EX30.5

REPORT FOR ACTION

Tax Policy Tools to Support Businesses

Date: January 16, 2018
To: Executive Committee
From: Acting Chief Financial Officer
Wards: All

SUMMARY

This report provides an evaluation of various tax policy options that may be adopted by Council to support small businesses affected by large assessment-related property tax increases, in response to M35.16: *Saving Toronto's Small Businesses and Character Streets with Intelligent Tax Reform*.

The 2017 province-wide reassessment saw many business properties face significant tax increases. These impacts can be expected to continue in each year from 2018 to 2020 as assessment increases continue to be phased-in over the 4-year reassessment cycle. Many properties, having reached their full CVA-level of taxation in a prior year, were no longer eligible for capping protection against assessment-related tax increases.

It is recommended that, for 2018, Council adopt measures to provide a level of protection against such unmitigated increases, as an interim strategy, while continuing to evaluate other tax policy options over the course of 2018 that will accelerate progress towards full CVA taxation, provide targeted tax relief measures for identified or vulnerable groups, and move towards equity in taxation levels.

Specifically, this report recommends that a tax increase capping limit of 10% of a property's prior year's taxes apply in 2018 to any property in the commercial, industrial and multi-residential tax classes that would otherwise experience a property tax increase of greater than 10%, regardless of whether the property had reached its full CVA-level of taxation in a prior year. This is a change from prior years, where, pursuant to Council's decisions, capping protection did not apply to properties that had reached their full CVA-level of taxation. This measure will ensure that no taxpayer within those tax classes will face an assessment-related tax increase that is greater than 10% of last year's property tax liability.

RECOMMENDATIONS

The Acting Chief Financial Officer recommends that:

1. City Council adopt the following property tax capping polices, for the 2018 taxation year, to:

    a) limit tax increases for the commercial, industrial, and multi-residential property classes by capping taxes at 10% of the preceding year's annualized taxes, through the adoption of subsection 292(1), paragraph 1, of the *City of Toronto Act, 2006,* for the 2018 taxation year;

    b) discontinue the policy of removing properties from the capping and claw-back system once they have reached their full CVA-level of taxation, by not adopting section 7.1 of Ontario Regulation 121/07 for the 2018 taxation year, such that the above capping limit apply for the 2018 tax year to any property that has experienced a property tax increase of greater than 10% over 2017 annualized taxes, regardless of whether the property had reached its full CVA-level of taxation in a prior year;

2. City Council direct the Acting Chief Financial Officer to review any additional tax options during 2018, including any potential requests for legislative change, for consideration for 2019 and future years.

3. The Acting Chief Financial Officer be directed to report to City Council following Council's approval of the 2018 Operating Budget to approve and enact by by-law the applicable 2018 clawback rates.

FINANCIAL IMPACT

There is no financial implication to the City of Toronto's Budget arising from the capping policy changes recommended in this report. Under the capping and clawback system, the foregone revenue resulting from the legislated limit on individual properties' Current Value Assessment (CVA)-related tax increases for properties in the commercial, industrial and multi-residential property tax classes is funded by withholding (clawing-back) a portion of the tax decreases that would otherwise be applied to other properties within each class.

It is anticipated that the recommended limits on tax increases will be entirely funded by tax decreases that would otherwise apply within each class. As the final claw-back rate percentages cannot be adopted until the 2018 Operating Budget has been approved by Council, these percentages will be reported to Council to approve and enact a by-law establishing the 2018 claw-back rates following final budget approval.

DECISION HISTORY

City Council annually sets property tax class rates and adopts tax policies in the early part of each calendar year. In 2017, Council adopted the following items that established tax rates and policies for the 2017 taxation year:

2017 Property Tax Rates and Related Matters
http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2017.EX22.1

2017 Education Property Tax Levy and Clawback Rate By-Law
http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2017.EX24.11

2017 Education Property Tax Levy and Clawback Rate By-Law - Part 2
https://www.toronto.ca/legdocs/mmis/2017/cc/bgrd/backgroundfile-103210.pdf

Additionally, at its meeting of December 5, 2017, City Council, in adopting Item MM35.16: *Saving Toronto's Small Businesses and Character Streets with Intelligent Tax Reform,* directed the Interim Chief Financial Officer to undertake a review of various tax policy tools that can be used to provide relief to small business owners facing unsustainable Current Value Assessment-related tax increases, and to report back to a future meeting of the Executive Committee (February 6, 2018) with recommendations on which tool or tools would most effectively achieve this.

MM35.16 requested that the report include evaluations and costing for the following specific mechanisms:

- the creation of a small business tax classification for independently owned, non-franchise businesses operating in a low-rise built-form context;
- changes to commercial graduated tax rate bands to lessen the burden on small businesses by either adjusting the graduated rates or creating a third band;
- a capping mechanism for properties experiencing Current Value Assessment-related tax increases substantially higher than average; and
- examining the frequency of Municipal Property Assessment Corporation's reassessment of Ontario property values to mitigate significant changes in assessment values.

Item MM35.16 is available at:
http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2017.MM35.16

COMMENTS

The province-wide reassessment that occurred in 2017 resulted in significant reassessment-related property tax increases for many properties and across all property classes. The reassessment undertaken by the Municipal Property Assessment Corporation (MPAC) follows the provincially-mandated 4-year reassessment cycle, and adjusted the Current Value Assessment (CVA) of all properties from a January 1, 2012 valuation date to a January 1, 2016 valuation date. 2017 was the first year of the four-year reassessment cycle, with assessment increases to be phased-in by equal increments in each of the 2017, 2018, 2019 and 2020 taxation years. Assessment decreases take effect fully in the first year. A summary of the 2017 property tax changes by class is provided in Table 1 below.

Table 1: 2017 Property Tax Changes by Property Class (2017 Reassessment)

	Number of Properties					
Property Class	Tax Decrease (# props.)	Tax Increase from 0 to 10%	Tax Increase from 10% to 50%	Tax Increase from 50% to 100%	Tax Increase >100%	Total # properties
Commercial	14,529	20,785	4,991	306	118	40,729
Industrial	1,835	1,742	134	33	4	3,748
Multi-Residential	2,006	1,755	180	16	9	3,966

Table 1 indicates that, for the commercial property tax class, 5,415 properties (or 13.3% of all commercial properties) experienced property tax increases greater than 10 per cent, while 424 properties experienced tax increases greater than 50 per cent, and 118 properties experienced tax increases of 100% or more. It can be inferred that, since Council's approved municipal tax rate increase for the commercial class was 1.25% in 2017, that most tax increases greater than this amount stem from relative increases in the current value assessment of the property that are greater than the average property increase.

Media attention in 2017 focused on large reassessment-related property tax increases, citing instances of assessment increases of 100 per cent and more, and included examples such as 401 Richmond Street West, and Yonge Street properties between College and Bloor Street. Many of the properties experiencing significant tax increases were those properties that had already reached their full CVA-level of taxation, and were therefore ineligible for existing capping protection. Since 2009, Toronto has adopted the practice that once a property has reached its full CVA-level of taxation, caps on the maximum allowable year-over-year increase no longer apply.

With no cap on increases, property owners that experienced large increases in assessed value as a result of the reassessment were faced with large and unmitigated tax increases. In many cases, these tax increases were either passed on to tenants through increased rents, or borne directly by business tenants under net leases. This gave rise to concerns about the impacts on businesses, particularly small independently-owned entities or single tenant proprietorships, and the potential associated impacts on the character and viability of entire neighbourhoods and retail districts.

More significantly, as 2017 was the first year of a four-year reassessment cycle, with increases to assessment to be phased-in over each of the following 3 years, the cumulative effect of year-over-year tax increases will continue to negatively impact businesses and business tenants.

A number of tax policy tools and options can be considered to mitigate the impacts of large increases on business properties. The following sections of this report evaluate the feasibility and implications of various policy alternatives, and conclude with recommended tax policies for the 2018 taxation year.

Creation of a Small Business Tax Class

Property tax classes are established under Ontario Regulation 282/98 under the *Assessment Act*. Currently, commercial properties are identified within the Commercial General class (consisting of properties classified as Large Office Buildings, Large Shopping Centres, Large Sports Facilities, and Parking Lots) or within the Residual Commercial class (consisting of all commercial properties not included in the commercial general class). There is currently no classification that identifies small business. A new tax class for small business would have to be approved by the Ministry of Finance, and enacted by a regulatory amendment.

In creating a small business tax class, the City would be recognizing the challenges inherent in operating small-scale businesses, including independent proprietorships and small retail outlets, where profit margins may be minimal. A small business tax class could allow for a reduced tax rate to apply to such properties, or other specialized tax treatments (e.g., alternate capping limits, targeted relief programs, etc.).

The issue surrounding the creation of a small business tax class is arriving at a suitable definition for the class, i.e., which properties would be included in the class, and how would such properties be identified? Staff (and learned professionals within government, industry and academia) have long studied how "small business" could be defined for the purpose of assessment and taxation, with no common consensus.

For example, a definition that focuses primarily on the *physical* aspects of a small business (e.g., a definition that prescribes a maximum square footage or gross floor area or lot area, or maximum number of storeys or other building dimensions), may identify properties that are small in physical size. However, this definition would include small properties owned by large corporate/international entities, (e.g., local bank or loan company branches, franchise outlets such as coffee shops/chains, fast food chain restaurants, car rental operators, specialty retailers, etc.). It can be argued that such corporate interests, however small in physical size, should not receive tax relief or preferential tax rates if Council's intent for a small business class is to provide tax relief to small, independent, single proprietor retail operations that may be affected by large tax increases.

Similarly, if a definition for a small business class required that a small business be owned by an individual or independent owner, and not part of a chain of multiple similar (albeit small) locations, or if a definition was tied to the total revenues or income of an operation to establish that it is a "small" business, this would require that information on ownership tenure and/or income/expense statements be furnished by the owner to substantiate that it met the definition of a small business. The collection and verification of this information on an annual basis to confirm continuing eligibility would create an enormous administrative burden, presumably on MPAC, to ensure that only qualifying properties were included within this tax classification. It is unlikely that MPAC would be willing to take on this additional administrative burden on a voluntary (or free) basis.

It is arguable, however, that a small business class, subject to developing a definition that is appropriate, transparent and efficient to classify and administer, would be an effective tool to target tax relief to properties that Council has determined require specialized treatment. This is an option that staff feel requires further analysis and continued consultation with provincial staff, MPAC and stakeholders. While the option of creating a small business tax class is not recommended for the 2018 taxation year as it is not possible for such issues to be resolved prior to Council adopting the 2018 tax levy in February, staff will continue to study this issue over the coming year to determine its applicability for 2019 or beyond.

Changes to Commercial Graduated Tax Rate Bands

Graduated tax rates allow different tax rates to apply to different portions of the total assessed value of a property. Currently, the City of Toronto applies graduated tax rates to properties in the commercial residual tax class. A lower tax rate applies to the first million dollars of CVA (Band 1), while a higher tax rate applies to any portion of a property's total CVA above $1,000,000 (Band 2).

In this way, lower valued properties receive more of a benefit from the reduced tax rate that applies to Band 1. However, higher valued properties pay a greater proportion of taxes, and consequently tenants, including small businesses which may reside in larger buildings, will pay higher taxes than those in lesser valued buildings. As such, graduated tax rates are not particularly effective as targeted tax policy tools.

Graduated tax rates for commercial properties are permitted under the *City of Toronto Act,* and up to 3 distinct bands of assessment may be specified. As such, it is within the City's authority to have different banding thresholds apply, to vary the percentage difference between Band 1 and Band 2 rates, or to introduce 3 bands of assessment.

In considering graduated tax rates, the City must consider that the total taxes levied upon a class cannot be increased (under current regulatory restrictions). As such, tinkering with graduated rates becomes a balancing exercise. If the tax burden is reduced for Band 1, the tax burden for Band 2 must be increased by a similar amount. If the differential in rates between Band 1 and Band 2 was increased to provide more of a benefit to the lower-valued portions of a property, the rate that applies to Band 2 would have to be increased. If a third band was added to the mix, the total levy across all three bands of assessment would have to remain the same.

As such, graduated tax rates cannot effectively target tax relief to small businesses, in that they apply across the class, and any benefit conferred (in the form of reduced tax rate) to lower-valued properties would come as a direct cost (via higher tax rates) to higher-valued properties. Hence while graduated tax rates could provide a lower tax rate to lower-valued properties, they do not provide protection against large assessment-related tax increases - in fact, graduated tax rates would likely exacerbate the impact of such increases on medium- to high-valued properties that have a higher proportion of their assessment taxed at the Band 2 (or Band 3) rate.

The potential effectiveness of graduated tax rates, particularly in combination with other tax policy approaches, will continue to be studied, but no changes to the current graduated rate tax scheme is proposed for 2018.

Frequency of Provincial Reassessments

Under Ontario's *Assessment Act*, province-wide reassessments are conducted on a four-year cycle, with assessment increases phased-in in equal increments over a four-year period. Any property experiencing an assessment decrease will see the decrease take effect fully in the first year. In Ontario, the 2017 reassessment adjusted the Current Value Assessment (CVA) of all properties from a January 1, 2012 valuation date to a January 1, 2016 valuation date.

Other jurisdictions, in comparison, update assessments annually, such as British Columbia, and the Cities of Calgary, Edmonton and Halifax.

For Toronto, where market value increases are driven primarily by demand and an active real estate market, the 2017 reassessment saw average assessment increases over the January 1, 2012 valuation date of 28.6% for residential properties, 33.6% for commercial properties, 18.8% for industrial, and 54.4% for multi-residential properties between valuation dates. Individual properties, particularly those located in high-demand areas or in redevelopment areas (e.g., Yonge Street) saw assessment increases far in excess of the average. The resulting property tax increases, especially for properties no longer eligible for capping protection, raised serious concerns amongst property owners, tenants and business operators over the threat posed to the financial viability of entire neighbourhoods and retail districts.

It has been suggested that more frequent reassessments, i.e., moving from a four-year cycle to annual reassessments, would result in smaller relative changes between reassessments, which would in turn reduce the magnitude of property tax increases that must be absorbed. This may or may not be the case in Toronto, where the real estate market continues to see significant year-over-year growth in property values - assessment change, whether reflected annually or phased-in over a four-year period, will still reflect the total relative market value change. Large increases in assessed value relative to the average market increase would still result in large tax increases for certain properties.

The province's rationale in introducing a four-year reassessment cycle was to mitigate the effects of market volatility on property values, and to provide a measure of stability and predictability to property owners, such that changes in assessment (and tax burden) could be reasonably anticipated and planned for.

A key factor in a decision to increase the frequency of reassessments would be whether the Municipal Property Assessment Corporation (MPAC) has the necessary resources to conduct and deliver reassessments annually - this could result in significantly increased costs to MPAC, and therefore direct costs to municipalities, which pay for the costs of MPAC's services.

It should also be noted that a change in the frequency of reassessments will not provide direct tax relief or tax mitigation to small businesses, or to businesses in general, nor would such a change address the impacts of property tax increases that occurred in 2017, or that will occur in the years 2018 and beyond.

Finally, a change to reassessment frequency would require the approval of the provincial government and amendments to legislation, and would have implications for all municipalities across Ontario, some of whom may favour the current four-year cycle. As the decision to change the frequency of reassessments is not within the City's jurisdiction, and given the limited and uncertain benefit such a change may have on mitigating assessment-related tax increases for small businesses and businesses in general, staff have made no recommendations in this respect.

Tax Capping

Tax capping refers to the practice of prescribing a maximum allowable limit on year-over-year increases in property taxes. Originally intended as a temporary transitional measure to mitigate large property tax increases arising from the introduction of the Current Value Assessment system, tax capping has been in place in Toronto since 1998. Under the *City of Toronto Act*, capping is mandatory for properties in the commercial, industrial and multi-residential tax classes, although municipalities have some flexibility in setting the tax capping parameters.

In order to recover the tax revenue foregone by the capping limits on properties experiencing tax increases, provincial legislation and regulations permit municipalities to withhold a portion of the tax decrease that would otherwise apply to properties that have experienced an assessment-related tax decrease, i.e., the "clawing-back" of decreases. Each year, Council establishes a claw-back rate, by class, that prescribes the percentage of the tax decrease that must be withheld (clawed-back) to fund the costs of capping protection.

Tax capping has proven to be an effective tool to mitigate large tax increases, and the rules surrounding capping and claw-back are now generally well understood by business property owners and the legal community and real estate and tax professionals that represent them.

The negative consequences of tax capping/claw-backs are that inequities in taxation are preserved and prolonged. Owners whose properties have experienced large increases in assessment continue to pay less than their full share of taxes (i.e., the taxes that would be payable if the taxes were based on full CVA times the tax rate), at the expense of owners whose properties would otherwise be entitled to a tax decrease.

Toronto's Current Tax Capping Policies

Toronto Council's long-term property tax policies have included, since 2009, provisions to accelerate progress towards full CVA taxation, as a means of restoring equity and simplicity in taxation. This included a requirement that a property, on having reached full CVA taxation levels, would no longer be eligible for capping or claw-back adjustments in subsequent years. This policy saw a gradual but steady increase in the number of properties paying taxes at full CVA levels, and a reduction in the number of properties subject to capping/claw-back.

In terms of municipal flexibility, the *City of Toronto Act* allows annual tax capping limits to be based on a maximum allowable increase equal to 5 per cent or 10 per cent of the prior year's annualized taxes, or 5 or 10% of the prior year's CVA-level taxes.

"Annualized taxes" refers to the actual amount of taxes levied in the year, or in the case of properties where, during the taxation year, a change in taxes occurred that applied to a portion of the taxation year (e.g., due to assessment or other appeals, a change in tax status, or a change in the assessed value of the property arising from new construction, improvements, renovations, demolitions, change in zoning, etc.), annualized taxes refers to the taxes that would have been payable had the change applied to the full year.

From 2006 - 2016, Council adopted a capping limit of 5% of the prior year's CVA-level taxes and prior to 2006 the City's caps were based on 5% of annualized taxes. In 2017, in order to accelerate progress towards full CVA taxation, Council approved an increase in the capping limit to 10% of the prior year's full CVA.

Recommended Changes to Tax Policies for 2018

The 2017 province-wide reassessment saw many business properties faced with tax increases of 10 per cent or more in 2017 (as shown in Table 1). These impacts can be expected to continue in each year from 2018 to 2020 as assessment increases continue to be phased-in over the 4-year assessment cycle. It is also recognized that many properties, having reached their full CVA-level of taxation in a prior year, were no longer eligible for capping protection against assessment-related tax increases.

It is recommended that, for 2018, Council adopt measures to provide a level of protection against such unmitigated increases, as an interim strategy, while continuing to evaluate other tax policy options over the course of 2018 that will accelerate progress towards full CVA taxation, provide targeted tax relief measures for identified or vulnerable groups, and move towards equity in taxation levels.

This report recommends that Council change its methodology for capping tax increases by limiting allowable tax increases for the commercial, industrial, and multi-residential property classes to 10% of the preceding year's annualized taxes. This represents a change from the capping limit adopted for 2017, where the tax cap was based on a maximum allowable increase of 10% of the prior year's CVA-level of taxes.

Moving to a limit based on the preceding year's annualized taxes means that the magnitude of the increase faced in 2018 will generally be less than the increase that would be faced if the cap was based on 10% of the prior year's CVA taxes. Put simply, this change means that no business property will experience a tax increase of greater than 10% over its prior year's annualized taxes (excluding budgetary rate increases).

It is further recommended that Council discontinue the policy of removing properties from the capping and clawback system once they have reached their full CVA-level of taxation, such that the 2018 capping limit apply to any property that has experienced a property tax increase of greater than 10% over 2017 annualized taxes, regardless of whether the property had reached its full CVA-level of taxation in a prior year. This ensures that the same level of protection against large tax increases is afforded to all properties.

The 2018 recommended measures are viewed as an interim strategy, pending further analysis of additional options, or a combination of various measures that may be used to provide targeted protection or tax relief to identified or vulnerable groups, and that align with Council's strategic objectives. This report includes a recommendation that staff be directed to review additional options during 2018 including any potential requests for legislative change, for consideration for 2019 and future years.

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