



ADMINISTRATIVE REPORT

Report Date: November 17, 2017
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VanRIMS No.: 08-2000-20
Meeting Date: November 28, 2017

TO: Vancouver City Council
FROM: Director of Finance
SUBJECT: Supporting Small Businesses Through Provincial Tax Reform

RECOMMENDATION

- A. THAT Council approve in principle the recommendation for a two-part approach to support small business tenants as outlined in this report, which includes:
- “Split Tax Bill” - the amount of property taxes that a landlord is allowed to pass on to a business tenant, through a triple net lease, be proportional to the rented space that a business tenant has exclusive right-of-use and, where applicable, common areas; and the residual property taxes on any actual or implied undeveloped density remain the responsibility of the landlord;
 - Commercial Tenant Protection - similar to the Residential Tenancy Act, the year-over-year rent increase a landlord is allowed to impose on business tenants be limited (e.g. no more than 2% above inflation);

FURTHER THAT Council direct staff to engage Metro Vancouver municipalities and other key stakeholders on the above measures;

AND FURTHER THAT Council instruct staff to submit a written request to the Province to make applicable legislative amendments to enable the above measures as soon as possible to correct the unintended consequences of triple net leases on small business tenants in times of rampant real estate speculation.

- B. To ensure equitable treatment of all taxpayers, THAT Council affirm its support for the current assessment framework whereby property values are determined objectively by BC Assessment based on “highest and best use”, regardless of subjective land use decisions of individual property owners.

- C. THAT Council reaffirm its desire to expedite the transition from 3-year to 5-year targeted land assessment averaging in 2018 (one year ahead of the original target transition in 2019 pursuant to the *Vancouver Charter*); and direct staff to resubmit a written request to the Province to make appropriate legislative arrangements to enable such transition in time for the 2018 tax year.
- D. THAT Council instruct staff to continue to monitor the application of the Amacon ruling on other properties, report back on the financial and land use implications, and recommend viable options for Council consideration.

REPORT SUMMARY

The City plays a leading role in enabling a thriving business environment and building a world-class, sustainable community. Vancouver is consistently ranked as one of the most livable cities in the world and, in 2016, the global accounting firm KPMG ranked the City as the second-most tax competitive in the world. To ensure property tax remains competitive and affordable, through continuous business transformation and innovation, Vancouver has consistently had one of the lowest average tax increases in Metro Vancouver over the past several years while making significant progress on key Council and community priorities.

Every property tax system has its limitations and challenges. Over the years, property assessment volatility has been top-of-mind for small businesses. The challenge has become even more prevalent in recent years due to rampant real estate speculation in Vancouver, driving up values and resulting in significant volatility in property assessment and taxes year-over-year. While property owners stand to gain from rising property values upon redevelopment or sale, small business tenants continue to shoulder the entire tax burden passed on to them by their landlords through triple net commercial leases.

In triple net commercial leases, tenants are most often required to pay their share of property taxes pertaining to the rented space of which they have exclusive right-of-use and, where applicable, common areas. In BC, real estate properties are assessed at their highest and best use and property taxes are levied on this value. In the case where a property is not developed to its highest and best use - for instance, only one floor of retail at grade with unrealized development potential above - through a triple net lease, landlords also pass on property taxes pertaining to the unrealized development potential to tenants. Typical commercial leases do not convey development rights to tenants and tenants do not realize any benefit of the increase in property values, as an owner would, upon redevelopment or sale. As such, the practice of passing on all property taxes to tenants, on both rented space and development potential, is viewed as unfair and punitive, and could cause significant financial distress for small business tenants who have very limited ability to absorb unforeseen expenses.

To correct this imbalance, staff recommend the "Split Tax Bill" approach whereby the amount of property taxes that a landlord is allowed to pass on to a tenant, through a triple net lease, be proportional to the rented space that a tenant has exclusive right-of-use and, where applicable, common areas. Payment of property taxes on any actual or implied undeveloped density should be the responsibility of the landlord, not the tenant.

As land speculation is also causing significant commercial rent increases across retail neighborhoods and small business tenants are bearing the brunt of such impact, staff recommend that the Province consider limiting the year-over-year rent increase a landlord is allowed to impose on a business tenant (e.g. no more than 2% above inflation). This measure

is already available to residential tenants through the Residential Tenancy Act, and would be equally impactful in protecting small business tenants from significant rent fluctuations and potential displacement.

Staff believe the recommended two-part approach - "Split Tax Bill" and rent protection - is the most impactful measure with the least unintended consequences; and would complement the City's targeted averaging program in alleviating unanticipated property tax and rent increases arising from land speculation and assessment volatility faced by business tenants. For all property owners, including landlords and owner-operator small businesses, staff continue to advocate for transitioning from 3-year to 5-year targeted land assessment averaging in 2018 (one year ahead of the original target transition in 2019 pursuant to the *Vancouver Charter*) to provide additional interim tax relief.

The above recommended measures would require provincial legislative amendments. In recent months, the Province has indicated willingness to consider City recommendation(s) on potential mitigations. With Council's in-principle approval, staff will submit a written request to the Province and work collaboratively with applicable Ministries and BC Assessment to affect these measures as soon as practical.

Staff recommend strongly against any changes to the assessment framework that could undermine the integrity of the City's land use policy and property tax system, further fuel land speculation, defer redevelopment, and cause inequitable treatment of taxpayers. As taxes are levied on properties based on their assessed values, it is crucial that such values are determined objectively by BC Assessment based on "highest and best use" and not influenced by any subjective land use decisions of individual property owners. Any opportunities for speculative land owners to lower their carrying costs would result in tax losses which have to be shared by all property taxpayers in Vancouver through higher tax rates.

COUNCIL AUTHORITY/PREVIOUS DECISIONS

In May 2017, Council adopted a motion of "Supporting Small Businesses in Vancouver through Provincial Tax Reform" with a call to action on the following:

- the Province to enable the City to transition from 3-year to 5-year land assessment averaging in 2018 through an exemption to the legislative requirement or legislative amendments as appropriate; and
- staff to report back on the outcome of their work with the Province, BC Assessment and key stakeholders, with associated policy recommendations that specifically address the impact of triple net leases on property tax payments for small business tenants.

CITY MANAGER'S/GENERAL MANAGER'S COMMENTS

The City Manager RECOMMENDS approval of the foregoing.

REPORT

Background/Context

Over the last decade, Council twice engaged the Tax Commission to review the impact of property tax on businesses. In 2007, the Tax Commission recommended shifting \$23.8 million in property taxes from non-residential to residential property classes at a rate of 1% of tax levy per year to achieve a target distribution of 52% residential and 48% non-residential. It also recommended holding the target tax share for five years unless the business tax differential between the City and its neighbouring municipalities widened considerably, or the balance of business investment tilted away from Vancouver to other parts of Metro Vancouver. The program was completed in 2012.

In 2013, Council reconvened the Tax Commission to reassess the situation. In 2014, the Tax Commission concluded there was no evidence of an increasing business tax differential between Vancouver and other Metro Vancouver municipalities, or of business investment moving from Vancouver to neighbouring municipalities. This suggests the tax shift program was effective in bringing Vancouver's business tax share in line with its peers. As a result, the Tax Commission recommended that the tax share for business property classes be maintained; and that metrics be tracked to gauge Vancouver's ability to retain and attract business investment relative to its neighbours. However, the Tax Commission remained concerned about assessment volatility and resulting tax impact on businesses, particularly those that rent space under triple-net leases which could be hard hit by assessment spikes with no ability of sharing any upside in property values upon redevelopment.

In assessing viable mitigation measures, the Tax Commission sets out the following guiding principles:

- targeted
 - "hot" properties only (defined as those that have experienced significant year-over-year increases in property values above the "threshold" set by Council)
 - unanticipated increases only, not owner-induced increases (rezoning, improvement upgrades)
- tailored mitigation to intensity of volatility
- time-limited to allow tenants time to react (re-negotiate, relocate)
- easy to understand
- straightforward to administer
- minimize unintended consequences
- maintain market assessment as much as possible
- not to unduly defer redevelopment to highest and best use

The Tax Commission concluded that targeted 5-year land assessment averaging best meets the above guiding principles. Council adopted the Tax Commission's recommendation and the City transitioned from across-the-board to targeted 3-year averaging in 2015. Due to legislative restrictions in the *Vancouver Charter*, the earliest time to transition from 3-year to 5-year averaging is 2019.

Between 2007 and 2017, the business tax share has reduced from 50% to 43% and the business tax rate ratio has reduced from 5.65 to 4.35. Non-residential development in Vancouver continues to be robust. 13.6 million sq ft of commercial and industrial floor space has already been completed since 2007, and major projects on the way will add another 10

million sq ft over the next five years, mainly in the downtown and central business district and along Broadway and other major transit corridors.

It is important to note that market forces beyond Council's control impact the tax rate ratio, and that a higher tax rate ratio between the non-residential property classes and Class 1 - Residential is not always an indicator of increasing tax burden on non-residential properties. For instance, if the value of residential property appreciates at a much faster pace than non-residential property, the tax rate ratio will increase even though the business tax share is decreasing. As such, it could be misleading to rely on only the tax rate ratio to gauge tax equity among property classes without considering other complementary metrics.

Please refer to Appendix A for further background information and applicable Council policies and practices relating to the property assessment and taxation framework.

Strategic Analysis

I. Impact of Property Assessment & Tax Volatility on Businesses

Stability and predictability are two desirable attributes of a property tax system whereby businesses, both owner-operators and tenants, can plan their expenditures within reasonable limits. Changes in property taxes generally reflect two factors: changes in tax rates and changes in assessed values.

Annual property tax increase in Vancouver has been reasonably steady over the last decade, and the City has consistently had one of the lowest average tax increases in Metro Vancouver in recent years. The City does not generate higher tax revenue as a result of rising property values as tax rates are lowered to reflect assessment increases.

However, significant, unanticipated changes in individual property assessment do occur in different parts of the city, resulting in tax volatility. Key factors include:

- City-led zoning changes, typically as part of a broader neighborhood planning effort, which define new highest and best uses for existing properties
- market speculation on properties in close proximity to an area under redevelopment and/or in anticipation of City-led planning initiatives which may introduce higher density and mixed uses
- major investment in rapid transit infrastructure in close proximity
- market trends driven by supply and demand of the day

Assessment and tax volatility impacts business owners differently, depending on whether they are tenants or owner-operators.

Business tenants - In triple net commercial leases, in addition to base rent, tenants are most often required to pay their share of property taxes pertaining to the rented space of which they have exclusive right-of-use and, where applicable, common areas. Higher taxes arising from unanticipated surges in assessed values, typically driven by approved or anticipated zoning changes, are borne by tenants during their lease term, typically five years or longer.

In the case where a property is not developed to its highest and best use - for instance, only one floor of retail at grade with unrealized development potential on top - through a triple net lease, landlords also pass on property taxes pertaining to the unrealized development potential to tenants. Typical commercial leases do not convey development rights to tenants and tenants do not realize any benefit of the increase in property values, as an owner would, upon redevelopment or sale. As such, the practice of passing on all property taxes to

tenants, on both rented space and development potential, is viewed as unfair and punitive, and could cause significant financial distress for small business tenants who have very limited ability to absorb unforeseen expenses.

To correct this imbalance, staff recommend the “**Split Tax Bill**” approach whereby the amount of property taxes that a landlord is allowed to pass on to a tenant, through a triple net lease, be limited to the rented space that a tenant has exclusive right-of-use and, where applicable, common areas. Payment of property taxes on any actual or implied undeveloped density should be the responsibility of the landlord, not the tenant. (Recommendation A)

Land speculation is also causing significant commercial rent increases across retail neighborhoods and small business tenants are bearing the brunt of such impact. Staff recommend that the Province consider enabling some form of **rent protection** to business tenants whereby the year-over-year rent increase a landlord is allowed to impose on a business tenant be limited (e.g. no more than 2% above inflation). This measure is already available to residential tenants through the Residential Tenancy Act, and would be equally impactful in protecting small business tenants from significant rent fluctuations. (Recommendation A)

Staff believe the two-part approach - “Split Tax Bill” and rent protection - is the most impactful option with the least unintended consequences; and would complement the City’s targeted averaging program in alleviating unanticipated property tax and rent increases arising from land speculation and assessment volatility faced by business tenants.

Owner-operators - Unlike business tenants, owner-operators do benefit from rising property values upon redevelopment or sale, though higher property taxes could pose a cash flow challenge in the short term.

Staff believe that targeted land assessment averaging (recommended by the Tax Commission in 2014) continues to be an effective tool for providing short-term, multi-year tax relief to businesses, particularly for owner-operators, through phasing in significant property tax increases over time. Averaging is the only mitigation available for commercial properties and Vancouver is the only municipality in BC that uses averaging at a city-wide level.

Section 374.4 (12) & (13) of the *Vancouver Charter* (enacted in 2013) allows Council to use up to five years of land value in the averaging formula. Once selected, the averaging formula must hold for five years. The City is currently using 3-year averaging and the earliest time to switch to 5-year averaging would be 2019, unless legislative amendment is approved by the Province.

Staff recommend transitioning from 3-year to **5-year targeted land assessment averaging in 2018** (one year ahead of the original target transition in 2019 pursuant to the *Vancouver Charter*) to provide additional interim tax relief. (Recommendation C)

II. Integrity of Property Assessment & Taxation Framework

The costs of property tax-supported services are shared among taxpayers based on individual property assessed values. To ensure equitable treatment of taxpayers, it is crucial that such values are determined objectively by BC Assessment based on “highest and best use”, and not influenced by any subjective land use decisions of individual property owners.

As an example, in recent years, developers have been converting vacant lots into temporary community gardens or parks to reduce taxes until redevelopment. Under the current regime, the property is still assessed at its “highest and best use”, but the classification changes from Class 6 - Business to Class 8 - Recreational/Non-profit which has a lower tax rate. If property

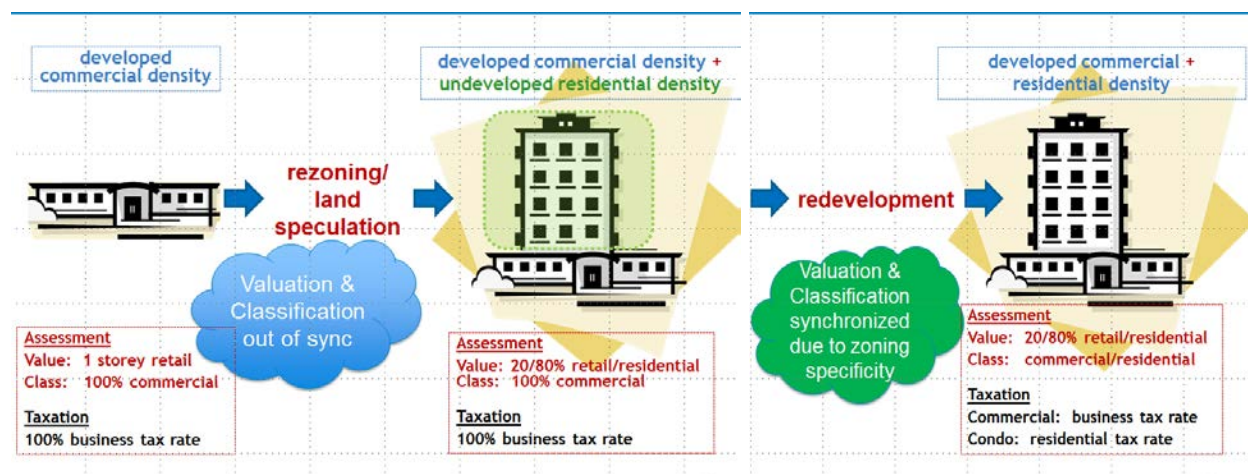
valuation were to be based on how owners choose to use their land, the assessed values would be further reduced to reflect community garden/park use, which would increase the tax savings substantially. Any opportunities for speculative land owners to lower their carrying costs through loopholes in the property assessment and taxation framework would result in tax losses which have to be shared by all property taxpayers in Vancouver through higher tax rates.

Staff recommend strongly the continued support for the current assessment framework whereby property values are determined objectively by BC Assessment based on “highest and best use”, regardless of subjective land use decisions of individual property owners, in order to maintain the integrity of the framework and mitigate the unintended consequences of further fueling land speculation and/or deferring redevelopment. (Recommendation C)

III. Assessment & Taxation Challenges for Redevelopment Properties

For properties that face the prospect of redevelopment, the market expects that there is a higher and better use than its current use, and begins to price in a premium over and above that value that is justified by the current use alone.

Figure 1 below illustrates the property assessment and taxation under the current regime over the time horizon.



At the start, the one-storey retail space is assessed and classified by BC Assessment as Class 6 - Commercial. As time passes, the market expects a higher and better use of the property, which may include some residential density above the commercial retail space. This expectation is priced in the market value of the property, and is reflected in its assessed value. As the actual use of the building continues to be retail, the property is classified as Class 6 - Commercial. Upon redevelopment, which includes retail at grade and residential condominium above, the property will be split-classified as Class 1 - Residential and Class 6 - Commercial. This situation applies to most zoning areas in Vancouver.

The Amacon ruling in 2014 introduced the possibility of classifying undeveloped density as Class 1 - Residential should there be enough specificity in the zoning by-law to cap the commercial density. Since then, a dozen assessment appeals that have similar characteristics as the Amacon properties have been settled in the last few months, resulting in ~\$7.4 million of lost City tax revenues (\$16 million including OTAs). More appeals are underway that are relating to the Amacon ruling.

Although this methodology would lower the overall tax bill prior to redevelopment, without the “Split Tax Bill” approach, business tenants will continue to shoulder the entire tax bill including the development potential, albeit lower. As well, this methodology requires specificity in the City’s zoning by-laws that limit commercial density, which is contrary to Council’s direction of preserving and expanding job space, particularly in the Metro Core, Broadway Corridor, Mount Pleasant and False Creek Flats etc.

It is important to understand the parameters within which split assessment could be applied. From a tax policy perspective, the viability of this option should be assessed considering a wide variety of factors including, but not limited to, the following:

- one-time and ongoing implications on the City’s property assessment and tax base
- tax shift implications on other properties across property classes
- potential deferral of redevelopment to achieve highest and best use

Staff will continue to monitor the application of the Amacon ruling on other properties, report back on the financial and land use implications, and recommend viable options for Council consideration. (Recommendation D)

With regards to the potential use of Revitalization Tax Exemption as an option to lower the tax bill ahead of redevelopment, the Tax Commission made the following comments:

- Current legislation does not envision the *Revitalization Tax Exemption* provision be used to combat hot spots.
- Exemptions only apply to municipal taxes; taxes levied by other taxing authorities are not exempt.
- Implementation would require the City to develop an onerous set of processes and procedures given the city-wide coverage and number of “hot” properties.
- Relative to the program in Richmond, it would be more complicated for Vancouver as i) Richmond’s program is focused only on one geographic area and ii) it only applies to light industrial and business properties that experienced more than 100% increase in land value from 2005-2011; whereas Vancouver’s program would need to target “hot” properties that emerge as a result of assessment volatility in any given year across the city.

Implications/Related Issues/Risk

Financial

Staff will continue to monitor the application of the Amacon ruling on other properties, report back on the financial and land use implications, and recommend viable options for Council consideration.

CONCLUSION

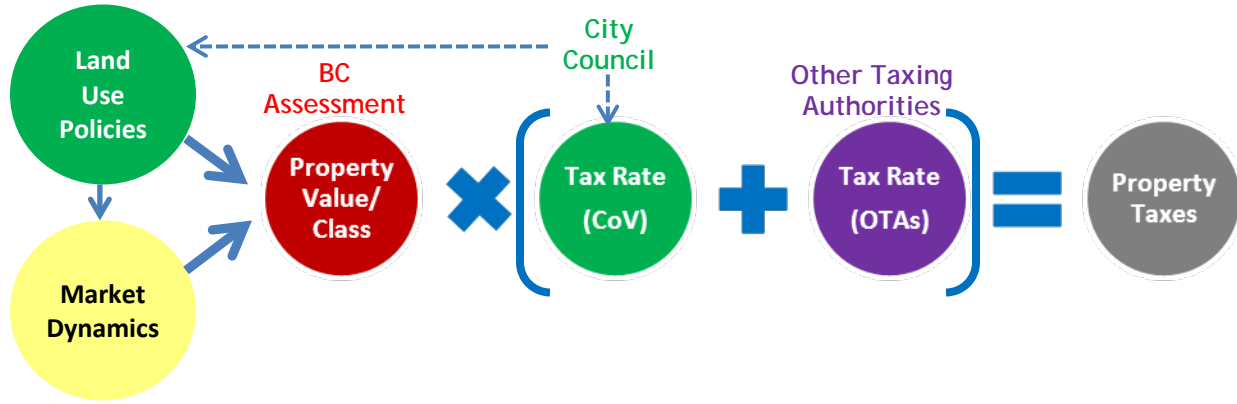
Real estate speculation has become more prevalent in Vancouver, resulting in significant volatility in property assessment and taxes and rent escalation year-over-year. While property owners stand to gain from rising property values upon redevelopment, small business tenants continue to shoulder the entire tax burden passed on to them by their landlords through triple net commercial leases.

To correct this imbalance, staff recommend “Split Tax Bill” and rent protection to alleviate unanticipated property tax and rent increases arising from land speculation and assessment volatility faced by business tenants. For landlords and owner-operators, staff recommend transitioning from 3-year to 5-year targeted land assessment averaging in 2018 (one year ahead of the original target transition in 2019 pursuant to the *Vancouver Charter*) to provide additional interim tax relief. These measures would require legislative amendments by the Province.

Staff recommend strongly against any changes to the assessment framework that could undermine the integrity of the City’s land use policy and property tax system; further fuel land speculation; defer redevelopment; and cause inequitable treatment of taxpayers.

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British Columbia's property assessment and taxation framework has been recognized as one of the best in class due mainly to the segregation of assessment and taxation functions that ensure objectivity and credibility; and the annual market valuation approach that ensures currency, equity and transparency.



Property taxes are levied by taxing authorities based on real property values, which are driven by zoning as defined in **land use policies** and by **market dynamics**.

BC Assessment determines the value of all real properties in BC based on their “highest and best use” as defined by zoning and market evidence, and assigns them to appropriate property class(es) based on their “actual use” in accordance with the *Assessment Act*. An Assessment Roll is produced annually for municipalities and other taxing authorities (“OTAs”) - Provincial schools, Translink, BC Assessment, Metro Vancouver and Municipal Finance Authority - to levy property taxes.

City Council sets land use policies that define zoning; determines the amount of general purpose tax levy required to support City operations; sets residential and business tax share and tax rates; and levies property taxes using the Assessment Roll. Council may also decide whether to apply mitigation tools such as land assessment averaging in any given year. If averaging is applied, the overall tax rates (City and OTAs) for the impacted property classes will be adjusted to ensure revenue neutrality. The City's general purpose tax portion accounts for ~50% of the overall tax rate.

OTAs set tax share and tax rate for each property class, and levy property taxes using the Assessment Roll. OTAs accounts for ~50% of the overall tax rate.

IMPACT OF ASSESSMENT CHANGES ON PROPERTY TAXES

While the Council-directed property tax increase applies to the overall tax levy, the extent of change, year over year, in an individual property's tax is determined primarily by how that property's assessed value has changed relative to the average change within its property class. Properties with a higher increase in value relative to the average change of the class could experience a much higher increase in property tax beyond the Council-directed increase, while properties with a lower increase in value could experience no change or a reduction in property tax. This situation is particularly prevalent in neighborhoods with significant growth opportunities and/or development potential where property values could experience a much higher increase relative to other areas in the city and, as a result, pay higher taxes.

MITIGATION MEASURES

Land assessment averaging is an optional tool available to Council under the *Vancouver Charter*. To date, Vancouver is the only municipality in BC that uses averaging to phase in significant property tax increases arising from assessment volatility at a city-wide level.

- For eligible residential properties, this program complements other provincial measures such as Section 19(8) of the *Assessment Act*, Property Tax Deferment and the Home Owner Grant (described below) in alleviating significant year-over-year tax increases.
- For light industrial and business properties, this program is the only mitigation that provides businesses with short-term, multi-year relief to enable market adjustments and/or lease renegotiations.

In May 2011, the Province enacted 2011 Municipalities Enabling & Validating Act (MEVA) (No. 4) in response to the City of Richmond's request for specific authority to provide targeted, transitional tax relief to eligible light industrial and business properties in the Brighthouse neighborhood. The program did not apply to other areas in Richmond or other municipalities in BC. The intent of that policy was to address the high vacancies and job loss arising from volatility in assessments and property taxes in the area, which were triggered by changes in Richmond's Official Community Plan (adopted in mid-2009) allowing higher density residential development in and around that neighborhood. In addition to exempting municipal taxes under the Revitalization Tax Exemption provision, the 2011 MEVA (No. 4) enables partial exemption of the provincial school tax. The program ran from 2012 to 2017, starting with only 39 eligible properties in 2012 and reduced to 29 properties in 2017.

Staff is not aware of any other mechanisms being used elsewhere in the province.

TAX DISTRIBUTION

Distribution of tax levy across property classes has been a subject of debate since the mid-1970s when market value assessments were introduced in BC. To determine how the costs of tax-supported City services are shared among property classes, the following criteria are considered:

- Equal treatment of equals
- Fairness, based on benefits received
- Fairness, based on ability to pay
- Economic behavior
- Accountability
- Stability and predictability
- Simplicity and ease of administration
- Regional and national competitiveness

There are two common approaches to tax distribution:

- (i) "**Tax Rate Ratio**" Approach - "Class multiples" are used to fix the ratio between the Residential (Class 1) tax rate and the tax rates of all other property classes. This often leads to significant year-over-year tax shifts between residential and non-residential property classes arising from differential market value changes among those classes.

- (ii) **“Tax Share” Approach** - Distribution of tax levy across property classes is determined by Council, subject to non-market changes within the classes (e.g. property transfers between classes, new construction) and/or Council decisions to adjust the share for each class. This means differential market value changes will not impact the tax share for each class.

In the late 1970s and early 1980s, the Province established the tax rate ratios for municipal governments annually. This resulted in significant year-over-year inter-class tax shifts arising from differential market value changes. At the request of Council and the Union of British Columbia Municipalities, the Province granted municipal governments the authority to determine their own tax distribution approach beginning in 1983. Since then, it has been Council policy to use the “tax share” approach.

Since the early 1990s, representatives of the business community have been advocating that distribution of tax levy be based on “consumption” of tax-supported City services by each property class. Council did not support the use of “consumption” studies as the basis for tax distribution in 1995 and again in 2007. One of the key reasons is that consumption models in general focus on properties that receive immediate and direct benefits, though fall short on identifying those that receive secondary and/or ultimate benefits from City services. Furthermore, determining benefits received is only one of the several criteria to be considered in setting tax distribution. The use of “consumption” studies within the context of property tax policy was also considered by the Tax Commission and was not recommended due largely to the reasons cited above.

CALCULATION OF TAX RATES

Under the “tax share” approach, Council determines the share of tax levy for each property class, but not for each individual property within the class. Section 374.2 (1) of *Vancouver Charter* further stipulates that Council determines and imposes a single tax rate for each property class, but not for each individual property within the class. To generate the Council-approved tax levy, when the total assessed value of a property class increases, the tax rate for the class is adjusted down; when the total assessed value decreases, the tax rate is adjusted up.