

Predictable and Fair Market Value Assessments

Issue(s): Since 2013 non-residential property assessment values have fluctuated, resulting in sudden, unexpected and significant increases to resulting tax liabilities for some property owners. The most recent concerns related to non-residential property assessments primarily included:

- a. *Calculation of capitalization rates*
- b. *Use of vacancy rates*
- c. *Subjectivity of rental income quality classifications*
- d. *Transparency and accountability*

Executive Summary

Through the 2013 process of assessing non-residential property values, the City of Medicine Hat interpreted data in a manner which varied from the assessment process used in previous years, which led to significant changes to the assessed values of a number of local properties. Additionally, businesses expressed concerns related to the level of customer service received, issues with compliance and disclosure of information, as well as fees associated with the disclosure of information. While many concerns related to consultation, customer service and communication have been addressed, there are still outstanding issues that continue to surface with various aspects of property assessments including capitalization rates, vacancy rates, rent rates, time adjusted sales values, subjectivity of assigned classifications and income quality rating, as well as overall transparency. For these reasons, the Medicine Hat & District Chamber of Commerce has updated its 2013 policy position to recommend the City of Medicine Hat put certain measures, processes and procedures in place to mitigate reoccurrence of this situation and the impacts that this process has imposed on business.

BACKGROUND

Through the 2013 non-residential property value assessment process, the City of Medicine Hat interpreted data in a way that differed from previous assessments, resulting in significant changes to the assessed value of numerous commercial properties. Since 2013 concerns have continued to surface, lessening in number leading up to 2017, but then have increased again in 2018. This was a direct correlation to the 2017 assessment roll with 41 appeals heard by the Composite Assessment Review Board from August to October 2018.

The concerns that have been raised primarily focus on the overall reflection of market value, which relates to capitalization rates, expense ratios, vacancy rates, rent or lease rates, along with concerns associated to assigned classifications and income quality ratings, resulting in assessment values that are not reflective of market value. There were also concerns that surfaced regarding transparency of the City of Medicine Hat when information that had previously been provided was removed. This included prior year's assessment values on the assessment notices, in addition to the removal of commercial comparable listings from the website.

Market value is the price a property might reasonably be expected to sell for, if sold by a willing seller to a willing buyer, after appropriate time and exposure in an open market. There are three approaches to determine the market value assessment of a property: the sales comparison approach; the cost approach; and the income approach. One or more of these approaches is used to arrive at a property's assessed value using the market value standard.

The sales comparison approach is based on the theory that the market value of a property is directly related to the sale price of similar properties. When property types are similar, the sales comparison approach provides an indication of market value. This approach is best suited to residential properties and other types of property that sell frequently.

The cost approach is used when the property being valued is new or nearly new, in situations where few comparable sales are available, or when the improvements are unique or specialized. The cost approach is based on the assumption that a purchaser would not pay any more to purchase a property than it would cost to buy the land and then rebuild the same improvements.

The Income approach is used in situations where income-producing properties are bought and sold based on their income-earning potential. This approach is used to assess the value of rental properties, such as apartment buildings or rental office buildings.

For non-residential properties in Medicine Hat, the income approach is most commonly used. However, the accuracy and reliability of an income approach analysis will depend on the availability of market data and the degree of comparability of the

subject and comparable properties. The main weakness of the income approach is the inability to find and verify reliable data on rents, vacancies, operating expenses and capitalization rates or gross income multipliers. Even in some larger urban centres where the assessor segregates properties into quality classes there might be a small number of sales of properties within each class over the past several years from which a capitalization rate can be extracted¹.

In our past research, we have found various examples of assessment methods, which include some municipalities citing a direct or sales comparison approach for condos; a cost approach used for properties such as partially completed buildings, churches, schools and industrial businesses; and a cost approach or sales comparison approach used in a few examples found for warehouses. Rental properties or revenue producing properties such as malls, restaurants and retail outlets were assessed using an income approach and we found circumstances where gas stations were assessed on a cost approach as their income is hard to predict.

Capitalization Rates

A market-based capitalization (cap) rate uses recent sales of comparable properties, with a good cap rate being one that is derived from similar properties in the same location. In Medicine Hat, the cap rates were calculated using qualified sales that occurred from July 1st, 2014 to June 30th, 2017. They were determined through analysis of improved sales of rented and owner-occupied properties. Typical rent was multiplied by model areas, with the sum of all these amounts equaling the potential operating income. The model vacancy allowance was then subtracted to arrive at an effective operating income. Structural and management expenses were subtracted from the effective operating income to obtain the net operating income. The typical net income was divided by the time adjusted sale price after deducting surplus land value or cost items to determine the indicated overall capitalization rate.

There were 74 properties on the City of Medicine Hat Improved Valid Sales List, 46 of those being improved commercial and 28 being improved industrial. The concern stems not only from the limited quantity of sales, when applied against various segments and rental income quality classifications, but also in relation to the numbers applied within the formula to obtain the cap rate. If any of the inputs into the formula are incorrect for our market, it will result in a cap rate that is not reflective of the market. The challenge becomes a determination of where the numbers are derived and whether it is based on our local market or if there are numbers being extracted from provincial data, such as typical appraisal allowances, shared between assessors, which may not be reflective of the Medicine Hat market. Some of the concerns are the vacancy allowance and typical structural or management expenses applied to obtain the effective operating income and the time adjusted sale prices. If there is an error in any of these components or if the time adjusted sales values are overstated, it directly affects the capitalization rate.

In addition, since 2013 the challenge has continued to be that in the Medicine Hat market there are few comparable or similar properties in some classification segments. The concern remains that the assessment department is grouping wide ranges of properties in with other properties that are not market comparables and applying incorrect capitalization rates, which then proves challenging to derive an accurate market value assessment.

Within the Municipal Affairs detailed assessment audit manual² it states that stratification within a property type (e.g. improved non-residential) depends on availability of sales. If sales counts are inadequate, older sales can be added and time-adjusted as appropriate. Generally, substrata with less than five sales are unacceptable, with fifteen being preferable. Strata with smaller sizes are useful for determining patterns, but are of little use when counts fall below five.

Vacancy Rates

In the 2017 assessment roll, there was concern that the vacancy rates were not a true reflection of the market and that the assessment department did not have a full account of all vacancies within Medicine Hat. There was also an identified concern through the appeals related to the fact that vacancy allowance adjustments would only be made in response to long term vacancies. However, it is reasonable that the preparation of annual assessments would include annual reviews of market indicators, such as vacancy rates, in order to develop typical valuation inputs and ensure that collection of vacancy data is thorough and complete. In addition it was concerning that the assessment department may not support a specific vacancy due to the subjectivity of the vacancy being related to “management decisions”, as this type of subjectivity should not be determined by the assessor.

¹ <https://open.alberta.ca/dataset/4e54312f-000c-4d8e-896f-86e6b60c20a7/resource/46eecea4-5bde-4f89-9928-54c049b3299c/download/principles-of-assessment-for-arb-members.pdf>

² http://www.municipalaffairs.alberta.ca/documents/as/Detailed_Assessment_Audit_Manual.pdf

The other challenges with vacancies is the application of the rates. For example, if the City uses a “City wide” vacancy or only consideration for “main” and “not main” floors, or perhaps only four vacancy rates applicable for industrial properties for four quadrants of the City, it ends up applying these vacancy rates in a very broad manner that may not take into perspective the various challenges in certain pockets or neighborhoods with this type of application.

Rental Income Quality

The Assessment Department assigns a numerical income quality to properties based on their capacity to earn rent with variables including tenant exposure, access, amenities and attractions along with physical characteristics all impacting the income quality classification. Physical characteristics include age, exterior treatment, interior finish, building design, visual appeal and condition or maintenance. The rental income quality becomes subjective if it’s largely opinion based without very specific criteria or guidelines to follow and without a proper inspection of the property to determine all the variables that will impact the rental income quality. In addition some properties have changed in rental income quality on their assessment, however there was no notification and the property owners impacted were not aware of any inspection that took place resulting in the income quality change.

Transparency

Concerns have been raised with the removal of the prior year’s assessment value. While it is understood that each year’s assessment is independent of the previous year and is not sufficient enough to draw a conclusion that an assessment is too high, it is reflective of the level of transparency and perceived trust that the assessment department has in its assessment process. If the assessment values are fair and reflective of market value, there should be no concern with disclosing this information year over year for the benefit of the property owner.

In addition, the removal of the non-residential commercial comparable listings is also a perceived indication of the lack of transparency. While it is appreciated that no other municipality provides this data, it was something that the City of Medicine Hat was providing and was appreciated by property owners due to the ability it provided to property owners to see how their property was classified and assessed compared to other properties. Removal of such data raises question as to the level of transparency within the department and why there was a concern with continuing to provide this information. While property owners can request comparable building details through a Municipal Government Act 300 request, by having thorough data in the assessment methodology report saves time by both the property owner and the assessment department when this information is readily available and easy to understand.

ANALYSIS

Within the Municipal Affairs detailed assessment audit manual, under uniform and equitable assessments, it states that procedures are not prescribed in MRAT for preparing market value assessments; therefore, the assessor takes into consideration assessments of similar properties. For market value assessments, the assessor is expected to uniformly apply valuation models arrived at through analysis of sales, income, and cost data for a similar property. Although factors such as location and municipality size affect markets, assessors must value similar properties in the same manner (not necessarily to the same amount). It goes on to state that some properties are not easily valued using mass appraisal models. Statistical testing may be very limited in a geographic area, and relate to groups of properties with few sales.

For capitalization rates, recommended practice would be to determine capitalization rates through an ongoing process of interviewing local appraisers, analyzing sales and consulting with ratepayers and their tax agents. As minimal sales make a more complex study difficult for the mass appraisal methodology, assessors should utilize local knowledge, expertise and consultation in determining appropriate capitalization rates. While there has been a willingness and openness to meet with appraisers and realtors in the market, there may be value in further and more frequent consultation in order to ensure that there is a wide range of local data that is considered when calculating cap rates, rent rates and vacancy rates. It would also be beneficial to consult with and review the findings of the data with industry experts prior to the assessment roll being finalized in order to ensure that the mass appraisal process has resulted in a reflection of fair market value.

In addition, there would be value in having greater detail in the rental income quality criteria and guidelines, as the descriptions provided in the non-residential assessment methodology are very generalized in nature and can lead to subjectivity of assessors and speculation by property owners that the rental income quality classification is not appropriate.

When there is a concern about an assessment value, it is encouraged that the first step an assessed person should take is to contact the assessor. The assessor may request to inspect the property to determine if an error was made or request further information from the property owner. However, it is sometimes perceived that the assessor may not be willing to make a correction or provide further due diligence, as there is a perceived attitude that “we will justify and argue how right we are, no matter what the information presented may state”. In an effort to ensure accuracy and correctness of the roll, if the assessor agrees that the original assessment notice is not accurate due to new information received, the assessor has and should use their

ability to make the necessary correction to the roll under section 305 of the MGA and issue a corrected notice.

If there is a concern with a property assessment, under section 299 (1) of the MGA³ an assessed person may ask the municipality to let the assessed person see or receive information prescribed by the regulations that is in the municipal assessor's possession at the time of the request, showing how the municipal assessor prepared the assessment of that person's property. In addition under section 300 of the MGA, an assessed person may ask the municipality to let the assessed person see or receive a summary of the most recent assessment of any assessed property in the municipality of which the assessed person is not the owner.

While the City of Medicine Hat does provide for information under section 299 and 300 of the MGA, there is a cost associated under Bylaw 3031, to establish fees for tax certificates and other information regarding assessments and taxes. The cost for written information regarding assessments and taxes and other property information is \$38.00 with verbal information for the same information at a cost of \$15.00. The fees established are charged on a per property, per year, per request basis and additional fees are payable if further requests are made for information regarding the properties.

Some municipalities interpret section 300 of the Municipal Government Act to read that because properties owners are entitled to this information, the municipality does not charge for the information, as they are required to provide it. Some municipalities will apply a limitation or restriction on the number of free summaries requested and, after a certain number of summaries, they will then charge a nominal fee to cover off the administration costs for supplies, copies and/or time.

We have noted over the course of the last couple of years that there have been several improvements implemented since 2013 in the communication related to assessments, particularly to the assessment request for information forms, including more communication about and instructions for the forms and adjusted timelines and modifications to the notification letter and form. The assessment department has also analyzed increases or changes within the assessment roll year over year in order to flag any areas of concern as a way to manage irregularities and proactively inform property owners, which has certainly been appreciated. After further review and consultation, it has been identified that further improvements to the request for information notification letter and form could be made to encourage property owners to complete this information, thereby providing more data by property owners to the assessment department.

The Medicine Hat & District Chamber of Commerce is committed to fostering a positive and predictable environment for businesses to operate and the ability to accurately predict expenses is important to the sustainability and growth of any successful business. Our aim is to have consistent, predictable and fair processes that will enable our municipality to move beyond past issues and create a better environment that meets legislative requirements moving forward, ultimately lessening the negative affect on businesses and allow a reasonable period of time to prepare for increased expenses.

The Chamber also understands the limitations of Council in that a Council cannot direct valuations of the assessor, as the assessor is independent, arms length and appointed by Council to ensure there is no political influence and vested stake in the results. We also understand that Council does have the power through the Municipal Government Act to cancel, refund, defer or phase in tax increases or decreases and they have exercised that right in past circumstances.

RECOMMENDATIONS

The Medicine Hat & District Chamber of Commerce recommends the City of Medicine Hat:

1. Assessment Department provides greater detail in methodology reports including cap rates, rental rates, vacancy rates, structural and management expenses, vacancy shortfall expenses and commercial comparable listings by classifications.
2. Assessment Department supports their conclusions on capitalization rates with specified data provided on vacancy rates and the values pertaining to how net operating income was derived, along with the time adjusted sales values and consults with local market experts semi-annually to support the calculations and conclusions so that the values used are reflective of market conditions.
3. Assessment Department provides more advanced vacancy rate applications applying vacancy rates based on variables such as type, location/neighborhood and quality versus having city-wide vacancy rate applications.
4. Assessment Department provides very specific criteria and guidelines for rental income quality classifications to support the justifications for the rental income quality assigned to a property. Criteria would clearly explain what variables a business must meet in order to be classified in a particular rental income quality.

³ <http://www.qp.alberta.ca/documents/Acts/m26.pdf>

5. Assessment Department applies rent rates to net lease area to capture actual leasable space versus applying rent rates to the total gross area of a building.
6. Assessment Department physically inspects each non-residential property at least once every four to six years to determine accuracy of the rental income quality and maintain and use that building information year over year for consistent application of assessment information, particularly if a property does not follow typical model/classification norms such as access/egress, deficiencies or structural problems, amongst others.
7. Assessment Department refrains from changing a rental income quality classification without notification and a physical inspection of the property.
8. Assessment Department works with property owners to ensure assessments are reflective of market value and make corrections to the roll when an issue is identified under section 305(1), applying corrections consistently for any properties with a 5% or greater error due to an error in data, calculations or incorrect assumptions on the property identified, along with correction to any similar properties.
9. Assessment Department reinstates the provision of the prior year's assessment on assessment notices.
10. Assessment Department continue to compare current assessments to prior year assessments and flag irregularities (in excess of a 20% variation), which would then be followed up with individualized consultation, education and information in order to gather proper information prior to assessment notices being distributed.
11. Update bylaw 3031 to establish fees for tax certificates and other information regarding assessments and taxes provided by the City's Assessment and Taxation Department to provide the first five comparable properties on a 300 request at no charge.
12. Work with the local Chamber and non-residential industry representatives to further redevelop the assessment request for information notification letter and form to simplify the collection of information and encourage a higher response rate from property owners.
13. Council implement a policy whereby when an assessment on a property is greater than a 30% increase on a year over year basis, without an equivalent change in the marketplace, that they would exercise their options to cancel or refund taxes for that property assessment in that year.
14. Council evaluate options for a review of the assessment department and other best practice methodology by working with other municipalities, if concerns continue to surface in relation to property assessment.

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