Vacant Commercial Properties in New Jersey: Causes and Solutions

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Research Questions

1. How significant of a problem is vacant and under-occupied commercial property in New Jersey? What are the causes?

    - Do commercial property owners strategically under occupy their property to minimize their property tax liabilities?

2. What current and future public policies are available to reduce the likelihood of vacant and under-occupied commercial property in New Jersey?

Outline

I. Basic facts about vacant commercial properties

- How big is the “vacancy” problem in New Jersey?
- What are the main causes?

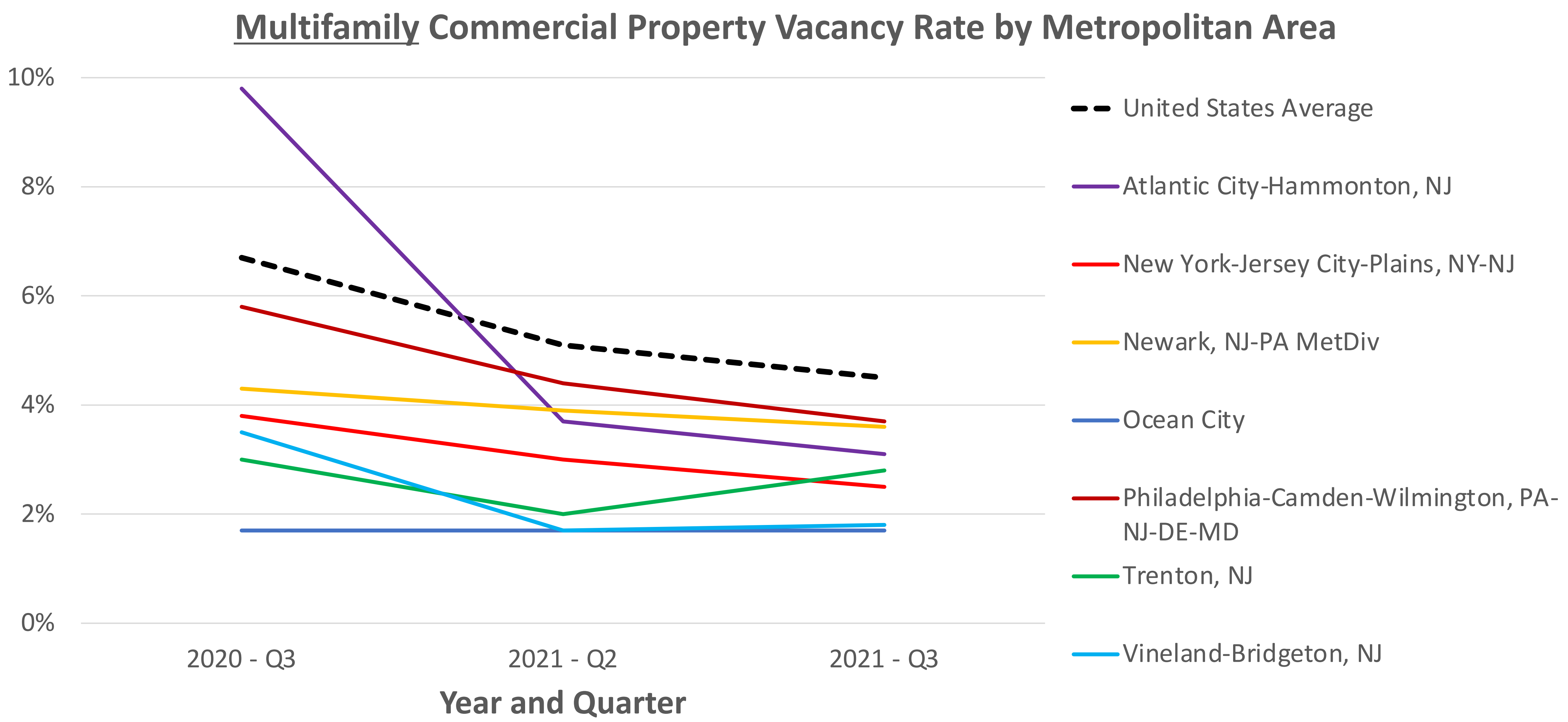
II. Policy tools and lessons from other cities in the world

III. Policy challenges and recommendations in New Jersey

I. Basic facts about vacant commercial properties

- Are commercial property vacancy rates high in New Jersey?
  - This is **not a straightforward question** to address.
    - very limited publicly available data
    - multiple sectors
    - no obvious comparison group
  - Beginning in Quarter 3 of 2020, the National Association of REALTORS Research Group **report data on:**
    - Seven New Jersey Metropolitan Areas:
      - Atlantic City, Jersey City; Newark; Ocean City, Philadelphia-Camden; Trenton; and Vineland
    - Commercial Property Vacancy Rates by Sector
      - Multifamily; Office; Industrial; and Retail

I. Basic facts about vacant commercial properties



Data Source: National Association of REALTORS Research Group

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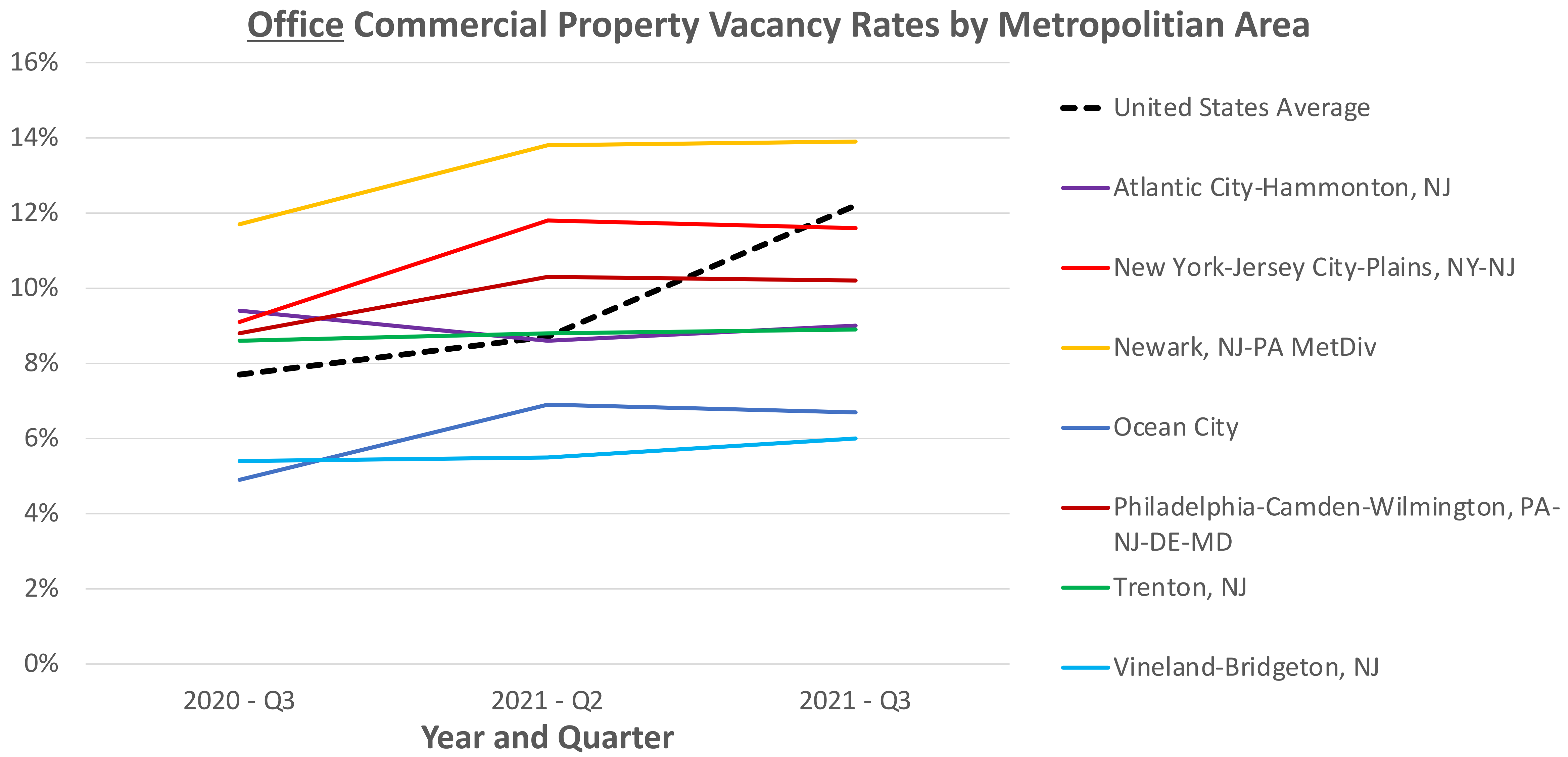

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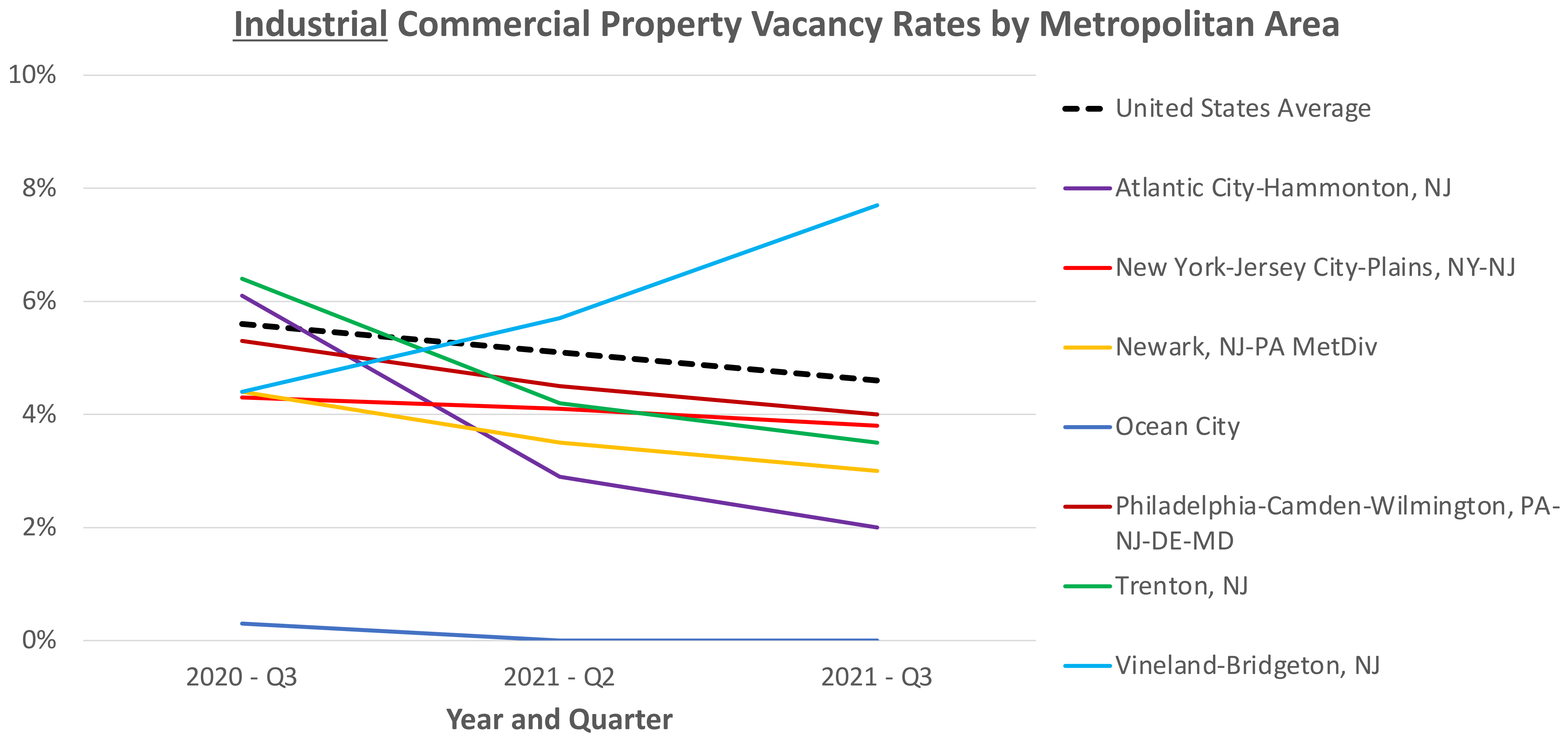

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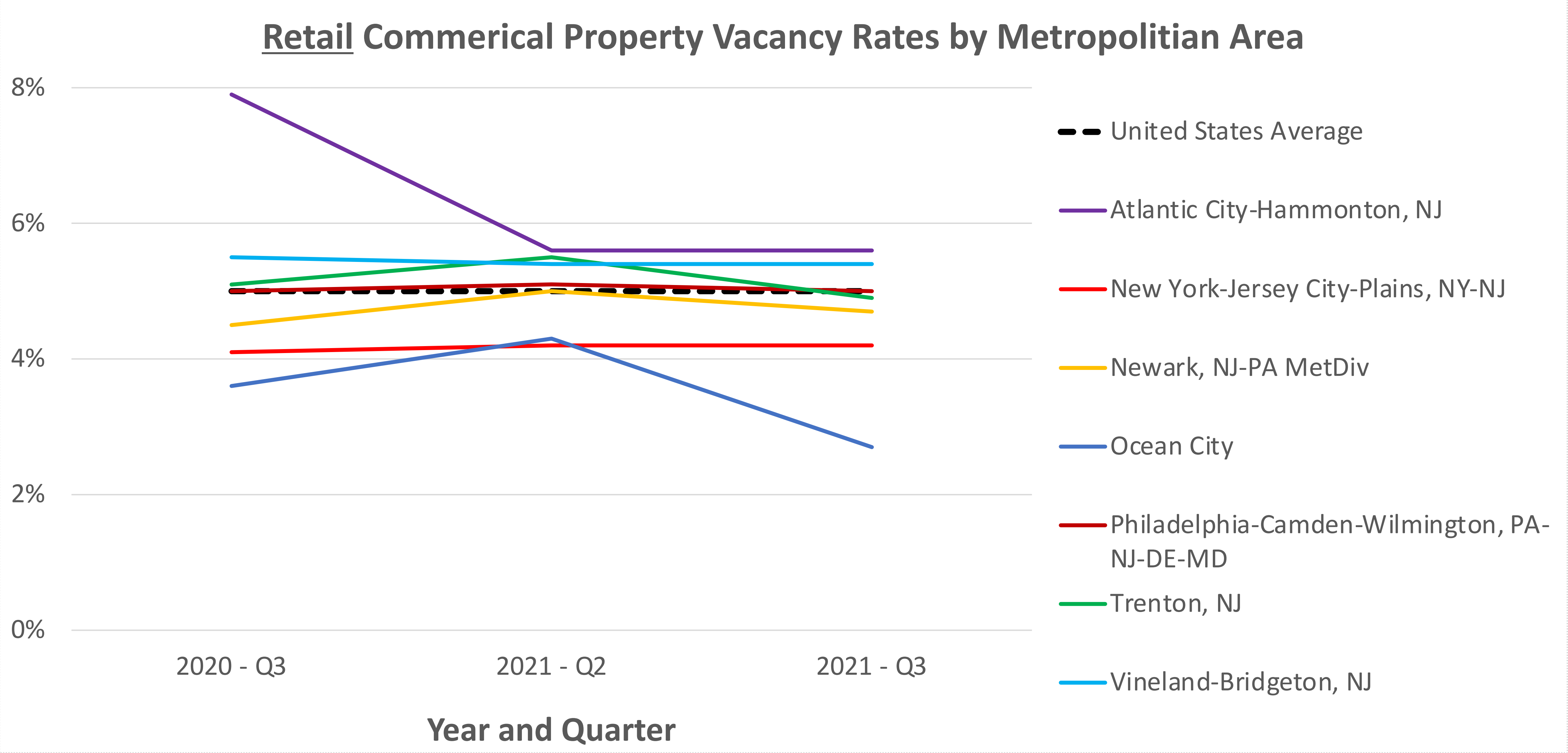

Data Source: National Association of REALTORS Research Group

I. Basic facts about vacant commercial properties

- Are commercial property vacancy rates high in New Jersey?
  - The quantitative data suggests:
    - Most NJ metropolitan areas **have lower vacancy rates than the national average** across all four commercial property sectors.
    - There are interesting **differences across sectors** and **across NJ metropolitan areas**.
      - For example, Newark CBSA has a higher vacancy rate than the national average for office spaces, but it has one of the lowest commercial vacancy rates for retail and industrial spaces.
  - However, this quantitative data likely **lacks important nuisances** about the commercial property industry in New Jersey
  - Therefore, it vital to **interview commercial property experts** across the state.

I. Basic facts about vacant commercial properties

- Are commercial property vacancy rates high in New Jersey?
  - We had **45-minute phone call conversations** with leaders from five separate property tax assessor's offices: Atlantic City, Camden, Jersey City, Trenton, and Newark
  - We asked them, "*How big of a problem is vacant and underutilized commercial property in your jurisdiction?*"
  - **Key takeaways** from interviews:
    - There are always particular sections of the jurisdiction that are under-developed.
    - However, there is currently strong demand for commercial property space and significant investment.
      - Spillover demand from NYC into North NJ
      - Apartment Rents are Surging
      - Most commercial/mix-use buildings are being fully utilized right now.
    - Demand and investment in office commercial space is weak.

I. Basic facts about vacant commercial properties

- What are the **main causes** of vacant/under-occupied commercial property?

1. Urban blight and suburbanization
2. The growth of e-commerce
3. Waiting for “national chains” tenants
4. Speculative investing
5. Covid-19 pandemic

I. Basic facts about vacant commercial properties

- What are the **main causes** of vacant/under-occupied commercial property?

  6. Incentive to minimize property tax liability

     - The leaders from NJ property tax assessor offices **argued that this is not a main cause**.
       - "… I speak to investors, and they don't ever say they buy a property to [under-utilized it] in order to reduce their property tax bill…"
       - "… commercial property owners will always try to find ways to reduce their property tax bill whether they are fully utilizing or under-utilizing their property…"
       - "… the subtraction from the assessed value is usually not large enough to justify under-utilizing the property…"
       - "… definitely not done on a widespread level…"
       - "… vacant problem is not a big problem here…"
       - "… very rare [for owners] to 'underutilize' their space to lower tax bill…"
       - "… don't see 'only activating first level' as a strategy …"

II. Policy tools and lessons from other cities in the world

- Given that the reason for vacant commercial property varies across cities, city governments need to carefully choose the policy tools that fit best with their local communities.

- We will review several high-profile policy tools adopted by cities in the U.S. and those in the rest of the world.

II. Policy tools and lessons from other cities in the world

1. Incentivize with extra tax

- Washington D.C. created a Class 3 property tax rate for vacant commercial and residential properties and a Class 4 tax rate for blighted properties in 2011.

Class	Tax Rate per $100	Description
1	$0.85	Residential real property, including multifamily
2	$1.65	Commercial and industrial real property, including hotels and motels, if assessed value is not greater than $5 million
2	$1.77	Commercial and industrial real property, including hotels and motels, if assessed value is greater than $5 million but not greater than $10 million
2	$1.89	Commercial and industrial real property, including hotels and motels, if assessed value is greater than $10 million
3	$5.00	Vacant real property
4	$10.00	Blighted real property

Data source: D.C. Office of Tax and Revenue. https://otr.cfo.dc.gov/page/real-property-tax-rates

II. Policy tools and lessons from other cities in the world

1. Incentivize with extra tax

- A vacancy tax was also approved by San Francisco voters (effective on January 1, 2022). The vacancy tax is a tax on keeping certain commercial space vacant for more than 182 days of a calendar year, and it is calculated based on a building's frontage (the total length of commercial space facing the Public Right of Way).

- In 2017, Vancouver implemented a tax on homes left vacant for more than six months per year. Such properties are subject to a tax of 1% of the property's assessed taxable value. And in 2021, the tax rate increase to 3% of the property's assessed taxable value.

II. Policy tools and lessons from other cities in the world

2. Incentivize with tax abatement/exemption

- The Obsolete Property Rehabilitation Act (OPRA), Public Act 146 of 2000, provides for a tax exemption to encourage the redevelopment of obsolete buildings in Michigan.
- A community essentially freezes the existing taxable value on a designated facility for up to 12 years. By freezing the taxable value, it incentivizes the developer to make significant improvements to a building without increasing the property taxes on the building.

II. Policy tools and lessons from other cities in the world

3. Improve code enforcement practices

- New Orleans turned to data science to optimize their decision-making process in code enforcement (BlightStat: https://datadriven.nola.gov/home/)
- Specifically, BlightStat helps identify properties that are most likely to have the best outcomes by taking account of the physical condition of the property, the owner's history of tax payment, the housing market in that neighborhood and other factors.

II. Policy tools and lessons from other cities in the world

4. Use land bank

- An increasingly popular tool is the local land bank, a governmental entity that acquires, holds, and manages vacant, abandoned, and tax-delinquent properties.
- The properties are acquired primarily through tax foreclosure, and then the land bank develops or, more likely, holds and manages the properties until a new use or owner is identified. (Brachman, 2005)
- In New Jersey, Newark became the first city to use land bank to combat neighborhood blight in March 2021.

II. Policy tools and lessons from other cities in the world

5. Other policy tools

- Reform tax foreclosure laws.
- Exercise eminent domain powers.
- Pass a receivership law or encourage municipalities to use existing receivership powers.

III. Policy challenges and recommendations in New Jersey

- Currently, there is **<u>no flexibility in the state constitution</u>** to apply special tax rules for vacant or under-occupied commercial properties.

III. Policy challenges and recommendations in New Jersey

- Recent Court Challenges to “Excessive” Code Enforcement Fines

  - Some tax assessors expressed concerns about the possibility of future restrictions on code enforcement fines.

  - This is especially true if the fines add up to a significant portion of the property value.

  - If these concerns become reality, then code enforcement fines will be a less effective “non-tax” tool for local governments in the future.

III. Policy challenges and recommendations in New Jersey

- Judges should allow for lower capitalization rates

  - One way to assess the value of commercial property is using the **income approach**.
    - Collect income and expense data from owners to calculate the *net operating income*.
    - Divide the net operating income by a capitalization rate to estimate the fair value of the commercial property.
    - The lower the capitalization rate → the higher the assessed value

  - During property tax appeal cases, judges tend to <u>permit a 6% or higher</u> capitalization rate.

  - However, this assumes that the property owner is fully utilizing their commercial property to generate the highest possible net operating income.

    - According to at least one tax assessor we spoke to, we shouldn't assume that property owners run their operation to earn the highest net operating income either intentionally or unintentionally.

III. Policy challenges and recommendations in New Jersey

- Judges should allow for lower capitalization rates (cont.)

  - Property Assessments Under **Two Different Assumptions**

	Fully Utilized Property	**Half Utilized Property**
Assessed value based on comparable sales	$1,000,000	$1,000,000
Annual Net Operating Income	$100,000	$50,000
Capitalization Rate	6%	6%
Assessed value based on income approach	$1,666,667	$833,333

  - Better case law could allow more flexibility to tax assessors to use a lower capitalization rate when there is evidence that the property is under-utilized.

III. Policy challenges and recommendations in New Jersey

- Better Training for Tax Appeal Judges

  - According to our interviews, most judges have little to no expertise in commercial real estate.

  - Better training may allow them to understand the nuisances within the commercial real estate industry, especially regarding under-occupied properties.

  - This will likely lead to better case law to give more flexibility to tax assessors.

III. Policy challenges and recommendations in New Jersey

- Vacant Property Registration

  - Encourage local officials to create an ordinance to require all owners of vacant property to register the property with the local municipality.

  - For example, Trenton City adopted a vacant property registration ordinance in 2015.
    - There is an initial registration fee and an annual renewal fee.
    - The renewal fee increases from $250 in the first year to 5% of the assessed property value by the fourth year.
    - Liability insurance is required.

  - These vacant property registrations could be expanded to include more detailed information about under-occupied commercial properties.
    - For example, the percentage of units currently vacant.