Vacant Storefronts:
A Research Study of the UWS Broadway Corridor, 2019

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In early 2019, a committee of UWS SOS undertook a survey of vacant storefronts on the Broadway corridor from 67th to 104th streets, to try to identify some of the factors contributing to the epidemic of long-term commercial vacancies. Our tracking of empty storefronts on this commercial corridor began in February 2019 and ended by May 2019.

Two citywide governmental studies of the storefront vacancy problem were subsequently published in the summer and fall of 2019, based on data that concluded in 2017 and in 2018.

For the purposes of our research, we reviewed and reference these two studies, as well as an earlier 2017 NY City Council report:

- *Retail Vacancy in NYC, Trends and Causes, 2007-2017*, Comptroller Scott Stringer's Office, Sept. 2019;
- *Assessing Storefront Vacancy in NYC, 24 Neighborhood Case Studies,* Department of City Planning, Aug. 2019.
- *Planning for Retail Diversity: Supporting NYC's Neighborhood Businesses,* NY City Council, Dec. 2017.

These government studies looked at multiple factors contributing to the problem, including e-commerce, commercial taxes, government regulations (including zoning), trends in commercial rents, etc.

Our research, however, started with the simple question: Who are the owners of these vacant properties and why are they no longer renting their formerly occupied commercial spaces? We examined building ownership, mortgage structure, building type and property values. We were looking for any discernible patterns that could help explain the phenomenon.

We counted and surveyed the Broadway corridor's 66 vacant storefronts, from 67th to 104th streets. While this area constituted our starting point, we were well aware that the Amsterdam and Columbus corridors also suffer from significant long-term vacancies.

UWS SOS SURVEY FINDINGS

We built on the findings of the NY City Council's Land Use Division Report, *Planning for Retail Diversity*, which surveyed all of the retail storefront properties on the Upper West Side in 2011 and 2016. That study found that vacancies on the Broadway corridor increased from 6.6% to 12.1% over those five years; 55 retail stores were vacant in 2016 as opposed to 31 in 2011, an increase of 24 vacant stores. Restaurants and stores selling clothing, shoes and accessories experienced the biggest decline between 2011 and 2016.

Our survey showed an increase in storefront vacancies to 20% by 2019. This is higher than what has been reported for the UWS, but we were only looking at the Broadway corridor.

Vacant commercial space ownership types on Broadway:
The ownership structure of commercial space was a key factor in helping us understand the forces driving the long-term vacancies.
Of our 66 vacant storefronts on Broadway:

24/66, 36% are stand alone condos
22/65, 33% are in rental buildings
9/66, 14% are in coops
7/66, 11% are commercial/one story
4/66, NA

We hypothesized that the duration of ownership might also inform owners' actions. Had ownership changed hands in the last 10 years or so after the 2008 recession? We found that two-thirds (43) of the vacant storefront properties (66) on Broadway were purchased before 2007. Thus, we can assume that it's not just new owners (who might include more private equity-based ownership), but long-time owners, as well, who are holding vacant commercial property.

FREQUENTLY ASKED QUESTIONS

Q: What's driving property owners on the UWS to keep their commercial storefronts empty long-term? Why is the market not working to bring rents in line?

A: The NY City Council study identified rising commercial rents as a key factor driving the commercial vacancy problem in New York City. The study found that rent throughout the city more than doubled from 2009-2015. The study also acknowledged that a pull-back of pricing had begun, but prevailing rents remained above where they were when the Great Recession took hold (2007-2009). Scott Stringer's report, *Retail Vacancy in NYC, Trends and Causes 2007 -2017,* concurred, albeit calculating a lower rate of increase, 22% on average, between those dates.

We can conclude from the NY City Council and Comptroller Stringer's studies that landlords may be reluctant to sign typical long-term commercial leases for fear of missing out on the rising market. We've seen evidence of this hot real estate market on the UWS since 2008, i.e., a noticeable number of teardowns and upscale new construction have been undertaken by large real estate firms. There are four new luxury residential construction projects underway on Broadway in the West 90s (91st, 93rd, 95th and 96th Streets), in addition to luxury buildings completed on Broadway at 80th and 81st, and near 100th Street, and on crosstown streets at 77th and 79th. These projects, which are likely putting upward pressure on local residential rents and unit sales prices, are in addition, possibly reducing the importance of commercial rental income to landlords in the short term.

Q: Can landlords deduct "lost" commercial rent from their earnings or overall tax liability, incentivizing them to hold out?

A: NO.

Q: Do landlords benefit from provisions in the tax code that mitigate the impact of lost commercial rent?

A: YES, in certain cases there are tax advantages that buffer the effect of lost commercial rental income. While these benefits do not fully compensate for foregone rent, they effectively reduce the financial loss. Lost rental income cannot be deducted as an expense for tax purposes, but tax law stipulates that investors in an LLC *(most commercial property on the UWS is owned by an LLC) can deduct a business loss against their personal income tax and/or offset profits from other real estate investments. Real estate holdings that are not structured as LLCs, but rather as corporations, can only deduct a business loss against gains from other real estate ventures (not from their personal income taxes) if the owner is a “real estate professional,” as defined by law.

Owners are allowed to deduct several expenses (mortgage interest, property taxes, maintenance, depreciation) from rental income when calculating their tax liability.
From a practical perspective, the tax benefits are likely to impact owners differently, depending on whether their building is a condo, a stand-alone storefront, a rental or a coop.

CONDO: In the case of a completely vacant stand-alone store or completely vacant commercial property in a condo, the building's rental income is zero. Thus, the expenses would generate a bona fide business loss that can be deducted from other taxes due. This is valuable: if an owner is in the highest personal income tax bracket, on every $100,000 in expenses/losses, he/she could potentially save $49,000 on his/her personal income taxes (figuring 37% federal tax and approximately 12% NY state and NYC tax). We concluded that owners of such vacant commercial storefront space (36%of the vacant storefronts we surveyed) that derive no residential or commercial rental income stand to benefit the most from these deductions

RENTAL: In an occupied rental building with vacant commercial space, there would not be a "business loss" as the property's residential rental income would offset the lost commercial rental income. However, in such cases, the owner’s overall income would be reduced, lowering the resulting tax liability. This is beneficial if he/she owns other profitable real estate or, if the building is an LLC, the owner falls into a high personal income tax bracket.

COOP: In a cooperative that owns commercial space, the same principle would apply, but in such buildings the owners have a deep incentive to rent their commercial space to lower residential owners' monthly maintenance charges.

It is worth noting that the changes in the tax code recently initiated by Trump significantly benefit commercial real estate at the expense of residential real estate; we can only guess at the extent to which these changes, in and of themselves, explain the heightened retail blight we are experiencing.

Paul Sullivan, author of the New York Times' Wealth Matters column, notes in his article, *How Loopholes Help Trump and Other Real Estate Moguls Avoid Taxes*, (New York Times, May 10, 2019):

> "The ways real estate gets preferential treatment are dizzying… In the 2017 tax overhaul, the deductions for real estate taxes and mortgage interest on a home were severely curtailed. Not so for commercial real estate. The taxes a property incurs are fully deductible as a business expense… Commercial real estate is generally owned through a partnership or limited liability company, in which there is no tax at the corporate level and all the gains and losses flow through to the individual. They have a built-in advantage allowing owners to transfer exponentially more to heirs free of taxes."

Q: Are there other mitigating, bottom-line factors that may be contributing to the long-term vacancies?

A: YES.

REFINANCING.

Refinancing is another factor contributing to owner's capacity to hold out for higher rents. Our data on vacant storefronts indicates that 61% of owners of condo and rental spaces have originated new mortgages since 2013, perhaps leveraging current and projected growing valuations.

Paul Sullivan (New York Times/Wealth Matters) writes: "The owner could have refinanced the building and taken the cash out. It's known in real estate parlance as "the harvest," and as long as the building's cash flow is enough to cover the debt payments, the money is tax-free."

BANK LOAN AGREEMENTS

Loans from banks and other lending institutions play an important role in reducing landlords' ability and willingness to lower their asking rent.

According to an article in the Wall Street Journal, *With So Many Vacant Stores, E-Commerce Is Only Part of the Problem,* (July 21, 2019), Suzanne Kapner and Esther Fung report that

> ". . . landlords have an incentive to leave space vacant because slashing rents would violate their loan agreements, industry executives said. Moreover, any devaluation of the property would make it harder for them to borrow in the future."

The Fall 2019 NYC Department of City Planning report had a similar finding:

> "Many lenders require minimum rent levels and/or credit tenants (typically national chain stores) for favorable lending terms, giving owners no choice but to hold out."

Q: Given the problem of rising commercial rent levels, would a VACANCY TAX/penalty [as under draft by NY State Senator Jackson and NY Assembly member Linda Rosenthal] effectively

incentivize owners to lower their asking rents and/or take any other necessary steps to more quickly rent their commercial spaces?

A. The proposal for a vacancy penalty is just one of many proposals being suggested to combat storefront vacancy.

What we have found is that the proposed tax of 1% of the assessed value of the commercial space may not be significant enough to incentivize owners. This is especially true for large real estate investors and highly capitalized condo owners operating in a bullish market and able to take advantage of the mitigants to their lost commercial rental income. For 34 of the 66 buildings researched so far, 16, or 47%, would be charged less than $10,000 if their entire commercial square footage is vacant. However, smaller rental owners, with less overall earnings to offset, might be more incentivized by the 1% penalty.

Large real estate owners might be incentivized should the bills include a feature whereby the penalty is compounded every 30 days, or some other interval, that the property remains vacant. Jackson and Rosenthal are continuing to refine their proposed legislation regarding a vacancy tax.

ADDITIONAL QUOTES FROM REFERENCES

RE: THE DRIVERS OF LONG-TERM COMMERCIAL VACANCIES:

The NY City Council report states:

> “There are numerous potential explanations for a vacant storefront, including ownership disputes or absentee ownership. . . this is a normal part of the market that keeps some properties vacant for periods of time. . . . More widespread vacancy problems come when there are changes in the economic environment. Commercial property owners and potential tenants can sometimes take a long time to come to terms with a new economic environment. There is a tendency for landlords to keep properties vacant while waiting for an expected higher price to sell or rent their property. Commercial brokers believe that a main driver of vacancy in high rent areas is speculation to hold out for “the big number.” Consequently, the “warehousing” of space offered at an unrealistically high rent makes it difficult for small business owners to find affordable commercial space." The Stringer report underscores the problem of rent levels, saying: “Regression analysis shows rising retail rents are a significant driver of retail vacancy. Controlling for other factors, a one-percent increase in average retail rents is associated with 0.33 percent increase in vacant retail square footage.”

The Department of City Planning Report, *Assessing Storefront Vacancy*, August 2019, concurs:

> "Post-recession, properties were purchased at high prices, encouraged by rising rents and low interest rates. Some property owners opted to keep spaces vacant while seeking high rents or waiting for rents in rapidly developing markets such as Downtown Brooklyn or Bedford-Stuyvesant to “mature.”"

RE: BANK LOAN AGREEMENTS FURTHER CONSTRAINING PROPERTY OWNERS

> The Wall Street Journal, *With So Many Vacant Stores, E-Commerce Is Only Part of the Problem*, (July 21, 2019), Suzanne Kapner and Esther Fung

“For these landlords, maintaining the valuation on their properties is more important than collecting an immediate rental stream,' said Richard Johnson, a partner in Odyssey Retail Advisors, a consulting firm that works with retailers and landlords. 'It’s a waiting game, and many landlords would rather wait it out, hoping the market improves….

“Even though Manhattan rents have fallen by one-third from their peak, they are still well above their prerecession levels, according to CBRE (Coldwell Banker Richard Ellis) and Cushman & Wakefield Inc. [two major commercial real-estate companies in the New York market]. In parts of the city, such as Madison Avenue, availability rates—a proxy for vacancies that include both occupied and unoccupied space offered for rent—have hit 30%....

“It’s a huge challenge to negotiate renewals,” said Alyssa Gates, director of U.S. real estate for cosmetics retailer Lush, speaking about the country as a whole, not just Manhattan. “Landlords aren’t willing to go backwards in terms of rent. They are hoping the business comes back.”

The 2017 NY City Council report:
“With New York City commercial real estate sales nearing $70 billion in 2015, surpassing the pre-financial crisis peak of 2007, there is immense pressure for investors and landlords to maximize the value of retail spaces. Many recent investors paid extremely high prices based on a limited number of high-profile leases and are looking to achieve comparable rents. ***In some cases, property owners have received financing that only "pencils out" if a very high ground floor commercial rent is secured****. . . .* Some of these rents are so high that it may be nearly impossible for the individual store to generate enough sales to be profitable. Despite the recent slowdown on the highest value corridors, the fundamentals of demographic growth, chain store expansion, tourism, capital investment inflows, and speculation continue to push retail rents in the hot markets of Manhattan and parts of Brooklyn to impractical levels for many kinds of businesses.”

GLOSSARY

From *Every Landlord’s Tax Deduction Guide,* Stephen Fishman, J.D., 15th Edition, 2019]

*** LLC:** New York State Limited Liability Companies (LLC) are treated as pass-through tax entities, which means that income is reported on each member's individual tax return. Thus, while the members are subject to income tax, the LLC itself is not. Among other advantages, it means personal assets are completely insulated from business liabilities, debt, and obligations, and allow the LLC partner to report income and losses of the corporation on your personal tax return.

*** Real Estate Professional:** To qualify as a real estate professional, you must: participate in one or more real property businesses; “materially participate” in one or more of such businesses; spend at least 51% of your annual work time at your real property business or businesses in which you materially participate; spend at least 751 hours per year working at your real property businesses in which you materially participate. (I.R.C. § 469(c)(7).)