

UNENCUMBERED FEE SIMPLE ASSESSMENT

Canadian Property Tax Association

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Introduction

For those of us that have been in the business of assessment for a long time, it is sometimes important that we set aside the baggage that we have built up over the years in order to consider with clarity the fundamental issues of assessment valuation, uncluttered by presumptions that are often the by-product of habit.

Hopefully, through the discussion undertaken by this panel, we can consider basic first principles from which we might ask ourselves the right questions as to what might constitute a correct assessment.

If we fail to ask ourselves the right questions, the likelihood of reaching the right answer is remote.

The question I pose is: what is the relationship between the determination of the value of real estate for assessment, on one hand, and the value of real estate for other purposes on the other?

Perhaps through this panel discussion we can consider things that are the same and things that are different on each side of this relationship.

In the assessment world, the context of that question typically flows from the issue of how to assess an unencumbered fee simple interest in land.

Scheme of Assessment

What is the purpose of a real property assessment?

A real property assessment valuation is certainly not prepared for the potential sale of the property. It is not prepared to establish an insurable value of the property. It is not prepared for financial purposes, nor for purposes of valuing a deceased person's estate.

The purpose of a real property assessment is:

*“not necessarily to arrive at the price which the property would in fact have fetched if offered to the highest bidder, but rather to establish a guarded valuation at a level uniformly applied throughout the municipality, for the specific purpose of providing a sound basis on which the costs of local government can fairly be distributed among property owners in proportion to the relative worth, free of encumbrance, of real property registered in their names.”*¹

The British Columbia Court of Appeal hit the nail on the head in linking an assessment valuation to its purpose of providing a sound basis upon which the costs of local government can be distributed.

That being said, it is clear that an assessment valuation is not the same as the values which might be determined for other purposes.

Within this context, therefore, we must proceed with caution as we look to various valuation techniques, appraisal texts, and market conditions. Those techniques, texts and conditions are not governed strictly by the statutory regime into which assessment practices, policies and procedures must fall.

An assessment valuation is a valuation based upon a statutory definition. It must therefore at all times be linked to and flow from that statutory definition. In my view, the first principles of an assessment that stem from the legislative authority are at times ignored in the determination of the application of those principles.

¹*Re Bramalea Ltd. and Assessor for Area 9 (Vancouver); T. Eaton Co., Intervener* (1990), 76 D.L.R. (4th) 53, (B.C.C.A.); leave to S.C.C. refused.

In British Columbia, for commercial/industrial property, the statutory definition is set forth in portions of section 19 of the *Assessment Act*, R.S.B.C. 1996, c. 20. Subsections 19(1), (3) and (4) read as follows:

19 (1) In this section:

'actual value' means the market value of the fee simple interest in land and improvements;

'eligible residential property' means a parcel of land on which there are improvements if

(a) the parcel does not exceed 2.03 ha in area, and

(b) the improvements are designed to accommodate and are used only to accommodate no more than 3 families.

(3) In determining actual value, the assessor may, except where this Act has a different requirement, give consideration to the following:

(a) present use;

(b) location;

(c) original cost;

(d) replacement cost;

(e) revenue or rental value;

(f) selling price of the land and improvements and comparable land and improvements;

(g) economic and functional obsolescence;

(h) any other circumstances affecting the value of the land and improvements.

(4) Without limiting the application of subsections (1) to (3), if an industrial or commercial undertaking, a business or a public utility enterprise is carried on, the land and improvements used by it must be valued as the property of a going concern.

The statutory definition for the determination of assessment in Ontario is established by a definition in section 1 of that province's *Assessment Act*, R.S.O., 1990 c. A.31, as amended, and reads as follows:

'current value' means, in relation to land, the amount of money the fee simple, if unencumbered, would realize if sold at arm's length by a willing seller to a willing buyer;

Prior to 1998, Ontario's *Assessment Act* provided the following definition:

19.(1) Subject to this section, land shall be assessed at its market value.

(2) Subject to subsection (3), the market value of land assessed is the amount that the land might be expected to realize if sold in the open market by a willing seller to a willing buyer.

Three separate definitions. Might they lead to three different assessments?

The British Columbia statutory definition has been the subject to significant jurisprudence over the years. The courts have considered its application under varying circumstances to different types of commercial property.²

Similarly, the legislation in Ontario in place prior to 1998 was subject to significant judicial interpretation, most recently in *Re Regional Assessment Commissioner, Region No. 11 and Nesse Holdings Ltd. et al.* (1986), 54 O.R. 2^d 437 (C.A.).

As a result of the jurisprudence, linking the determination of the assessed value flowing from the statutory definition to an actual property transaction became judicially crystalized as a correct approach to valuation for assessment purposes.

The open question now is whether Ontario's present statutory definition leads to a different conclusion as to establish an appropriate assessment than would be the case with either of the other two statutory definitions.

²*Re Standard Life Assurance Co. and Assessor Area #01 - Capital* (1997), 146 D.L.R. (4th) 247; *Vancouver Assessor, Area No. 9. v. Cadillac Fairview Corp.* (2004), 44 M.P.L.R. (3^d) 131; *Bentall et al. v. Area 09* (2004 PAABBC 20041246); *Bentall et al. vs. Area 10* (2004 PAABBC 20041721).

In looking to each of these statutory definitions and the jurisprudence arising from them, it is important to remember the purpose for which the assessment is being made, and thus the connection between the assessed value and the statutory definition from which it must be derived.

Even if an assessed value is to be treated as an appraisal, it should not be forgotten that fundamental to the establishment of any appraisal is the purpose and intended use of that appraisal. An opinion of value as required in any such appraisal must be linked to that purpose and intended use.³

The Importance of the Statutory Definition

An assessment valuation is a statutory valuation. Any assessed value must therefore be determined in accordance with that statutory definition.

To assist in reaching a conclusion as to the proper assessment, reference can be made to jurisprudence by which assessment issues have been considered by various courts. The requirement to interpret on a regular basis the applicable legislation in assessment review matters reinforces the fundamental nature of the statutory basis of assessed values.

None of this, of course, means we have certainty of how a particular court will treat a particular issue. To recognize that there will always be a range of possible judicial interpretations we need only to compare the rationale of the Supreme Court of Canada in *Regional Assessment Commissioner Region No. 14 v. Office Specialty Ltd. et al.* (1974), 49 D.L.R. (3^d) 471 and the rationale of the British Columbia Court of Appeal in *Southam Inc. v. Surrey/White Rock Assessor, Area No. 14* (2003), 39 M.P.L.R. (3^d) 85 (B.C.S.C.); affirmed 2004 B.C.C.A. 245.

³*The Appraisal of Real Estate*, 2nd Cdn. ed., p. 1.10; *The Appraisal of Real Estate*, 12th ed., p. 13.

It is not my intention in this discussion to analyze in detail the rationale of the British Columbia Court of Appeal, but rather to illustrate the fluidity of the principles by which assessed values can be determined and the linkage of those values to the applicable statutory definitions and judicial analysis.⁴

It is within this environment of fluid interpretation that we can consider the issue of establishing an assessed value based upon an unencumbered fee simple interest.

The Determination of “Current Value”

In the legislative amendments to Ontario’s *Assessment Act* that took effect in 1998, the Legislature saw fit to change the statutory definition by which an assessed value might be determined.

The prior statutory definition determined that land must be assessed at its market value. The market value of the land assessed was to be the amount that the land might be expected to realize if sold in the open market by a willing seller to a willing buyer.

The jurisprudence involving that prior statutory definition culminated in *Re Regional Assessment Commissioner, Region No. 11, and Nesse Holdings Ltd.*

The new statutory definition established that the assessed value would be a “current value” which meant, in relation to land, the amount of money the fee simple, if unencumbered, would realize if sold at arm’s length by a willing seller to a willing buyer.

Clearly, the definition now requires the determination of an assessed value based upon the phrase “fee simple, if unencumbered”.

⁴*Regional Assessment Commissioner Region No. 14 v. Office Specialty Ltd.*, supra; *Southam Inc.*, supra.

It is not the same statutory definition as historically in place in Ontario, nor is it the same as British Columbia's statutory definition. In fact, one could suggest that the "current value" statutory definition has some aspects that are completely redundant.

By reference to the applicable appraisal texts, it is commonly accepted that the fee simple interest implies absolute ownership unencumbered by any other interest or estate.⁵ Fee simple ownership is subject only to the government limitation of eminent domain, escheat, police power and taxation.⁶

Applying that appraisal concept to the statutory definition in the Ontario legislation, the legislation could be interpreted as if it read as follows:

'current value' means in relation to land the amount of money the absolute ownership unencumbered by any other interest or estate, if unencumbered, would realize if sold at arm's length by a willing to a willing buyer.

However, in my view, the legislative emphasis on the lack of encumbrances clearly must have meaning, linked to the purpose of the scheme of assessment.

Looking to the comparable legislative scheme in British Columbia, there the assessor is directed to determine "actual value", but to do so with certain statutory tools within section 19 of British Columbia's statute. While the "actual value" means the market value of the fee simple interest in land and improvements, in his or her determination the assessor is permitted to give consideration to such items as present use, location, revenue or rental value, the selling price of the land and improvements, and other specific items.

⁵*The Appraisal of Real Estate*, Cdn. ed., p. 6

⁶*The Appraisal of Real Estate*, 2nd Cdn. ed., p. 5.2.

More importantly, the assessor is directed to a specific consideration for the valuation of industrial or commercial undertakings. This specific consideration established in subsection 19(4) directs the assessor to value such land and improvements as the property of a going concern.

In considering therefore an appropriate value for commercial property in British Columbia, the assessor has the twin task of determining the value of the fee simple interest (without the redundancy set forth in the Ontario statute) while being obligated to consider the lands and improvements as the property of a going concern.

How these concepts can be reconciled is an interesting task for Mr. Shevchuk and other members of the British Columbia assessment bar.

Current Value - What Does it Mean?

For purposes of valuing large commercial properties, the statutory definition in Ontario's *Assessment Act* compels the determination of the value of those large commercial properties in fee simple, if unencumbered.

From our ongoing investigations, it has become apparent that there are virtually no transactions of the fee simple interest, if unencumbered, of large commercial properties anywhere in North America. In virtually all circumstances, transactions of such properties are of properties subject to leases in place. Only in circumstances in which the "white elephant syndrome" might be in play are there transactions of large commercial properties unencumbered by leases in place.

In the absence of transactions that match the specific statutory requirement, the valuation exercise must still be carried out, and must be carefully considered and implemented in order to ensure the establishment of an appropriate assessed value utilizing appropriate valuation tools.

The statutory definition in Ontario does not contemplate in its express language the valuation of a large commercial property on the basis of being a going concern property.

A going concern value of real estate is something different than the value of the fee simple, if unencumbered. A going concern is an established and operating business with an indefinite future life.⁷ Traditionally, going concern value has been defined as the value of a proven property operation.⁸

There is a clear and obvious distinction between the concept of the market value of real estate in operation and the concept of fee simple, if unencumbered.

This important distinction may lead to the requirement for different analyses to establish the assessed value of commercial property under the different statutory regimes.

For example, in considering the traditional income approach to value, it may be necessary to give consideration to the specific requirement of establishing what constitutes the fee simple, if unencumbered, interest of a property when analyzing the rents that are often considered by an assessor in determining the rental stream of that property for valuation purposes.

Essential to the valuation of commercial property utilizing an income approach is to determine the “market rent” and/or “economic rent” for the property being assessed.⁹

The concept of establishing market/economic rent centres on the consideration of the distinction between contract rent and market rent as of the valuation date for the derivation of the assessment.

⁷*The Appraisal of Real Estate*, 12th ed., p. 27.

⁸*The Appraisal of Real Estate*, Cdn. ed., p. 21.

⁹*Stevens Building Ltd. v. Sudbury (City)*, [1973] O.J. No. 393 (C.A.); *Re Cardinal Plaza Ltd. et al. and Regional Assessment Commissioner, Region No. 19 et al.* (1984), 49 O.R. (2^d) 161 (C.A.); *Re Standard Life Assurance Co.*, *supra*.

Utilizing assessment practices, policies and procedures, an attempt is typically made to establish the market rent for the property being assessed on the assumption of the availability of space for lease at market at the valuation date.

In considering the requirement to establish a market/economic rent as prescribed by the jurisprudence, it may be necessary to ask different questions than those habitually asked, which may lead to different answers from those habitually expected or accepted.

In considering the evidence available, the import of the statutory definition must be weighed.

If the property is to be valued as the property of a going concern, the state and condition of the lease structure at the time of assessment may have to be taken into account in the ultimate valuation.

The utilization of the “market rent” of a going concern may include space subject to lease as expansion space for existing occupants; as renewal of the tenancy of an existing space; as a blending and extending of a previous occupancy; and as particular transactions of particular space at particular time for particular circumstances.

The use of such evidence has been accepted by the Property Assessment Appeal Board in British Columbia.¹⁰ In fact, it has been generally accepted in British Columbia that to establish a “market rent” such transactions can form the basis of determining the market rate for a particular commercial property.

Are these considerations, however, appropriate for the determination of the “market rent” to be utilized to derive a current value of the fee simple, if unencumbered interest in a property?

¹⁰*Bentall et al. v. Area 09*, supra; *Bentall et al. v. Area 10*, supra.

There are distinct appraisal criteria required to establish an arm's length transaction. These criteria are well accepted in the assessment field. If an analysis of market rent is required to be made to establish a fee simple, if unencumbered interest, those guidelines should be applied in considering the appropriate market rent.

In determining market rent for assessment purposes in Ontario's current value regime, in my view one must be guided by criteria which include the following:

- (a) that the transaction being analyzed is between informed parties free from duress;
- (b) that neither of the parties was influenced by speculative considerations;
- (c) that the transaction was not in consideration of any "special value" to a particular lessee; and
- (d) that the parties come to the bargaining table with relatively equal bargaining power in an extended market.

Only by looking at these several considerations can it be said that the market rent is reflective of an open marketplace as opposed to being reflective of only the "going concern" in place at the valuation date.

If the determination of market rent must include these several considerations, then the result of the valuation exercise for assessment purposes might well be at variance with the utilization of the term "market rent" in the real estate community, which invariably is dealing with going concern properties.

As an example, is it appropriate for assessment purposes to establish the "market rent" of the property a "market transaction" for limited new space abutting the premises of the existing tenant? In such circumstances, questions must arise as to the appropriateness of that transaction as it might be extrapolated to establish a "market rent" of the whole property, particularly if it is a large

property. In many respects, such transactions might be more reflective of a “spot market” rather than a transactional marketplace for the rental of the entire property.

In my view, to establish a fee simple, if unencumbered interest in a property all the criteria of an arm’s length transaction utilized on a direct sales comparison approach must be applied. In this way, one can then establish an arm’s length lease transaction for purposes of expert analysis in order to establish a market/economic rent for assessment purposes.

Fee Simple, if Unencumbered

Ontario’s arguably redundant definition must nevertheless be subject to statutory interpretation.

Each word of a statute is presumed to have meaning.

It is suggested that the intent of this statutory definition is to provide the determination of the value of land based upon the concept of vacant possession on closing. With over 90 percent of the properties within the Province of Ontario being residential and being uniformly assessed by utilization of the direct sales comparison approach, in my view, it is clear that the legislative intent is to determine the value of all properties based on vacant possession on closing.

The tool used by Ontario’s assessment authority for making those current value assessments is known as Multiple Regression Analysis (“MRA”). The assessment authority’s procedures for applying MRA clearly contemplate transactions that involve vacant possession on closing for the purpose of analysis.

This method of establishing valid assessments makes a lot of sense having regard to the need to distribute the costs of local government on a fair and equitable basis in proportion to the relative worth, free of encumbrance, of real property.¹¹

When that legislative intent is applied to large commercial properties, however, the task is somewhat more daunting. Nevertheless, as a matter of first principle, to maintain consistency in statutory interpretation, the assessment practices, policies and procedures must be directed to establishing an assessed value based upon the concept of vacant possession on closing.

Large commercial properties must, therefore, be valued free of encumbrances based upon vacant possession on closing.

Actual market transactions of large commercial properties are invariably transactions of the leased fee interest not the fee simple, if unencumbered interest.

In order to derive the value required by the statutory definition, it is necessary to consider independent criteria derived from the market, and to then consider the risk and cost required to transform a vacant building to one that is occupied and functioning.

In essence, the fee simple, if unencumbered interest of a property may be the value of the going concern, fully leased property less the risk, cost and time required to reach that fully operational status.

By mirroring a new development scenario the current value assessment can be established utilizing the existing valuation tools in place and also accounting for the requirements of the statutory definition.

¹¹ *Re Bramalea Ltd.*, supra.

The provisions of the British Columbia legislative scheme directs a predisposition to determining a property's value as a going concern. In contrast, the legislative scheme in Ontario reflects a predisposition to determining a property's current value based on the fee simple, if unencumbered interest consistent with being a vacant property.

Only by valuing properties as if unencumbered can it truly be said that Ontario's statutory definition has been met.