Chief Financial Officer's Report to **ISC: UNRESTRICTED**
Priorities and Finance Committee **PFC2018-1134**
2018 October 30

2019 Projected Tax Shift Non-Residential Properties

EXECUTIVE SUMMARY

Changes in market value due to fluctuations in the real estate market are a regular part of the annual property assessment cycle in Alberta. As a result, a property's assessed value can either increase or decrease from one year to the next. In addition to individual properties, entire property types can also experience changes to market values based on economic conditions, which can lead to a redistribution of property taxes amongst the other property types.

In 2017-2018, a redistribution of property taxes occurred after market changes led to both a substantial decrease in the office property type, specifically downtown offices, and increases in the industrial and retail property types primarily located outside of the downtown core. The portion of property taxes that was previously paid by downtown offices shifted to other property types within the non-residential property class, in particular industrial and retail properties primarily located outside the downtown core.

In response, two separate one-time programs, the 2017 Municipal Non-Residential Phased Tax Program, and subsequently, the 2018 Municipal Non-Residential Phased Tax Program, were developed to mitigate the impacts caused by the tax distribution. These programs limited the increase in 2017 and 2018 municipal non-residential property taxes for eligible non-residential property owners to 5 per cent (not including the effect of Business Tax Consolidation).

An additional redistribution is expected in 2019 due to the continued decrease in values of downtown office properties; specifically, from 32 per cent of the total non-residential assessment base in 2015 to an expected 19 per cent in 2019.

A cross-corporate working group was formed in 2018 to address this issue. The Assessment and Tax Working Group (Working Group) intends to provide a report to the Priorities and Finance Committee (PFC) in Q1 2019 which will investigate short, medium and long-term options to address the potential financial and economic impact of the expected redistribution of 2019 property taxes.

This interim report is being provided to PFC to share information on the 2019 preliminary Assessment Roll and the expected 2019 property tax redistribution. In addition, the Working Group is seeking PFC's direction to prepare its final report, which would be presented in Q1 2019.

ADMINISTRATION RECOMMENDATION:

That the Priorities and Finance Committee:

1. Receive this report for information; and
2. Direct the Assessment & Tax Working Group to present its final report to the Priorities and Finance Committee, no later than Q1 2019.

PREVIOUS COUNCIL DIRECTION / POLICY

On 2012 April 09, Council approved PFC2012-35, the consolidation of business tax revenue into the non-residential property tax, based on the following schedule for the incremental transfer of budgeted 2013 business tax revenue, adjusted for physical growth and contingency amounts in future years:

- zero per cent in 2013;

- 10 per cent in each of the years 2014-2015; and
- 20 per cent in each of the years 2016-2019,

with business tax, for business tax purposes, eliminated in 2019.

On 2017 January 23, Council approved C2017-0057, which recommended the implementation of the one-time 2017 Municipal Non-Residential Phased Tax Program (2017 PTP). The 2017 PTP limited the increase in 2017 municipal non-residential property taxes for eligible non-residential property owners to five per cent (not including the effect of Business Tax Consolidation (BTC)).

On 2018 March 19, Council approved PFC2018-0045, which recommended the implementation of the one-time 2018 Municipal Non-Residential Phased Tax Program (2018 PTP). The 2018 PTP limited the increase in 2018 municipal non-residential property taxes for eligible non-residential property owners to five per cent (not including the effect of BTC).

On 2018 April 25 Council approved the indicative tax rates set out in C2018-0489.

BACKGROUND

The Real Estate Market in Downtown Calgary

The recession impacted many aspects of the downtown including the real estate market. Some market transactions (sales) have been observed over the past year that have indicated a further decline of the market value of properties in the downtown. However, the full view of the impact on not only the downtown real estate market, but the entire non-residential assessment and tax base has not been evident until the recent completion of the preliminary 2019 property assessment roll. The preparation of the 2019 preliminary assessment roll confirmed that the market value of downtown office properties will continue to decrease in 2019. This will lead to a redistribution of property taxes from non-residential property owners in the downtown to non-residential property owners with properties in other areas of the city. To investigate this issue, a cross-corporate working group was formed.

Administration is currently compiling information on the forecasted real estate market environment in Calgary to provide context around the future challenges of the vacancy rates in downtown Calgary. The Calgary office real estate market has also seen many market transactions over the past two years where properties have sold for substantially less than they did in sales just a few years prior.

Administration’s initial research, using third-party data from the Altus Insite, has found that the office vacancy rate in downtown Calgary has increased since 2013, peaking in 2018 at 23 per cent. The downtown office vacancy rate is expected to decline slowly in the next three to seven years, from 22 per cent in 2019 to 13.3 per cent in 2025.

The demand side shock from the 2015-2016 economic recession triggered the high office vacancy rate in downtown Calgary. At the same time construction of new downtown office buildings was completed in 2017, which added to the inventory.

Due to the excess inventory in downtown offices, developers are not expected to start new major downtown office construction for some time. Most of the additions to downtown office space is expected to be due to completion of projects that are already underway. Alternative office space is also available through the recent buildup of good quality office space outside

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downtown. As a result, the absorption of the downtown office buildings will depend on the demand side activities, principally employment growth for office workers.

Economic and employment growth in the Calgary Economic Region is expected to improve compared to 2015-2018 and will help to absorb excess capacity pushing down the vacancy rate. The primary forecast risk relates to uncertainty with market access for Alberta crude. This factor will have an impact on the level of investment relative to the pre-recession levels, the pace of downtown office space absorption and by extension the pace of vacancy rate decline.

Other components of Calgary's economy have weathered the recent economic stressors better and in different ways. This corresponds to the relative stability and even slight increase in the market value of properties in other segments of the non-residential assessment and tax base. Calgary's support of the retail market has translated into market values holding and Calgary's leadership in the area of logistics and distribution also translated into stable market values within the industrial and warehouse sections.

The Property Assessment System in Alberta

In order to assess the issue of decreasing market value in downtown office properties and the impact on the overall assessment and tax base, it is important to consider Alberta's property overarching assessment and taxation system. Property in Alberta is taxed on the principle of *ad valorem*, or "according to value" using property assessments as the basis for the fair and equitable distribution of property tax. In this system, a property's assessed value is an indicator of a property owner's ability to pay. Property assessment is a method of determining the distribution of property tax and does not determine the amount of property tax that must be collected by a municipality. A property value-based distribution system for municipal and provincial (mainly school) funding is widely used across Canada, the United States and is used in some form across most developed countries.

In accordance with the *Municipal Government Act* (MGA) and the *Matters Relating to Assessment and Taxation Regulation*, *2018*, (MRAT) annual property assessments are prepared on the basis of market value. A property's assessment must be an estimate of the value of the property as of July 01 and reflect the physical condition of the property on December 31, in the year prior to the tax year.

The MGA categorizes properties into different property classes. The property classes used in Calgary are: "residential", "non-residential", "farm land", and "machinery and equipment". Sub-classes can also be established for residential properties through bylaw and non-residential properties through the *Matters Relating to Assessment Sub-classes Regulation*, which came into effect on 2018 January 01.

To ensure property assessments are prepared fairly and equitably, Administration follows the quality methods and standards outlined in the MGA and MRAT when preparing annual property assessments. The Government of Alberta also completes an audit of market value-based assessments in each Alberta municipality to confirm the property assessments meet the legislated provincial quality standards before assessment notices are mailed to property owners. Assessors must also ensure they meet professional appraisal standards, guidelines and principles when preparing property assessments including the qualifications outlined in the *Qualifications of Assessor Regulation*.

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There has been recognition of the benefits of a market value property assessment and taxation system. As noted by Enid Slack and Richard M. Bird in *The Political Economy of Property Tax Reform* "[t]he conventional consensus is that capital (or market) value taxation is best, for several reasons." One reason being that other assessment systems which do not take into account value changes over time can result in inequities compared to the market assessment system which reflects value changes.

The use of market value assessments for the distribution of taxes was reviewed by Council's Property Tax Mitigation Special Advisory Group (SAG) in FCS2007-05, *Review of Market Value Assessment and Tax Policy*. It was noted in Attachment 6 that there were a number of alignment points between a market value assessment and property tax system and the Fair Calgary (Social) Policy. One reason being that a market value assessment system and property tax system treats all individuals with "respect, and without discrimination (equality")". To the extent that individuals who own similarly valued homes are considered to be in similar circumstances, market value assessment ensures they pay similar taxes. Attachment 1 to that report contained a report prepared for the SAG by Enid Slack and Steve Pomeroy. This report, *An Evaluation of Tax Policy and Market Value Assessment Using Calgary's Triple Bottom Line Framework*, outlined that "…most studies of property taxation over the last 30 years have recommended that market value assessment be used as the base for property tax on the grounds that it is superior to any of the alternatives in terms of fairness."

Property Taxes in The City of Calgary

The annual property assessment cycle does not influence the amount of property tax revenue generated. Property taxes are collected to fund municipal services as well as the provincial property tax requisitions. Specifically, the municipal property tax rates are based on the total municipal property tax requirement set out in The City's annual budget. The provincial property tax rate is determined by the annual provincial property tax requisitions provided by the Government of Alberta.

Each property class is assigned its own tax rate through the annual Property Tax Bylaw. Effective 2016 May 31, the MGA requires that the ratio of the highest municipal non-residential tax rate when compared to the lowest municipal residential tax rate not exceed 5:1. The 2018 property tax rates are outlined in Attachment 1. The amount of property tax a property owner is required to pay is calculated by multiplying the applicable provincial and municipal tax rates by the property's assessed value.

Changes in Market Value and Related Tax Shifts

Increases and decreases in market value are a regular part of the annual assessment cycle. Since a property's annual assessment must reflect the value of the property on July 01 of the previous year, a property's assessed value is influenced by fluctuations in the real estate market. From one year to the next the assessed value could stay the same, increase or decrease, based on market conditions.

This type of market value change, and corresponding property tax shift, is a natural occurrence in market value assessment system and the real estate environment in general. Since property assessments are a proxy for ability to pay property tax, as a property decreases in value, the system adjusts, and the owner's share of property taxes decreases. On the other hand, as the value of property increases, the system adjusts, and the owner's share of property taxes increases.

In addition to the regular shifts experienced by individual properties, entire property types can also experience changes to assessed values based on market conditions. These shifts can lead to a redistribution of property taxes amongst the other property types. Usually these changes occur slowly over time; however, in some circumstances a specific property type or industry sector can experience a substantial change. If the assessed values of one property type decrease significantly so does the amount of property tax paid by that property type. Since The City must still gather the property taxes required in the municipal budget and the provincial requisitions, the amount of property taxes paid by other property types will increase to close the gap in property taxes collected. In certain cases this can lead to a material increase in property taxes paid by the other property types, especially when the real estate market for one property type is changing differently than others.

In 2017-2018, a redistribution of property taxes occurred after market changes led to both a substantial decrease in value for the office property type, in particular downtown offices, and an increase in values for the industrial and retail property types primarily located outside of the downtown core. As outlined in Attachment 2, in 2015, 32 per cent of all non-residential assessment value resided in downtown offices. This means that the non-residential property assessment base (and tax base) was heavily dependent on downtown office properties. By 2018, the non-residential assessment base was more balanced throughout the various property types with 23 per cent of all non-residential assessment value residing in downtown offices, despite the addition of new office properties in 2018.

During 2017-2018, the portion of property taxes that was previously paid by downtown offices was shifted to other property types within the non-residential property class, in particular industrial and retail properties primarily located outside of the downtown core that experienced either:

- an increase to their assessed value;
- no change to their assessed value; or
- a smaller decrease to their assessed value than the downtown office property class.

The 2017 PTP and, subsequently, the 2018 PTP were developed to mitigate the impacts caused by the tax redistribution. Both the 2017 PTP and 2018 PTP were separate, one-time programs which limited the increase in 2017 and 2018 municipal non-residential property taxes for eligible non-residential property owners to 5 per cent (not including the effect of BTC).

The 2017 PTP was funded by a transfer of $45 million to the Community Economic Resiliency Fund from intentional savings in 2016 Corporate Programs. As of 2018 September 20 approximately $26.4 million in 2017 PTP credits have been distributed to over 5,000 accounts. 2017 PTP credits of approximately $4 million are currently set aside for accounts with outstanding proceedings before the Assessment Review Board or Alberta Court of Queen's Bench.

The cost of the 2018 PTP is estimated to be $41 million, which was funded by the Fiscal Stability Reserve through a transfer from intentional savings in 2017 Corporate Programs. As of 2018 September 24 approximately $20.4 million in 2018 PTP credits have been distributed to over 6,500 accounts. Approximately $18.9 million in 2018 PTP credits is set aside for accounts currently before the Assessment Review Board or Alberta Court of Queen's Bench.

INVESTIGATION: ALTERNATIVES AND ANALYSIS

The Working Group was established in 2018 to investigate the impacts of the redistribution of property taxes from non-residential property owners of downtown office properties to non-residential property owners of properties located outside the downtown core.

Based on the 2019 preliminary assessment roll, Administration forecasts there will be a further redistribution of property taxes in the 2019 tax year due to a continual decrease in market value of the office property type, mainly downtown offices. As outlined in Attachment 2 the percentage of the preliminary non-residential assessment roll allocated to downtown offices is anticipated to be 19 per cent in 2019. This is a decrease from 23 per cent in 2018. It is expected that this will contribute to a tax increase for non-residential property owners located outside of the downtown core, where market values have remained more stable. The preliminary 2019 non-residential assessment roll demonstrated the proportion of assessed value born by all office properties will decrease from 26 per cent in 2018 to the expected level of 21 per cent in 2019 (Attachment 3).

Further analysis of the preliminary 2019 assessment roll indicates:

- The assessed value of office properties is expected to drop whereas other components of the non-residential assessment roll are expected to maintain market value (Attachment 4).
- While all sub-components within the office property group are expected to experience a decline in market value, the decline in the downtown office is expected to be largest (Attachment 5).

Based on preliminary 2019 assessed values and the preliminary 2019 estimated tax rates, 2019 non-residential property taxes will increase where there has been no market value change, a market value decrease or a market value increase for a specific property's assessment as between 2018 and 2019. Further details are outlined in Attachment 6.

Based on a preliminary analysis of the 2019 assessment roll, if there were to be a Phased Tax Program similar to the previous programs, it is expected that the one-time cost of such a program would be approximately $89 million.

If directed, the Working Group will investigate and identify short, medium and long-term options to address the potential financial and economic impacts of the expected redistribution of property taxes amongst property owners and provide a report to PFC in Q1 2019.

Stakeholder Engagement, Research and Communication

If directed, the Working Group intends to engage an external consulting group to complete the necessary research required for preparation of the property tax redistribution part of the report. The Working Group also intends to work with multiple stakeholders to identify and evaluate potential options to address the tax redistribution. This engagement will be completed using a variety of mechanisms including facilitated workshops and individual interviews.

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Strategic Alignment

The proposed options for tax policy reform and/or tax relief are intended to align with two fundamental Council Priorities:

- A Well Run City; and
- A Prosperous City.

This proposal will also support Key Result Areas within the Economic Resilience Strategy; in particular:

- Continue to provide service delivery to Calgarians;
- Focus on ensuring value for money in the services we offer;
- Review economic situation and respond to impacts to *Action* Plan with an eye towards the One Calgary timeline;
- Identify and respond to what is required to retain productive people, businesses, incomes, jobs and investment projects; and
- Contribute to the creation of a vibrant and prosperous downtown Calgary.

Social, Environmental, Economic (External)

The 2015-2016 economic recession impacted many parts of the business community in Calgary. Many of the negative impacts on citizens, business and community organizations have been identified and discussed in the Economic Development Investment Fund report, PFC2017-1081. Recent economic growth has not been as robust as required to address these challenges.

Financial Capacity

Current and Future Operating Budget:

The cost of retaining an external consultant will be funded by the current operating budget. There are no significant future operating impacts associated with this report.

Current and Future Capital Budget:

There are no capital budget impacts associated with the preparation and distribution of this report.

Risk Assessment

The Working Group will analyze the risks associated with the options presented in the final report.

REASON(S) FOR RECOMMENDATION(S):

The Working Group intends to provide a report to PFC regarding the continued redistributive tax effect of the rapidly declining market value of certain non-residential properties in the city.

The Working Group, with the assistance of a consulting group, other business units and stakeholders will investigate several options to address the current and future effects of the property tax redistribution and present its recommendations to PFC in Q1 2019.

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ATTACHMENT(S)

1. City of Calgary 2018 Property Tax Rates
2. Preliminary Non-Residential Assessment Roll and Downtown Offices
3. Preliminary Office Contribution to the Assessment Roll
4. Preliminary 2019 Non-Residential Assessment Roll Overview
5. Preliminary Office Inventory Overview
6. Estimated 2019 Property Taxes for No Market Value Change, Market Value Decline and Market Value Increase