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Update on San Francisco's Treatment of Vacant Properties

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Update

This article is partly a republication of a Client Alert that was issued on December 6, 2022 titled "San Francisco's Commercial Vacancy Tax." Readers who have already read the original article can simply read ahead to the sections labeled "Update."

Commercial Vacancy Tax

In March 2020, the voters of San Francisco approved Proposition D, also known as the Commercial Vacancy Tax. The ordinance applies to ground floor, street-facing, commercial properties within any of the 32 districts listed in Section 201 of the Planning Code (which the regulation defines as "Taxable Commercial Space"). The districts listed in the Planning Code include the major neighborhood commercial areas of San Francisco such as Polk, Inner Clement, Broadway, the Castro, the Mission, Haight and portions of the Mid-Market and South of Market (around Folsom Street) areas. See: <https://sftreasurer.org/business/taxes-fees/commercial-vacancy-tax-vt>. The downtown financial district (north and south of Market) is not included. The type of properties covered by Proposition D are telling of its intended purpose. Section 2909 of the San Francisco Business and Tax Regulations Code explains that "[r]etail storefronts are the building blocks of neighborhood vitality, encouraging people to stroll through San Francisco's streets, sidewalks, parks, and other open spaces, and inviting them in."

Who Must Comply

The first reporting period ends on the last day of February 2023. The ordinance requires that every owner, lessee, and sublessee of Taxable Commercial Space in the City is required to file a Commercial Vacancy Tax Return regardless of whether such space has sat vacant or not. This means that if you are a landlord or a tenant of Taxable Commercial Space, whether or not the space is occupied or vacant, and whether or not you are ultimately responsible for paying the tax, each person is required to file the Commercial Vacancy Tax Return. The person ultimately responsible for paying any taxes due is the person entitled to possession. In other words, the owner pays the tax unless the property is leased or subleased.

Update: Commercial Vacancy Tax Return

The Commercial Vacancy Tax Return form is now available and can be found here: <https://etaxstatement.sfgov.org/CommercialVacancyTax/>.

What Is Required

The ordinance specifies that a person is responsible to pay the Vacancy Tax if that person has kept Taxable Commercial Space Vacant in a tax year. A property is "Vacant" when it is unoccupied or unused for more than 182 days in a tax year, whether consecutive or not. This broad language raises several questions. For example, if Taxable Commercial Space is leased but vacant for the last 120 days of the lease and the owner then leaves the space vacant for an additional 62 days after the lease ends, is either party liable for any amount of Vacancy Tax? The ordinance language seems to suggest that neither would be liable as neither party kept Taxable Commercial Space "Vacant" for the requisite period. However, both parties will still need to file the return, and time will tell how the City applies the ordinance to these more nuanced scenarios. To avoid any surprises, landlords and tenants should ensure that the allocation of the responsibility to pay the tax is expressly addressed in their leases.

The amount of tax is calculated based on the length of store frontage facing a public right of way and the number of consecutive years that the space has been left Vacant. For the first year that a property is Vacant, that amount is \$250 per linear foot of frontage, for the second year it is \$500 per linear foot, and then increases to \$1,000 per linear foot at the third year and thereafter.

There are some exceptions. For example, the 182-day clock is put on hold during the application process for building permits and conditional use permits. There are also some exceptions for properties damaged by casualty within the preceding two years. Another exception is carved out for struggling businesses; if a tenant under a lease with a term of two or more years occupies the space for 182 consecutive days but thereafter shuts down or otherwise abandons the property, the property will be exempt from the tax for the remainder of the lease. In other words, if a restaurant operates for the required time but ultimately does not continue to operate in the space for the remainder of its lease, neither the landlord nor the restaurant tenant will be liable for the tax.

Consequences of Non-Compliance

Administration and enforcement of the Commercial Vacancy Tax is with the San Francisco Office of the Treasurer and the Tax Collector. The Treasurer and Tax Collector have stated that the late filing penalties applicable to the Commercial Vacancy Tax Return will be waived for the 2022 and 2023 tax years. This only applies to the filing penalties, however, meaning that the penalties on late payment of any tax owed will still apply. These penalties can be quite high if the tax is left unpaid for long.

Will the Tax Have any Impact on Retail Occupancies

According to the recitals in the ordinance, it was enacted to combat widespread vacancies in the designated districts that "occur when a property owner or landlord fails to actively market a vacant retail storefront to viable commercial tenants and/or fails to offer the property at a reasonable rate." Many remain skeptical that a vacancy tax is the cure to what ails San Francisco's commercial districts. The city's own economic analysis found that the rise of internet based commerce has contributed to the decrease of physical store traffic. Further, the report pointed out that the tax is unlikely to improve the situation to the extent vacancies are the result of an economic downturn. Others note the fallacy of the underlying assumptions of the ordinance – that someone would intentionally leave space vacant and not rent it, and that a tax somehow incentivizes someone to enter into what is otherwise a bad business transaction.

Update: Additional Vacancy Obligations

It is important to remember that the Commercial Vacancy Tax is not the only ordinance that penalizes land owners for vacancy. The San Francisco Building Code imposes additional burdens by requiring an owner of

a Vacant or Abandoned Commercial Storefront to register that property with the City and County of San Francisco Department of Building Inspection within 30 days after it has become vacant or abandoned. The owner must also pay a registration fee of \$711. Further, unlike the Commercial Vacancy Tax, the Building Code applies to all buildings located in the City (except for some state-regulated buildings). After registering the property, the owner must post a sign at the front of the building, in a conspicuous location protected from the weather, displaying the name, address, and phone number of the owner and authorized agent if different from the owner. The ordinance also provides specific requirements on the maintenance that must be performed on both the interior and exterior of the building.

If an owner of a vacant building does not register and pay the fee, the Department of Building Inspection may serve a Notice of Violation stating that the owner has no more than 30 days to comply. Noncompliance is considered to be a public nuisance and can have steep consequences including fines of up to four times the registration fee. Owners who do not comply with a Notice of Violation and fail to pay the penalties can eventually find themselves facing a hearing where they can be ordered to pay additional costs.

A building is considered “vacant or abandoned” if it has been unoccupied for over 30 days. It is important that building owners take care in registering any such property and responding to any Notice of Violation. The registration form and instructions can be found here https://sf.gov/sites/default/files/2023-01/Vacant%20Building%20Package_Fillable.pdf.

Update: Property Owners’ Challenge Vacancy Tax

On February 9, 2023, a group comprised of various property owners, the San Francisco Apartment Association, the Small Property Owners of San Francisco Institute, and the San Francisco Association of Realtors filed a complaint against the City of San Francisco that challenges one of the city’s vacancy taxes as unlawful. The complaint is focused on Proposition M which is a recently passed ordinance that imposes a tax on vacant residential properties. Proposition M has a very similar structure as the Commercial Vacancy Tax in that it applies to properties in certain parts of the city that sit “vacant” for more than 182 days in a year.

The complaint challenges Proposition M by arguing that the ordinance violates one of the most fundamental aspects of property ownership: the right to exclude others from property. It points to long-standing Supreme Court case law that states that the government cannot compel a property owner to rent his or her property to third-parties without violating the Takings Clause. The Takings Clause comes from the Fifth Amendment of the U.S. Constitution and provides that the government cannot take private property for public use without just compensation. In other words, the complaint argues that imposing a penalty on property owners for exercising their right to exclude others from their property is a form of unconstitutional taking of property. The complaint points out that a similar vacancy tax law in New York was struck down as unconstitutional by the New York Court of Appeals.

While the complaint does not specifically address Proposition D (the Commercial Vacancy Tax), the legal arguments used against Proposition M could likely be used to challenge Proposition D as well. The results of this case could prove to be of substantial importance to the property owners of San Francisco.

Please contact us if you have properties or leases that may be affected by these issues.



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