COUNCIL AGENDA: 1/27/26
FILE: 26-074
ITEM: 8.2

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Erik L. Soliván
Jon Cicirelli
John Ristow
Jim Shannon

SUBJECT: **See Below**

DATE: January 14, 2026

Approved [signature] Date: 1/15/26

COUNCIL DISTRICT: Citywide

SUBJECT: Downtown Residential Incentive Program Expansion to Include Commercial-to-Residential Conversion Projects

RECOMMENDATION

(a) Adopt a resolution renaming the Downtown Residential High-Rise Incentive Program to the Downtown Residential Incentive Program, expanding the Program to include appropriate commercial-to-residential conversion projects for mid-rise and high-rise buildings located in the Downtown Planned Growth Area, and reducing the Inclusionary Housing In-Lieu Fee to $0 for eligible conversion projects and 0% deed restricted residential units.

(b) Approve an ordinance amending Section 4.46.036 of Chapter 4.46 and amending Section 4.47.089 of Chapter 4.47 of Title 4 of the San José Municipal Code to provide for conversion projects eligible under the Downtown Residential Incentive Program that waive:

(1) 100% of the Building and Structure Construction Tax and the Commercial-Residential-Mobilehome Park Building Tax for up to 500 units in projects that obtain building permits by December 31, 2026, and pass first inspection within 12 months of obtaining a building permit; and
(2) 50% of the taxes for the next 1,000 units in projects that obtain building permits by December 31, 2027, and pass first inspection within 12 months of obtaining a building permit.

(c) Adopt a resolution for conversion projects eligible under the Downtown Residential Incentive Program and provide:

(1) 50% reduction in the Parkland In-Lieu fees for the first 500 units in projects that obtain building permits by December 31, 2026, and pass first inspection within 12 months of obtaining a building permit; and
(2) 30% reduction in the Parkland In-Lieu fees for the next 1,000 units in projects that obtain building permits by December 31, 2027, and pass first inspection within 12 months of obtaining a building permit.

(d) Adopt a resolution amending the Fiscal Year 2025-2026 Schedule of Fees and Charges to revise the Rental Inclusionary In-Lieu Fee for eligible projects under the Downtown Residential Incentive Program.

SUMMARY AND OUTCOME

Approval enables the City of San José to:

- Leverage the existing Downtown incentive program framework to promote housing production by allowing the conversion of obsolete office space into residential units, creating up to 500 units in the first phase.

- Address the feasibility gap identified in the City's 2025 Development Cost Study,[1] which found office-to-residential conversions are still too expensive to be financially feasible without comprehensive incentives.

- Continue to implement all four policy levers recommended from the 2025 Cost of Development Study completed by Economic & Planning Systems. Inc. (EPS) and CSG Advisors to unlock conversion opportunities: fee reductions, parking flexibility, amenity adjustments, and streamlined approvals, with a focus on fee reductions.

- Generate new property tax revenue from currently vacant office buildings while supporting Downtown activation.

- Position San José competitively with other cities that have established successful conversion programs.

[1] City of San José Cost of Residential Development Study Session: https://sanjose.legistar.com/LegislationDetail.aspx?ID=7770199&GUID=D937483C-2AF3-4ADD-A74F-99388291946D

BACKGROUND

The Downtown Residential High-Rise Incentive Program (Program) was established in 2012 to catalyze high-density residential development projects that are at least 150 feet above street level and have 10 or more residential floors in height, in the Downtown Planned Growth Area. This incentive intends to support job growth, transit use, and vibrant urban neighborhoods. The Program has evolved through multiple extensions, with the most recent update in June 2024, extending benefits through 2026 and beyond.

In recent years, the Program has successfully facilitated 1,226 completed residential units across three major projects: The Graduate (261 units), Miro (630 units), and The Fay (335 units). These projects demonstrate the effectiveness of targeted financial incentives in overcoming feasibility challenges for high-density residential development. The current program structure provides graduated incentives through two phases, with Phase 1 offering maximum benefits for early adopters and Phase 2 maintaining substantial support to ensure continued development momentum.

The COVID-19 pandemic fundamentally altered Downtown office demand patterns, with remote and hybrid work models becoming permanently established across Silicon Valley. Downtown San José's office vacancy rate has increased from 12% pre-pandemic to over 20% currently, representing a significant amount of underutilized commercial space. This structural shift in office demand and the ongoing housing crisis creates unprecedented opportunities for adaptive reuse by converting underperforming commercial assets into critically needed naturally occurring affordable housing units.

The City's 2025 Cost of Residential Development Study conducted by consultants EPS and CSG Advisors confirms that while conversion opportunities exist, they face significant economic challenges. It found that new Downtown podium, wrap, and tower developments show negative financial returns under current market conditions, with office-to-residential conversions facing challenges due to physical constraints and high modification costs. The study reveals that the costs of conversions are likely too expensive to be financially feasible given the current market-rate rents, with the cost gap between conversion and ground-up development remaining narrow due to high construction and soft costs. The study concludes that fee waivers may tip the scales for some projects, though feasibility primarily depends on building specific physical attributes, supporting the need for comprehensive incentives. The study was not able to quantify a typical cost gap for office-to-residential conversion projects due to the variability in building type, physical constraints like floorplate depth, core location, window access, floor-to-floor heights, and façade modifications, causing feasibility to vary significantly block-to-block based on individual building characteristics and local submarket conditions.

Other cities with established conversion program, such as New York, Los Angeles, Washington D.C, and San Francisco, provide tools like property tax exemptions, development fee waivers, and streamlined approval processes to facilitate office-to-residential conversions. Unlike those cities, San José currently lacks conversion-specific financial incentives, placing the City at a competitive disadvantage. While the Program has flexible requirements around parking, amenities, allowances for by-right housing, and a streamlined process for conversions, the gap in market feasibility for conversions is difficult to overcome without additional incentives. This expansion addresses San José's feasibility gap while leveraging proven administrative structures from the Program and Multifamily Housing Incentive Program by implementing policy changes designed to promote housing production and Downtown area reactivation.

ANALYSIS

Market Opportunity Assessment

The City's 2025 Development Cost Study identifies specific physical and economic factors determining conversion feasibility in San José's market. According to the study, successful conversions require careful evaluation of building characteristics, with pre-1960 buildings (and select buildings up to 1980) offering the best conversion potential.

Key physical determinants for conversion success are:

- Floorplate depth of 40 to 60 feet (most influential factor) – deeper buildings often need expensive cut-outs or light wells to bring in natural light;
- Operable windows on multiple sides of the building, allowing natural ventilation;
- Floor-to-floor heights sufficient to accommodate residential plumbing, electrical systems, soundproofing, and ventilation;
- Regular and consistent column layout that allows housing units to be stacked efficiently from floor to floor;
- Building cores (elevators, stairs, utilities) located near the perimeter so more units can access windows; and
- Exterior building systems that already allow windows to open, or that can be modified without high cost.

For example, the Bank of Italy Building at 30 S. 1st Street, developed in 1926, already identified in the City’s pipeline, exemplifies ideal conversion characteristics with narrow floorplates, punched windows, and strong street presence. The study specifically cites this building as a "good candidate" for conversion. Conversely, modern glass towers present significant challenges due to deep floorplates, curtain wall systems, and center-core layouts requiring extensive modifications.

The current vacant office inventory has the potential to produce approximately 1,500+ new residential units that could be delivered through conversion. This estimate reflects the limited pool of physically suitable buildings meeting the study’s stringent feasibility criteria.

Owners of three projects in Table 1 shown to demonstrate these favorable characteristics, have already expressed strong interest in the expanded Program:

Table 1: Pipeline Conversion Projects Meeting EPS Criteria

Project Name	Address	Year Built	Proposed Units
Bank of Italy	30 S. 1st St	1925	109
CityView Plaza	125 S. Market St	1969 to 1973	321
Security Building	74 S. 1st St	1892	47
PG&E Building	111 S. Almaden	1977	134
			Total: 611 units

Most of the projects in the pipeline align with findings that pre-1980 office buildings with relatively narrow floorplates offer the most viable conversion opportunities. They represent $16.94 million in potential development subsidies that would generate 611 new housing units.

Program Structure and Requirements

The expanded Program maintains the proven two-phase incentive structure while incorporating or enhancing EPS's four recommended policy levers for conversion success.

Eligibility Requirements:

- Location within the Downtown Planned Growth Area boundary;
- Existing commercial buildings constructed before 2021, excluding Class A office space;
- Building characteristics supporting conversion as determined by the Planning, Building, and Code Enforcement Department and the Fire Department;
- Creation of minimum 20 residential units on upper floors;
- Ground-floor retail space and second-floor occupied commercial space in mixed-use buildings are not eligible for conversion;
- Building permit obtained by December 31, 2026; and
- First inspection passed within 12 months of permit issuance.

Specific incentives for qualifying developments are detailed in Table 2 below.

Table 2: Pipeline Conversion Projects Meeting EPS Criteria

Phase 1 Incentives (First 500 Units)	Phase 2 Incentives (Next 1,000 Units)
100% waiver of Building and Structure Construction Tax	50% reduction in Building and Structure Construction Tax
100% waiver of Commercial-Residential-Mobile Home Park Building Tax	50% reduction in Commercial-Residential-Mobile Home Park Building Tax
50% Parkland In-Lieu Fee reduction*	30% Parkland In-Lieu Fee reduction*
Reduction of Inclusionary Housing Ordinance in-lieu fees to $0 and 0% of deed restricted units	Continued reduction of Inclusionary Housing Ordinance in-lieu fees to $0 and 0% of deed restricted units

** Fee reductions will be calculated based on the applicable parkland in-lieu fees for each residential unit type.*

Program Structure and Requirements

Despite cost savings compared to new construction, economic and fiscal challenges remain for conversion projects due to San José’s high cost of development and prevailing market conditions. Recognizing these unique financial challenges, the Program incorporates modified Inclusionary Housing Ordinance requirements: 0% of deed restricted units.

This structure acknowledges that conversion projects face inherent cost premiums including:

- Older or obsolete building systems, structural limitations, or hazardous materials often require larger construction contingencies.
- Systems designed for office occupancy rarely meet residential requirements for ventilation, plumbing, and unitized distribution.
- Seismic retrofits, egress requirements, accessibility upgrades, daylight and ventilation standards can all trigger significant redesign costs.

In addition, because there are few comparable conversion projects, the long-term value of these buildings at sale or refinance is uncertain. As a result, lenders tend to be more cautious, often requiring more upfront cash, lower loan-to-value ratios, or reduced financing leverage.

Financial Feasibility Analysis

As discussed earlier in this memorandum, the 2025 Cost of Residential Development Study confirms that both new construction and conversion projects face significant economic challenges.

For new construction, the study found that Downtown podium, wrap, and tower developments show negative returns under current market conditions. This indicates that 10% to 15% rent increases for wrap and podium products and 35% increases for towers would be needed to achieve feasibility.

Office-to-residential conversions also face feasibility challenges, with the study revealing that conversion costs continue to be too high, affecting feasibility. Critical physical constraints, such as floorplate depth, window access, and ceiling heights, combined with high modification costs for systems and façades, create office-to-residential conversion costs nearly equivalent to ground-up development.

The study concludes that targeted flexibility can unlock a limited set of viable buildings. To implement these recommendations, the City has developed a Program that applies these policy levers to an initial pipeline of four projects for office-to-residential conversions.

Phase 1 Program Cost Summary / Implications

Based on the Housing Department's conversion pipeline, including four projects expected to produce approximately 611 units, the estimated value of proposed fee / tax relief is summarized in Table 3. These estimates are meant to illustrate the expected loss of revenue from the program if units were to be otherwise built without the recommended incentives, not exact project costs, and will vary by project scope and timing.

Table 3: Total City Fees and Taxes Waived Projection

Incentive Type	Department	Amount (Millions)
Inclusionary Housing Ordinance In-Lieu Fee	Housing	$8.82
Building & Structure Construction Tax	Transportation	$0.89
Commercial-Residential-Mobile Home Park Tax	Transportation	$1.40
Parkland In-Lieu Fee	Parks, Recreation, and Neighborhood Services	$5.83
Total: $16.94 million		

Per-unit: ~$27,725 per home (611 units, 0 deed-restricted).

Summary of expected Program outcomes enabled by both phases:

- Supports delivery of approximately 611 units, the majority expected to lease below 110% AMI.
- Includes $0 inclusionary fees (0%) and 0 deed-restricted affordable units.
- Improves assessed values and activates Downtown blocks, and corresponding gains in property, sales, and utility-tax bases over time.

Table 3 represents the initial pipeline and is intended for fiscal planning. Staff will review project applications prior to making fee / tax reduction approval recommendation and will report actual realized waivers / reductions at permit and certificate-of-occupancy milestones. The city expects that the success of Phase 1 developments will serve as a catalyst to spur interest from other developers, demonstrating both the feasibility of conversions and the effectiveness of the incentive Program.

As shown in Table 4, the majority of units in this area function as naturally occurring affordable housing relative to the 110% AMI benchmarks, as the market competition remains weak in Downtown, thereby depressing market-rate rents below existing affordability levels.

Table 4: Average Proposed Rent Levels for Downtown San José Conversion Projects

Unit Type	Rent ($/month)[2]	110% AMI Rents	110% AMI Income
Studio	$2,675	$3,756	$150,260
1-Bedroom	$3,503	$4,295	$171,820
2-Bedroom	$5,074	$4,831	$193,270

COST SUMMARY/IMPLICATIONS

The full fiscal impact of the amended Program, now expanded to include commercial-to-residential conversion projects, will not be completely understood until development moves forward in the construction process. The Program allowed up to 4,078 units that qualified for reduced Inclusionary Housing Ordinance In-Lieu Fees, Building and Structure Construction Tax, Commercial-Residential-Mobilehome Park Building Tax, and Parkland In-Lieu Fees. With the expansion of this program, 4,078 units can be achieved through a combination of different projects, including approximately 1,500

[2] Market rents shown are average proposed rents from actual conversion project proposals in the San José Downtown pipeline. These rents are determined by developers based on market analysis and proforma submissions to the Housing Department.

commercial-to-residential conversion units that will draw from the previously approved unit allocation under the High-Rise Program. This change adds flexibility for the Program but does not add to the total cost of the program.

Pursuant to California Government Code section 53083, the City must disclose information related to any fee waiver over $100,000 through a public hearing, and pursuant to City Council Resolution No. 77135, must also disclose any fee waiver over $1,000,000 through a public hearing. These disclosures must include detailed information on the estimated total amount of expenditure of public funds or revenue lost, and the project tax revenue resulting from the project. Staff will bring back these disclosures for individual projects, including commercial-to-residential conversions, in conjunction with the required Project Completion Agreement.

The Inclusionary Housing Ordinance In-Lieu Fee for rental residential development providing a minimum of 5% inclusionary units on-site is $21.71 per square foot per rental unit in Strong Market Areas and $13.78 per square foot for rental units in Moderate Market areas. This fee structure will apply equally to commercial-to-residential conversion projects creating 20 or more units. Although these changes would result in fewer fees collected on both traditional high-rise developments and commercial-to-residential conversions, these fees are already considered foregone under the current Program and are not included in budget projections or in the Five-Year Affordable Housing Investment Plan.

The Building and Structure Construction Tax is based on the valuation of the building at a tax rate of 1.54% for residential. The Commercial-Residential-Mobilehome Park Building Tax is also based on building valuation at a rate of 2.42% for residential. Commercial-to-residential conversion projects will be assessed on these taxes based on the residential valuation methodology. These construction taxes fund a significant portion of the City's Traffic Capital Improvement Program. Although these changes would result in less tax revenue collected on the high-rise developments and conversion projects that would have been received, these revenues are not included in the projections included in the 2026-2030 Adopted Traffic Capital Improvement Program.[3]

The Parkland In-Lieu Fee is determined by identifying the applicable Real Estate Multiple Listing Service District, selecting the corresponding per-unit fee for the residential unit type, and multiplying that fee by the total number of residential units in the project. Pursuant to City Council Resolution No. 78733, the current Parkland In-Lieu Fee obligation for new Downtown development is $14,600 per unit for qualifying high-rises and $22,600 per unit for multifamily housing projects with five or more units. The proposed fee reductions will be applied to the Parkland In-Lieu Fees for these residential unit types. Due to the forgone Parkland In-Lieu Fee revenue shown in Table 3, conversion projects that receive a parkland fee reduction are ineligible for other park

[3] https://www.sanjoseca.gov/home/showpublisheddocument/125753/638974384141400000

fee incentives, waivers, or credits under existing programs, such as private recreation credit, except for fee reductions applicable to affordable housing units. Parkland In-Lieu Fee collections are budgeted on an annual basis. None of the current entitled high-rise projects, nor any anticipated commercial-to-residential conversions, are included as potential revenue in 2025-2026. However, Parks, Recreation and Neighborhood Services Department staff does depend on estimates of future collections, including those from the anticipated 1,500 conversion units to pair long-term planning and park construction efforts with funding needs.

Conservative valuation estimates on currently entitled high-rise projects and anticipated commercial-to-residential conversions show that each would result in approximately $600,000 in annual revenue to the City in taxes received in the General Fund (Property Tax, Utility User Tax, Business Tax, and on-site Sales Tax). The addition of commercial-to-residential conversion projects as eligible under the High-Rise Program is expected to accelerate the absorption of the 4,078-unit allocation while maintaining a similar fiscal framework. This does not alter the indirect revenue generated through the purchase of goods and services in Downtown by each new resident living in these developments, whether in new construction or converted units.

COORDINATION

This memorandum was coordinated with the City Attorney's Office.

PUBLIC OUTREACH

This memorandum will be posted on the City's Council Agenda website for the January 27, 2026 City Council meeting. The Housing Department also promoted the upcoming Downtown Commercial-to-Residential Incentive Program through virtual community meetings on January 8 and 22, 2026.

COMMISSION RECOMMENDATION AND INPUT

No commission recommendation or input is associated with this action.

CEQA

Statutorily Exempt, File No. PP17-005, CEQA Guidelines Section 15273, Adjustment to Fees, Rates and Fares without changes to or expansion of services.

PUBLIC SUBSIDY REPORTING

This item itself does not include a public subsidy as defined in section 53083 or 53083.1 of the California Government Code or the City's Open Government Resolution. Housing Department staff will bring forward each eligible project for a required individual public hearing in accordance with City Council Resolution 77135 and California Government Code Section 53083.

/s/
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/s/
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