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ASSESSMENT AND TAX POLICY IN A HIGH TECH SOCIETY

By Richard N Poole **October 1, 2001**

Introduction

The State must raise revenues in order to function. Traditionally, revenues have been raised from a variety of sources with particular reference to the taxation of tangible property. As the scheme of taxation has evolved over the years, levies have been based on asset value, income or consumption.

The real property taxation scheme has been in existence for thousands of years and reflects a capital tax on real estate. Funds raised from this levy are used to provide varying government services depending upon the tax policy initiatives undertaken by the various taxing authorities.

Over the years, vigorous debate has transpired over the definition of Ataxable property@. Traditional valuation principles related to hard assets have often formed the basis upon which property taxes are levied.

Historically, the economic foundation of the State has been closely linked to tangible property, particularly in Canada because of our resource-driven, fabrication society.

More recently, there has been a significant transfer of wealth from hard assets to intangible assets and rights as our economy has evolved from a fabrication economy to a

service-oriented technologically based economy.

This evolution of the economic foundation of the country, the creation of wealth and the advent of a technological society raises challenges related to the appropriate valuation and taxation of real property.

Intangible Property

Assessment analysis should be undertaken to establish the relationship of the value of real estate to the value of intangible property associated with the utilization of that real estate for a business purpose within the current economic environment.

Several years ago, it was the general consensus of economists that the role of real property taxation as a source of government revenue would be truncated as more and more wealth was generated through intangible property.

More recently, however, the State has become aware of the difficulties of enforcing taxation policies in the absence of a direct connection of wealth generation with a local environment. The trading of stocks and bonds transpires throughout the world through various exchanges. The internet allows commercial transactions to occur in jurisdictions without attracting any taxing authority. The United States Congress has recognized this difficulty by declaring a tax holiday on internet transactions.

Similarly, the transfer of capital and the direction of income to various jurisdictions create significant enforcement problems.

The taxation of real property on the other hand is the taxation of the immovables. Enforcement can be readily achieved simply by access to that tangible asset by the State should the taxes not be paid.

Within this context, therefore, it is important to establish the appropriate property tax base in an appropriate manner utilizing appropriate tax policy. Property tax in the future as

a source of State revenue, in my opinion, will be at least as profitable to the State as presently and may actually be utilized more stringently as a source of revenue.

Caution, however, in establishing the burden of taxation will need to be expressed by the State given the relationship of the property tax burden to competitiveness in an international economy.

In these circumstances, consideration must be given to various emerging situations for which appropriate valuation principles and tax policy must be developed.

Carrier Hotels

In order to understand some of the concepts addressed in this paper, consideration can be given to what are known as Acarrier hotels@ to demonstrate the challenges of appropriate valuation and taxation for this segment of the economy. Carrier hotels are buildings with a high degree of technological infrastructure including computer hardware, servers, switchers and security systems that are used as a basis through which major telecommunication and e-commerce companies operate their business. The buildings are ideally Abunker style@ with few windows that create an environment conducive to the maintenance of computer equipment and technological infrastructure. Extremely heavy floor loads are required to support the equipment and the rooftop structures necessary for the operation of the facility. Duplicate electrical heating, ventilation and air conditioning systems predominate in these developments.

Ironically, many of these structures presently in existence in the United States and Canada are converted Class B office buildings otherwise at the end of their economic life. The building at 151 Front Street West in Toronto, historically utilized by CN/CP as a switching station for telegraph communication, has been resurrected in this capacity. The old Western Union Building in New York City has likewise been rejuvenated.

Development costs associated with the construction of such facilities are enormous. These costs include standby power and cooling infrastructures, data centre environments,

data centre protections and telecom conductivity facilities.

Generally, the costs associated with the development of this infrastructure as well as those of the base building are recovered through lease agreements establishing rentals for the occupants of the carrier hotel.

Depending upon the package accepted by the tenant, rents can be in excess of $100 US per square foot.

Clearly, assessing such a facility using the traditional assessment practices, policies and procedures for the valuation of real property would lead to exorbitant property taxes attributable to the property.

There is a need to establish an appropriate tax policy directed to this entity so important to the establishment of a technological infrastructure within any given municipality.

The *Assessment Act* in the Province of Ontario, for example, is directed not to innovation but to fabrication. A series of property tax exemptions excludes from the property tax regime the machinery and equipment used for the manufacturing base of the economy of Ontario. Similarly, with respect to the resource extraction industry, elemental infrastructure applicable to those properties is exempt from property taxation.

Similar tax policy initiatives need to be considered with respect to the technological infrastructure constructed at such facilities as carrier hotels.

Our office has been involved over the past four months with representatives of the Municipal Property Assessment Corporation with a view to establishing appropriate tax policy to be applied to carrier hotels in the Province of Ontario. Ironically, as these discussions were ongoing, the NASDAQ collapsed. With that collapse, the need for immediate determination of tax policy relating to carrier hotels was no longer necessary. Rents at carrier hotels in the range of $50 to $100 per square foot had suddenly

evaporated.

The newly developed carrier hotel at 9 Hanna Street in Toronto has been put up for sale and remains listed for sale for warehouse purposes at warehouse prices.

The bricks and mortar remain, but the economic viability of these facilities is postponed until the recovery of the technological economy.

Another lesson is learned.

There is no certainty in the current high tech economy. Can there be certainty in establishing appropriate assessments for properties linked to that economy?

Obsolescence

One could suggest that with respect to carrier hotels, the remaining economic life was less than six months as the rents flowed downwards daily in the wake of the NASDAQ collapse.

In the present high tech economy, however, the issue of obsolescence of buildings and improvements has been quantitatively altered.

Depreciation tables projecting economic lives of forty to fifty years for industrial buildings have little or no relevance to the present economy.

Recently, a facility was built in the Republic of China as a manufacturing facility to service the Chinese and Asian markets. The facility houses machinery and equipment valued in excess of several hundred million US dollars and was built to North American construction standards, both for building components and health and safety requirements.

The facility, approximately 400,000 square feet, has a similar production capacity to more traditional facilities situated in North America.

These historical facilities built with traditional construction techniques have survived for several years and have been valued for assessment purposes by utilization of life tables of forty to fifty years.

The facility built in the Republic of China is designed with an economic life of five years and a useful physical life of ten years.

It is the intention of the owner/manufacturer to recover capital costs for the building, the infrastructure, machinery and equipment within five years. It is further anticipated that within ten years capital costs, appropriate rate of return, and profit will have been recovered from the facility and the facility will be redundant.

It is further assumed that by that time, the technological infrastructure used for manufacturing purposes will itself be redundant having been superceded by new technological advancements.

Industrial buildings with the remaining economic life of ten years at the time of construction? How should they be valued? How should that economic reality be considered in valuing all industrial buildings?

In valuing real property for assessment purposes, the concept of economic and functional obsolescence needs to be revisited in light of the technological change, the growth and fluidity of the economy and the linkage of real value to real time assessment.

The issue of the advances of technology in relation to obsolescence of industrial facilities is equally demonstrated with reference to the assessment and valuation of a steel mill. Traditional valuation practices and procedures provide depreciation tables reflective of a forty to fifty year economic life for steel mills.

The valuations are based upon the physical characteristics of the site and the technology employed by the steelmaker.

Traditionally, steel mills have been developed as integrated facilities based upon a basic oxygen furnace. The technology dates from the last century. Steel is manufactured by combining iron ore, coke (coal) and limestone.

The capital costs associated with the development of an integrated steel mill in the traditional sense are prohibitive. The most recent large basic oxygen furnace was built in 1999 in Wollongong, Australia for BHP Steel. It replaced previously existing structures.

In considering an appropriate assessable value for a steel mill, therefore, any consideration of a reproduction cost being used as the basis of the assessable value, removes the assessment from any realistic value which could be established for the real property.

Presently, most construction cost manuals, although professing to be replacement cost manuals, are in fact reproduction cost manuals. In the face of new technology, such manuals undoubtedly overvalue existing facilities.

Determination of remaining economic life of the facility by traditional life tables presupposes the capital investment required to maintain the basic oxygen furnace which requires significant reconditioning in a ten to fifteen year cycle.

Replacement technology is available by way of electric arc furnace requiring significantly less infrastructure and building components than those necessary to develop an integrated steel mill.

A real measure of obsolescence of a steel mill must reflect the economic realities of this new technology and the actual capital costs associated with the ongoing requirements of maintenance and repair of the basic oxygen furnace. An assumption of new capital expenditure to maintain the operating integrated steel mill in the face of alternative technology should not be made by the assessment authority.

Realistically it could be said that for assessment purposes the remaining economic life of an integrated steel mill should be no greater than the remaining economic life of the basic oxygen furnace should there be no new capital reinvestment in that facility.

Once again, in valuing this type of real property for assessment purposes, the concept of economic and functional obsolescence must be revisited in light of the technological change associated with steel production.

We need not, however, limit ourselves to the relationship of technology to the valuation of industrial property.

Consideration must be given as well to the economic realities of the technological requirements in the office/commercial sector. The need to retrofit prime office space to meet the needs of occupants and tenants must be linked to appropriate assessment valuation procedures for valuing that retrofit.

The determination of the rental value for valuation purposes of such buildings must be analyzed appropriately. Those properties responding to the challenge of rapid technological change which develop the appropriate telecommunications infrastructure should not be penalized in the determination of the assessable value by that upgrade.

In a fabrication society, the machinery and equipment utilized for manufacturing is not taxable. In an innovative society, should the infrastructure developed to the needs of the tenant occupants of realty property be liable to taxation?

In a changing world, the need to re-evaluate assessment practices, policies and procedures is ongoing.

Telecommunication - Linear Property

Traditionally, linear property as a concept has been linked to rights-of-way and roadways utilized as routes or corridors for transportation and communication. Generally speaking, it can be said that linear properties are roadways, fee owned rights-of-way, easements, telegraph, telephone, wire and cable lines, gas, oil and water pipelines that transverse distances crossing through several municipal jurisdictions.

Over the years, various methods have been adopted for the valuation of these types of properties. The base led to significantly different treatment amongst the various types of linear property.

The development of the telecommunications industry over the past several years has been manifested by the use of cable as a transmission device. Significant infrastructure has been developed and routed through rights-of-way and easements for the purposes of the industry.

In addition, the use of traditional linear property has been expanded to include cable connection at transmission facilities as the cable network expands across the country.

The local municipal politicians are closely watching the construction of this infrastructure and are demanding its inclusion in the property tax regime.

To date, the issue has been confined to disputes arising over the use of public land for the purposes of developing the infrastructure for the industry.

In Vancouver, a significant dispute evolved over charges which might be made by a municipality for the use of its public land. In decision 2001/23, the Canadian Radio and Telecommunications Commission (CRTC) found that companies installing telecommunication infrastructure on public property were liable for minor costs of installation but could not be charged significant ongoing cost by the municipality. The City of Vancouver had wanted compensation for other costs such as the cost of traffic disruptions, sewer and water construction to work around existing cables, and argued for compensation for a shortened life span of municipal roads due to the installation of cable. Vancouver proposed to charge annual linear land charges based on the value of adjacent lands.

Clearly, the concept of linking a value for the use of a right-of-way to the value of adjacent lands is well founded in the historical tradition of assessment and taxation of linear property.

The CRTC, however, correctly noted that the development and maintenance of communication networks was of benefit not only to the stakeholders in the private companies, but also in the generalized benefits throughout the municipality attracting industry, creating jobs and increasing revenue.

It is clear that in a technological society, a technological infrastructure is necessary in order to ensure the growth of the broader based economy.

Having new telecommunication infrastructure would clearly, in the eyes of the CRTC, be the lifeblood of a developing new technological industry.

Ironically, local municipal government policy would appear to be directed to discouraging economic development instead of fostering it. The position of the City of Vancouver that a legal principle that an owner of the land was entitled to be compensated for the use by the private sector reflects the mentality of municipalities that the taxation and charges to private owners with respect to the use of public facilities should continue unabated.

With respect to fiberoptic cable in the telecommunication industry, the capital asset should be considered independent of the route through which the fiberoptic cable passes. In addition, the value of that capital asset enhances the value of the abutting land or property generally occupied by users of the data transmitted by the fiberoptic cable and having access to its services.

The issue, therefore, is whether it is prudent tax policy to tax that capital asset in a manner which might give rise to double taxation given the enhancement of the value of the abutting improvements resulting from that route being in that location.

In a fabrication economy, the bricks and the mortar prevail. In an innovative

economy, caution must be expressed in determining the need to tax that infrastructure so important to the economic development of the State.

Ironically, as it is so important, how long will it last? With the advances of technology within the telecommunications industry, one questions whether wireless technology will supercede cable technology in the near future. Satellite transmission, cellular phone, wireless connection of local area networks lessen the need for fiberoptic cable infrastructure year by year.

Should appropriate valuation principles be developed for the valuation of this infrastructure, the relationship of the physical asset to the intangible value will need to be calculated and the residual physical value deducted based upon the limited remaining economic life of that physical asset.

Many senior assessors are of the view that the complexities arising from the valuation of these facilities far outweighs appropriate tax revenues which may result.

Utilization of Real Estate Within the Economic Environment

As the economy has moved more to a service oriented technological economy, the integration of real estate to business activity has become profound.

The development of sports facilities, entertainment centres, gaming facilities, theme parks and other interactive facilities give rise to significant assessment valuation and taxation concerns.

As an example, consideration could be given to the development of Air Canada Centre.

The property was constructed as the home of the Toronto Maple Leafs hockey team and the Toronto Raptors basketball team. Development costs were incurred in excess of $275,000,000 to build the facility as a replacement to Maple Leaf Gardens. Significant revenues are obtained through a variety of sources available to the franchise owners, some of which link to the real estate and some of which are completely independent of the real estate. Premium seating is sold for the purposes of establishing an environment conducive to spectator sports. The most expensive premium seating, in fact, consists of areas of Air Canada Centre which in a traditional sports facility would be utilized for storage.

In determining the value of the facility, it is important to segregate those value concepts associated with the consideration of real property as an arena and those associated with the utilization of the real property as the home of the Toronto Maple Leafs and the Toronto Raptors.

The facility is a state-of-the-art broadcast facility cabled to permit live broadcasts to be conducted from some 150 locations within the facility. Clearly the broadcast capabilities of this facility are directly linked to the business activities on site.

In valuing the property for real property tax purposes, it is important that consideration be given to the utilization of the property within this economic environment so as to establish an appropriate tax burden without reference to the intangible value of the franchises.

Similar analysis should be undertaken with respect to the gaming industry now so prominent throughout Canada.

The negotiation of a video lottery terminal license permitting the installation of terminals at gaming locations once again reflects the utilization of real estate within a modern service oriented technological economy.

The owner of the real estate upon which video lottery terminals are permitted receives significant revenues from those terminals.

In establishing the assessable value of the property, a tax policy consideration must be made with respect to the relationship of the property value and the revenues generated from the video lottery terminals.

This is particularly true in circumstances in which there is already, as part of the license agreement, significant revenues flowing to the municipalities in which the video lottery terminals exist as part of the compensation to those municipalities for the permission given to establish such facilities. One would question the adequacy of tax policy which would both obligate the payment as a portion of the license fee of significant revenues to the municipality and the utilization of the residual revenues as a basis for additional property tax.

The Manitoba Court of Appeal has recently determined that video lottery terminal income is no different from any other income derived from operations in a hotel.

One questions the validity of that assumption in relation to the need to consider real property taxation as a capital tax on real estate as opposed to an income tax on business operation.

Conclusion

It has never been more important to establish the appropriate definition of Ataxable property@.

Many of the traditional tools used to value real property for assessment purposes must be adapted in light of current economic realities.

The review should not be limited simply to an analysis of the assessment valuation, practices and procedures, but should be tied closely to the implementation of an appropriate tax policy by the State.

Ultimately, it will be the State that decides the issue. We should all be involved in those deliberations and be a part of the solution.