

Sounding the Alarm on Code Compliance Costs

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Most multifamily owners are familiar with reserve requirements for items such as fire alarms and alarm replacement. Yet those owners may be surprised to learn that complying with the latest fire code changes can jeopardize statutory caps on property tax increases. In fact, recent changes to the International Fire Code (IFC) could substantially increase fire safety requirements, trigger loan defaults and escalate repair and property tax costs for apartment owners.

By their nature, apartment buildings are not, and cannot be, constructed to meet future unanticipated building code requirements. In many jurisdictions, property owners know that if their building suffers more than a 50% loss, they will be required to satisfy new code requirements during reconstruction. However, few owners expect to be saddled with retroactive application of new code requirements even if there is not a casualty.

The IFC provides a comprehensive regulatory framework of code templates setting minimum standards aimed at both safeguarding buildings from fires and protecting building occupants when fires occur. Among other things, the IFC addresses the installation and maintenance of automatic fire alarm and sprinkler systems and fire safety requirements for new and existing buildings.

States and local jurisdictions are often slow to adopt and apply the latest building codes to existing properties. So while the 2015 version of the IFC has been published, many state and local governments are still coming to grips with the 2009 version, which incorporated retroactive requirements regarding the installation of fire alarms into existing buildings. For property owners, significant concerns arise when governmental officials adopt an IFC version that retroactively imposes new requirements.

For example, the 2009 IFC included several potentially expensive retrofit requirements for existing buildings. Chapter 46 of the IFC recommended the installation of smoke detectors in each bedroom for existing structures. For buildings that are more than three stories high or contain more than 16 multifamily units, the IFC imposes retroactive requirements, including installing manual or automatic fire alarm notification systems; installing audible fire alarms in each unit; and wiring all units to ensure visual fire alarms may be installed for the hearing impaired.

Retroactive application of new requirements creates issues for owners of existing properties. Modifications to meet new regulations for existing buildings can cost thousands of dollars per unit, and failure to make required upgrades can have serious consequences, including fines, possible

insurance and liability problems not to mention that violation of local building codes generally constitutes an event of default under standard loan documents such as the Freddie Mac form loan agreement.

Moreover, the capital reserves that most permanent lenders require borrowers to maintain for building maintenance are seldom adequate to fund fire-safety retrofits, since borrowers and lenders could not reasonably anticipate the nature and cost of these improvements when establishing reserves. Most apartment complexes are owned by single purpose entities. Their loan documents strictly limit obtaining new loans. If cash flow is tight, these owners face financial challenges in funding retroactive code-mandated improvements.

Increases in property taxes represent an additional hidden risk to property owners in jurisdictions where statutory caps limit property tax increases, such as Florida and South Carolina. Caps limit increases in taxable value for properties subject to reassessment that would otherwise rise to reflect the market. Florida, for example, generally limits annual increases in taxable value to 10% of the prior year's assessment. South Carolina limits increases to 15% of the property's prior assessed value unless there has been a property improvement, ownership change, or assessable transfer of interest.

Caps can be removed if an existing project undergoes renovations, adding a substantially heavier tax burden atop the renovation expense. For that reason, property owners who are required to make IFC-mandated improvements must determine whether the renovated properties will run afoul of the statutory cap limitations, and prepare accordingly.

There is no problem in California where the law protects properties from reassessment unless renovations make the property "substantially equivalent to new."

IFC compliance measures are more likely to jeopardize assessment caps in states such as South Carolina where state law requires taxing authorities to include the value of new construction when valuing properties. South Carolina excludes minor construction or repairs from taxation, but does not define these terms and interpretation is often left to local taxing authorities.

No one advocates ignoring fire safety, but multifamily owners must investigate all potential costs—both obvious and hidden—of bringing their properties into compliance.

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