Sublessor Deduction for the Commercial Rents Tax: Economic Impact Report

CITY & COUNTY OF SAN FRANCISCO

Office of the Controller

Office of Economic Analysis

June 15, 2023

Introduction

- The proposed legislation would reduce the tax liability of sublessors of commercial real estate in San Francisco, in certain situations.
- The City levies a 3.5% Commercial Rents Tax on rent from most non-residential buildings in San Francisco. The tax is imposed on both lessors and sub-lessors. Rent from a single location could be taxed multiple times, if it was both leased, and sub-leased.
- The proposal would allow a sub-lessor to deduct, from taxable rents, the lesser of the amount it receives in sub-leased rent, and the amount it pays in rent to its landlord. The deduction would be available for tax years 2023 through 2029.
- At present, office vacancy in San Francisco has remained at record-high levels for more than two years, and a significant share of the vacancy is in the sub-lease market.
- The Commercial Rents Tax is a dedicated tax, deposited in the Babies and Families First fund. 85% of revenues are pledged to fund early childhood care and education programs. The remaining 15% is deposited in the City's General Fund and may be spent on any governmental purpose.
- The Office of Economic Analysis has prepared this report after determining that the proposed legislation could have a material effect on the San Francisco economy.

Office Vacancy and the Broader City Economy

- In San Francisco, and across the country, office vacancy rates have risen since 2020, owing to the continuing prevalence of remote work among office workers.
- According to JLL, office vacancy in San Francisco reached 26.4% in the first quarter of 2023, the highest rate on record. 8.2 million square feet was available for sub-lease in the quarter, which is approximately one-third of all vacant space.
- However, according to CompStak data, relatively little subleasing is occurring. In the past four quarters, an average of 240,000 square feet was sub-leased in the city, or about 3% of the total sublease availability identified by JLL.
- Office-based industries contributed 80% of the city's GDP in 2021. Given their importance, high office vacancy has had a variety of negative economic impacts, particularly downtown.
- Sales tax collections in certain downtown neighborhoods, including the Financial District, South of Market, and Union Square, are still well below 2019 levels.
- BART ridership to downtown San Francisco stations is less than 40% of 2019 levels, while MUNI metro ridership is slightly above 50%.
- The City has also experienced a loss of business tax revenue from office industries, due to remote work and the high office vacancy rate.

Commercial Rents Tax Revenue and Expenditures

- The Commercial Rents Tax has generated an average of $210 million annually during its first three years of collection, 2019-2021.
- Because of litigation against the City that was not resolved until 2021, spending has trailed collections, and the Babies and Families First Fund currently has a balance of approximately $400 million.
- In Fiscal Year 2021-22, spending from the Fund was $68 million, or approximately 35% of collections.
- Sub-lessors paid an average of $17 million annually in Commercial Rent Tax, over the 2019-2022 period. Thus, if the proposed legislation is adopted, revenue would be reduced by that amount.
- In the short term, the large fund balance may prevent a decline in spending on early childhood care and education programs.

Economic Impact Factors

- The proposed legislation is projected to have both positive and negative effects on the economy.
- As a positive impact, the legislation should make it more likely that vacant office space on the sub-lease market will be occupied in the short term. Unlike building owners, sub-lessors have the option to retain the space for future use as a tenant. The more a sub-lessor can receive from sub-leasing, the less likely they are to retain the space, and keep it vacant until they need it for their own use in the future.
- To the downside, the proposed deduction would reduce revenues available for early childhood care, and the General Fund. As noted earlier, the large fund balance in the Babies and Families First fund may mitigate the decline in its revenue, at least in the short term.
- However, because 15% of Fund's the revenue is distributed to the General Fund, the City would face that loss of revenue immediately.

Economic Impact Assessment

- Based on CompStak data on San Francisco Class A office subleases over the 1989-2022 period, our analysis suggests that office subleasing is significantly more sensitive to rent and tax changes than the overall office market.
- This suggests that, unlike the Commercial Rents Tax as a whole, whose burden falls primarily on property owners, the benefits of the proposed deduction for sub-lessors would disproportionately flow to potential office tenants, who would see lower rents in the market.
- We estimate that the deduction could stimulate an additional 50,000 – 100,000 square feet of subleasing annually.
- We estimate this amount of new leasing could stimulate approximate $3.8 million in new rent payment, $1.5 - $2.5 million in downtown spending by new office employees, $0.5 - $1 million in additional business tax revenue for the City, and $0.3- $0.7 million in transit fares.
- On the other hand, as noted earlier the proposal would reduce revenue by $17 million annually. Even if spending on early childhood care and education programs were not reduced in the short term, because of the large fund balance, the City's economy would still lose $2.5 million in General Fund spending in the first year (15% of $17 million).

Conclusions

- The proposed legislation likely would be somewhat effective at encouraging new subleasing activity, reducing the city's high office vacancy, and stimulating economic activity downtown.
- However, the proposal is quite broad – allowing all sublessors, even those with existing leases, to claim the deduction. There is essentially no broader benefit associated with reducing the tax on those leases.
- As a result, the economic benefits of the proposal would be largely outweighed by the lost spending from the General Fund, before considering the longer-term impact on early childhood care and education funding.
- If the proposal were to only allow a deduction for *new* subleases, the benefits would be essentially the same as the current proposal, while the costs to the City would be far lower in the early years, as shown below.

	2023	2024	2025	2026	2027	2028	2029
Total Cost ($m)	$5.6	$9.4	$11.9	$13.6	$14.7	$15.5	$16.0
General Fund Impact ($m)	$0.8	$1.4	$1.8	$2.0	$2.2	$2.3	$2.4

- The proposal could be further tailored by limiting the number of years that it applied, or was open to new leases, which could maximize the near-term benefits while minimizing the City's costs.

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