**Chief Financial Officer's Report to
Priorities and Finance Committee
2019 June 04**

**ISC: UNRESTRICTED
PFC2019-0559**

Non-Residential Assessment Sub-Classes

EXECUTIVE SUMMARY

The prolonged economic downtown in Calgary has strained the business community. Recently, The City of Calgary (The City) has gained new legislative authorities to administer non-residential property sub-classes for assessment and municipal taxation. Classes and sub-classes enable Council to distribute tax burden between different types of properties and property owners. This mechanism could be used to alleviate a portion of the municipal property tax burden from some businesses and re-allocate it to others. As directed by Council, Administration has explored the creation of a small business assessment class. In sum, the current property assessment and taxation system will require considerable investment to implement non-residential assessment sub-classes.

ADMINISTRATION RECOMMENDATION:

That the Priorities and Finance Committee recommend that Council receive this report for information.

PREVIOUS COUNCIL DIRECTION / POLICY

At Priorities and Finance Committee on 2019 April 1, Council directed Administration to:

- Explore the creation of a small business assessment class for implementation in 2021 reporting back to the Priorities and Finance Committee in 2019 June.

BACKGROUND

Property assessment classes and sub-classes enable Council to shift tax burdens between different types of property; they are not designed to change municipal tax revenues overall. Currently, the property classes that The City applies (as required by legislation) are: “residential”, “non-residential”, “farm land”, and “machinery and equipment”. Each class is assigned its own tax rate through the annual Property Tax Bylaw (most recently, Property Tax Bylaw 13M2019).

The *Municipal Government Act* (*MGA*) provides the authority for Council to create sub-classes within certain classes. In previous years, Council had the option of dividing the non-residential property class into two sub-classes – “improved” and “vacant” property – for the purposes of assigning separate municipal tax rates. These sub-classes have not been used by The City to date.

More recently, The City has gained new authorities through the updated *MGA*; the *Matters Relating to Assessment Sub-Classes Regulation,* Alta Reg 202/2017 (the *Regulation*, see Attachment 1); and the *City of Calgary Charter, 2018 Regulation*, Alta Reg 40/2018 (the *Charter*). These include the option to create new non-residential property sub-classes for the purposes of assessment and taxation.

The *Regulation* provides the option for a municipality to adopt three non-residential property sub-classes: (1) “vacant non-residential property” (2) “small business property”; and, (3) “other non-residential property”. Vacant non-residential property (Vacant) is not defined in the *Regulation*, nor is it defined in the *MGA*. It is often understood to mean vacant, unimproved land. Other non-residential property (Other) captures properties that do not fall into the other two sub-classes. The City may consider use of all three sub-classes prescribed in the *Regulation* but must adopt at least two of the three (e.g. “small business property” and “other non-residential property”) for the purposes of assigning separate tax rates within the sub-class. If these sub-classes are implemented, each non-residential property must be assigned at least one sub-class.

Section 2(3) of the *Regulation* defines “small business property” as:

> “…property in a municipality, other than designated industrial property, that is owned or leased by a business
>
> (a) operating under a business licence or that is otherwise identified in a municipal bylaw, and
>
> (b) that has fewer than
>
> (i) 50 full-time employees across Canada, or
>
> (ii) a lesser number of employees as set out in a municipal bylaw,
>
> as at December 31 or an alternative date established in a municipal bylaw.”

The *Regulation* states that the tax rate for the small business property sub-class (SBSC) must be between 75 and 100 percent of the Other non-residential property sub-class, providing for the shifting of the tax burden from properties occupied by small businesses to properties occupied by businesses that do not qualify for the SBSC (hereinafter referred to as “large businesses”). The SBSC provides a means for municipalities to directly promote and incentivize small business through a lower municipal property tax rate.

More than one class or sub-class may be assigned to a property. For example, if 50 percent of a property is owned or leased by small business, 50 percent of the property would be assigned the SBSC, while the remaining 50 percent would receive another class or sub-class, as applicable.

The *Charter* also provides the option for The City to establish two additional non-residential sub-classes for “derelict” or “contaminated” properties. A summary of available non-residential property assessment sub-classes can be found in Attachment 2.

INVESTIGATION: ALTERNATIVES AND ANALYSIS

There has been insufficient time to fully explore all aspects of a SBSC and to gather, consider, and incorporate stakeholder feedback. However, Administration has considered what would be required to implement the SBSC having regard for legal, data collection, and technological requirements and risks. Considerable care and attention to detail will be necessary to develop all required systems and processes to ensure successful and efficient implementation that provides for maximum benefit while minimizing risk and unintended consequences.

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Other Jurisdictions

At the time this report was written, Administration identified six municipalities within Alberta that have established the SBSC pursuant to the *Regulation*. All are very small relative to Calgary:

- County of Vermillion River;
- The Municipal District of Bonnyville;
- Smoky Lake County;
- Rocky Mountain House;
- The Regional Municipality of Wood Buffalo (Rural Service Area only); and
- Thorhild County.

The following larger Alberta municipalities have not established the SBSC:

- City of Edmonton;
- City of Red Deer;
- City of St. Albert;
- City of Lethbridge;
- City of Medicine Hat; and
- City of Airdrie.

Small Business in Calgary

According to Statistics Canada, approximately 95 percent of all businesses in Calgary have less than 50 employees. Precisely how this information translates into non-residential leases and/or ownership is currently unknown. Not all small businesses occupy real estate, and some operate out of residential dwellings.

For the purposes of this report, Administration roughly estimates that there are at least 25,000 small businesses occupying non-residential properties in Calgary, accounting for approximately 60 percent of the total taxable non-residential assessment value. This is a high-level estimate based on the limited information available; actuals may be significantly different as research indicates upwards of 50,000 small businesses may operate in the city.

Estimated Tax Implications

Assuming that (i) small businesses comprise approximately 60 percent of the taxable non-residential assessment base; (ii) the SBSC tax rate would be set at 75 percent of the Other non-residential municipal tax rate; and (iii) the Vacant and Other sub-classes would both receive the same tax rate; Administration estimates that approximately $73 million of municipal property taxes would transfer from small business to the remainder of the non-residential assessment class.

Because the taxable assessment base of the SBSC is estimated to be larger than the Other and Vacant sub-classes combined, the overall tax burden of the SBSC would decrease by approximately 12 percent, while the Other and Vacant non-residential sub-classes would see an overall increase of 18 percent.

Therefore, for example, a multi-tenant, non-residential property classified as 50 percent SBSC and 50 percent Other would see an increase in overall tax liability. While the expectation is that property owners would pass the tax benefit on to their small business tenants (and distribute the remainder of the burden to its large business tenants) The City has no ability to control or monitor how property tax costs are distributed between private parties.

Demonstrative calculations and examples can be found in Attachment 4. These are high-level estimates; actuals may be significantly different.

System Requirements

If The City proceeds with establishing non-residential sub-classes for property assessment and taxation, Administration would leverage existing technology, data, and processes as much as possible. However, the current system is not capable of implementing non-residential sub-classes. To develop an effective and efficient system, there are legal, data collection, and technical considerations that must be explored and the costs may be significant.

Legal Considerations

<u>Regulation Analysis</u>

Section 2(3) of the *Regulation* states that a small business property is one that is <u>owned or leased</u> by a small business. The *Regulation* does not indicate if leasing or owning is paramount to the other. This implies that in either case of a small business owning or leasing a property, that property (or a portion thereof) may benefit from the SBSC. Assuming the above is correct, where a small business owns a property in its entirety, that property could potentially qualify to receive the benefit of the SBSC even if it is leased by a large business. Most non-residential properties in Calgary, including the largest and highest value properties, are owned by holding companies with less than 50 full-time employees. Assuming the above is true, if such a holding company wholly owns a property, that property could qualify for the SBSC in its entirety despite the fact that (i) the holding company is but one component of a much larger entity; and (ii) the property may be leased by large businesses. Even if a sub-class bylaw attempted to eliminate holding companies from qualifying as *bona fide* small businesses, this could be subject to legal challenge. In addition, if holding companies can benefit from the SBSC it may encourage other parties to do the same, increasing the number of “small businesses” and shifting the tax burden to a smaller group.

The wording of section 2(3)(a) of the *Regulation* may require The City to license all businesses for the purpose of the SBSC. The language of section 2(3)(a) fails to capture small businesses that do not require a business licence to operate in Calgary, meaning that the business types listed in Attachment 5 would fail to meet the qualification in 2(3)(a) and would therefore not qualify for the SBSC. However, if The City were to use a sub-class bylaw to identify additional businesses to be included for the purposes of section 2(3)(a), it could reduce or eliminate the need to license all businesses.

Section 2(3)(b) gives The City the ability to prescribe a lower maximum number of full-time employees and alter the effective date of the employee count. However, The City does not have the ability to displace the full-time employee count as the method by which to identify a small business property.

Section 2(4) of the *Regulation* states that “a property that is leased by a business is not a small business property if the business has subleased the property to someone else”. Based on this provision, it appears that a property that may be sub-leased and subsequently occupied by a small business may not get the benefit of being classified within the SBSC.

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Non-Residential Assessment Sub-Classes

Sub-Class Bylaw

A municipal bylaw would be required to allow for the effective administration of the sub-classes pursuant to the *Regulation*. In order to administer the SBSC for 2021, a sub-class bylaw must be in force prior to 2021 January 1. Therefore, the bylaw should be in its drafting phase no later than 2020 Q1 to allow for other stages of bylaw development.

The sub-class bylaw could potentially include the following:

- Reference to at least two of the three sub-classes prescribed in the *Regulation*.
- The criteria required for a business to qualify as a “small business”, including:
    - The number of full-time employees across Canada (less than 50, or a lower number if The City chooses a different threshold); and
    - Language to identify businesses that do not require a business licence to operate and to possibly eliminate the reliance on licence status.
- A definition of “full-time employee”.
- A description of the process by which The City may collect and verify the requisite business information.
- Dates and deadlines, including:
    - The effective date(s) on which the number of full-time employees is determined (if The City selects a date other than December 31).
- A provision whereby a property may be deemed as “Other non-residential property” for assessment and tax purposes if the requisite business information has not been provided.
- Any other procedures needed for the “effective administration” of a SBSC tax rate.

Property Tax Bylaw Integration

Upon adopting the sub-classes prescribed in the *Regulation*, the tax rates for each sub-class must be integrated into the existing property tax bylaw.

Data Collection Considerations

Data Required

The *Regulation* would require The City to gather the following data:

1) The business licence status of each business that owns or leases a non-residential property; and
2) The full-time, Canada-wide employee count for each of those businesses.

As discussed within the above Legal Considerations, The City could reduce or eliminate the requirement to license all businesses for the purpose of the SBSC through the creation of a carefully worded bylaw.

Non-Residential Assessment Sub-Classes

Current Data

The City does not currently have sufficient business licence or location data to effectively administer the SBSC. While some data has been achieved through Business Licensing, not all businesses require business licences to operate. Similarly, Property Assessment historically collected data on businesses occupying non-residential real estate to administer business tax. The elimination of business tax has resulted in the degradation of that data, since it has not been updated to reflect new, closed, or moved businesses over the past several months, for businesses outside of the Business Improvement Areas (BIAs).

More importantly, The City does not have the full-time, Canada-wide employee count of each business operating within non-residential properties in Calgary. This would be an entirely new undertaking. Additional information about the current data available can be found in Attachment 6.

Data Collection Strategies

To date, Administration has explored two broad options to collect the requisite business data to implement the SBSC:

1. Collection through Property Assessment; or
2. Collection through Business Licensing.

All data collection options are accompanied by the risk of incomplete data due to their reliance on self-reporting. Incomplete data greatly increases the risk of error in applying sub-classes. Consequently, the rate of amended non-residential property assessment notices would likely increase. Further, since assessment class and sub-class can be complained upon to the Assessment Review Board (ARB), the volume of non-residential complaints may increase.

Collection through Property Assessment

Assessment currently sends Assessment Requests for Information (ARFIs) to non-residential property owners in accordance with section 295 of the *MGA* to obtain relevant property data. Assessment could modify the current ARFI to request additional information about the businesses that own or lease non-residential real estate. Alternatively, Assessment could administer a small business application process, similar to its current exemption application process (see PFC2019-0491).

The estimated capital cost to facilitate data collection through Property Assessment range from approximately $150,000 to $450,000 depending on the specific method by which the data is obtained. The operating costs for this option are estimated to be $650,000 which would be the cost of adding 5 additional full-time employees.

Collection through Business Licensing

The Business Licensing service currently collects business information from businesses that require a business licence, which is approximately half of businesses operating in Calgary. Administration could expand on the information that it currently collects to additionally include employee count (and any other business information prescribed by the sub-class bylaw). A comprehensive licensing or registry regime could be designed to encourage self-reporting, thereby improving data quality.

To effectively administer this option, the current Business Licensing system would require significant modifications. It would need to be expanded to include all businesses that occupy non-residential real estate and would require those businesses to provide more information than they do currently. This change would result in additional administrative encumbrance to the business community. The workload of the Business Licensing service would effectively double, increasing the required operating budget by an estimated $7.9 million annually. There would also be impacts to the Legal Counsel and Advocacy and Fire Inspection and Enforcement services. The impact to these two services has not yet been estimated.

Attachment 7 provides further detail on collection of data through both Property Assessment and Business Licensing, including some of the relevant assumptions, pros, cons and costs associated with each data collection method.

<u>Data Maintenance</u>

Given the legislated requirement to prepare assessments on an annual basis, The City would require updated business information annually to ensure that property classifications remain accurate. In addition, The City would require that information well in advance of the tax year to effectively process the volume of information.

Technological Considerations

The City does not currently have the technological capability to administer the SBSC. Technological modifications to current systems would be required. The specific technological requirements to effectively administer the SBSC will be dependent on the process by which the business data will be collected.

The technological systems of the following services would be affected:

- Property Assessment;
- Taxation;
- Appeals and Tribunals; and
- Business Licensing (if data collection is achieved though Business Licensing).

The time required to complete all technological system modifications would be approximately 18 months and would cost an estimated total of $1.3 million. Note that this estimate includes technological costs for Assessment’s current system only, not the future system, which is in development and scheduled to be implemented for the 2022 tax year. Additional capital investment would be required to change the scope of the future system to include sub-class functionality. Alternatively, any implementation of non-residential sub-classes could be delayed to coincide with the launch of the new assessment system.

Stakeholder Engagement, Research and Communication

Administration has engaged several stakeholders from the local business and real estate communities to invite commentary on the *Regulation*. A list of stakeholders contacted is provided in Attachment 3.

Strategic Alignment

The SBSC aligns with the following Council Priorities:

- A Prosperous City
- A Well Run City

Social, Environmental, Economic (External)

The trying economic conditions in recent years have had a negative impact on the business community within Calgary. The substantial drop in the price of oil, together with increased taxes imposed by other orders of government, and continued strong economic headwinds faced by business owners including rising labour and other input costs have all negatively impacted the business community. The rapid decline in the market value of a small number of very high valued non-residential properties re-distributed the property tax responsibility to other non-residential properties such that some properties have experienced large property tax increases. This has exacerbated the financial hardship for many businesses. The SBSC has the potential to alleviate some of the financial hardship for small businesses by transferring some tax responsibility to large businesses.

Financial Capacity

Current and Future Operating Budget:

It is anticipated that there will be operating costs associated with the implementation of the SBSC as discussed throughout this report. Administration does not currently have the resources or funding available to execute this work, and funding is required if the program is approved. The operating budget required to implement non-residential sub-classes varies widely depending on the method of data collection and maintenance used. Early estimates of the required operating budget if data is collected through the Property Assessment service is approximately $650,000 annually. If data is collected through Business Licensing, the workload of that service would effectively double, requiring an estimated $7.9 million annually (see Attachment 8). In addition, operating costs of communication are estimated at $500,000 annually. Communication would include marketing and increased inquiries to Citizen Information & Services, Property Assessment, and Taxation. This is a high-level estimate and actual costs may be significantly different.

Current and Future Capital Budget:

Proceeding with the SBSC will require capital funding for technological upgrades and data collection procedures. Administration does not currently have the resources or funding available to execute this work, and funding is required if the program is approved. Early estimates of the required capital investment to implement the SBSC in 2021 range from approximately $1.3 million to $1.7 million, depending on the method of data collection used (see Attachment 8). This estimate does not include enhancements to Assessment's future system, which does not have sub-class functionality within its scope. The future system is expected to be implemented for the 2022 tax year. To avoid capital investment in current Assessment technology, implementation of non-residential sub-classes could be delayed to coincide with deployment of the future technology.

Non-Residential Assessment Sub-Classes

Risk Assessment

Administration has identified the following issues and/or risks associated with implementing the SBSC:

1. Unintended Beneficiaries: Most large non-residential properties in Calgary, including large shopping centres and office buildings, are owned by holding companies which may have few employees. As the *Regulation* is written, such properties could be categorized as SBSC, which may not align with the original purpose and intent of the *Regulation*. This circumstance exists for some of Calgary's largest and most valuable properties.

2. Benefit Distribution: The hope and intent of the SBSC is that property owners will pass on the tax benefit to small businesses who lease space; however, The City does not have the ability to control or interfere with how private parties distribute costs amongst one another (in accordance to the terms of their lease agreements or otherwise). For example, some property owners distribute the tax burden based on proportion of the physical space occupied by each tenant. Some business owners, therefore, may not actually realize any or all the resulting tax benefit, which may be shared amongst other tenants.

3. Full-Time Employee Count: Section 2(3) of the *Regulation* implies that full-time employee count is the primary qualifier of a small vs. large business. The language of the *Regulation* does not allow for a different requirement. One criticism of this qualifier is that it does not factor in other measures of business operations that may be more probative in determining the size of operations or the degree of success, including financial characteristics.

   Further, many large chains (fast food, for example) exist in the form of individually-held franchises and employ less than 50 full-time employees. As a result, these would likely qualify for the SBSC. In contrast, large chains that are wholly owned would likely have more than 50 full-time employees and would not qualify for the SBSC, despite conducting similar business.

   Lastly, employee count is not currently collected by The City and processes and systems will need to be put in place to do so as discussed in the Data Collection Considerations section of this Report.

4. Competitiveness Within the Calgary Economic Region (CER): Re-distributing tax burden from small to large businesses may discourage large businesses from choosing to operate/continue operations in Calgary. Further, large businesses looking to move to, or expand operations in, Calgary may choose to move to other jurisdictions, which may include surrounding municipal districts within the CER.

5. Unintentional Influence on Business Behaviour: Businesses may change their behaviour to benefit from the SBSC tax implications. For example, it may influence some businesses to hire less full-time employees (or restrict growth beyond the SBSC threshold), redesign how a property is owned or leased, or restructure a business entity to form a qualifying small business solely to benefit from the favourable tax rate.

The current wording of the *Regulation* also disincentives subleasing activity, as section 2(4) of the *Regulation* appears to exclude such properties from being classified as a small business property.

6. Quality Assurance / Verification: Administration will likely have little to no ability to effectively verify the number of Canada-wide, full-time employees that are reported for any business, unless that information is publicly available or can be procured from a reliable third-party source. For example, Administration could request that business owners provide documentation from other governmental bodies to corroborate their employee count. This may create additional privacy concerns, as third-party documentation may include confidential information. Manual verification whereby Administration verifies the information itself without some kind of third-party documentation would likely not be possible, nor sustainable.

   Similarly, complaints filed with the ARB alleging an incorrect sub-class on the basis of employee count would be difficult for Administration to respond to, particularly where no documentation is available. The best evidence available may simply be the testament of the business or property owner. In these circumstances, Administration expects the ARB to amend the property assessment to reflect the sub-class described by the property owner.

7. Incomplete Information: Each year, Administration expects that some property owners will be non-responsive to requests for information. Historically, ARFI response rates for non-residential properties are approximately 80 percent. Using history as a guide, it is possible that The City may receive incomplete business information, resulting in roll corrections and/or sub-class complaints to the ARB.

   In addition, business and/or property owners that know they will not qualify for the SBSC may not respond to requests for information. One possible way to address this problem may be to incorporate language in the sub-class bylaw deeming a property as “Other non-residential” after a prescribed date and assigning the full non-residential tax rate to the property (or a portion thereof, as appropriate).

8. Privacy: Businesses and/or property owners will be providing Administration with information that is often not generally available to the public. Safeguards will be required to ensure that information is not improperly disclosed.

   In addition, when a complaint is filed with the Assessment Review Board all documents submitted are placed on the public record unless a formal request for privacy is made for all or a portion of the hearing. Both business and property owners must be sufficiently aware of this to avoid business information being provided on public record without proper awareness.

Non-Residential Assessment Sub-Classes

9. Accountability / Transparency: Business owners may refuse to disclose, delay disclosing, or provide incorrect business information. The property owner may not have the ability to verify the information and, in some cases, may not even see the information (depending on how the data is collected). Nevertheless, the property owner – not the business owner - will be directly reliant on that information such that their property tax liability will be derived using it.

10. Increased System Complexity: The SBSC will increase the complexity within The City's Property Assessment and Taxation services. As is the case with many complex systems, sophisticated parties may have a greater ability to devote resources to ensure they take advantage of potential benefits, while less sophisticated parties may not.

11. Legal Risks: Implementing a small business sub-class that provides for a financial incentive upon meeting certain criteria creates a substantial risk of challenge by those who are not eligible to receive the same benefit. Therefore, the stated criteria and methodology for determining whether a property falls within the SBSC should be clear and transparent.

12. Cost: Administration of the SBSC will come at a sizeable cost, specifically: a minimum of $2,555,000 to $2,855,000 if the data is collected through Property Assessment; or a minimum of $9,675,000 if the data is collected through Business Licensing. Some of the costs have been estimated throughout this report and its attachments, summarized in Attachment 8.

REASON(S) FOR RECOMMENDATION(S):

On 2019 April 1, Council directed Administration to explore the creation of a small business assessment class for implementation in 2021. Due to the time limitations, this report endeavours to provide relevant considerations relating to the establishment of non-residential assessment sub-classes pursuant to the *Regulation* for the Priorities and Finance Committee's review to aid in informing further direction to Administration.

ATTACHMENT(S)

1. Attachment 1 – Matters Relating to Assessment Sub-Classes Regulation
2. Attachment 2 – Summary of Available Non-Residential Property Assessment Sub-Classes
3. Attachment 3 – Stakeholder Engagement Summary
4. Attachment 4 – Estimated Tax Implication Summary
5. Attachment 5 – Business Licence Bylaws and Business Types
6. Attachment 6 – Current Data Summary
7. Attachment 7 – Data Collection Summary
8. Attachment 8 – Cost Estimate Summary