013	-42%
123 Townsend	A	\$523.26	\$1,017.44	2020	-49%
55 New Montgomery	BC	\$150.00	\$654.00	2018	-77%
650 7th St. / 600 Townsend East	BC	\$305.93	\$609.08	2016	-50%
33 New Montgomery	A	\$326.79	\$604.57	2014	-50%



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