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LONDON LIFE INSURANCE CO.

v.

ASSESSOR OF AREA 9 -- VANCOUVER

Supreme Court of British Columbia (A872713) Vancouver Registry

Before The Honourable Mr. Justice Cohen (in chambers)

Vancouver, B.C., October 25, 1988

John R. Lakes for the Appellant
John E. D. Savage for the Respondent

Reasons for Judgment November 7, 1988

I

This is a case stated by the Assessment Appeal Board ("the Board") pursuant to s. 74 (2) of the Assessment Act R.S.B.C. 1979, ch. 21 at the requirement of London Life Insurance Co. seeking the opinion of the Supreme Court on the following questions:

1. Did the Assessment Appeal Board err in law because it did not make a separate allowance for tenant inducements as being part of the actual value of the property of a going concern?

2. Did the Board err in law by finding that tenant inducements is included in the vacancy rate and that therefore a further allowance for tenant inducements would result in "double counting"?

3. Did the Board err in law objecting to tenant inducements on the basis that consideration of them would be value to owner?

4. Was the Board's refusal to make separate allowance for tenant inducements arbitrary and unreasonable?

5. In refusing to make a separate allowance for tenant inducements, did the Board err by misinterpreting the decision of this Court in Lordina Limited and Privest Properties Ltd. v. Assessor of Area 9 -- Vancouver?

II

The facts upon which the questions must be considered are set out in paragraphs 1 - 7 of the stated case as follows:

1. The subject building is a nine-storey office building located in Vancouver. It has a basement used for parking. The main floor is used for retail sales and the upper floors are offices.

2. Both the appraiser for the appellant and the appraiser for the respondent assessor relied upon the "income" method of valuing real estate, in arriving at the final valuation of this property for assessment purposes.

3. One of the essential factors in the use of this approach is the calculation of the expected gross income of the building.

4. The appraiser for the respondent assessor took the view that tenant inducements should not be taken into consideration when calculating the income of a building. He estimated the gross economic rent to be $18 per sq. ft. for the main floor, $14.25 for the upper floors, and $75 per parking stall.

5. The appraiser for the appellant estimated the net income received after making a rental survey of ten properties and allowing for "tenant inducements". His retail space (main floor) was estimated to rent for $14 per sq. ft., and the upper floors at $11.50 per sq. ft.

6. Tenant inducements are defined as the reputed cost to the owner of having to offer free rent to prospective tenants for specific period of time, or the provision by the owner of fixtures, such as ceilings or rugs, or even a reduction in rent to existing tenants in order to keep them from moving at the end of their lease.

7. The Board valued the subject building without considering an allowance for tenant inducements. It had evidence before it of sales of two buildings where the purchaser paid the same price (adjusted) per square foot of gross leasable area as the assessor assigned to the subject, which indicated to it that the market place does not take into account inducements.

III

The issue before the Board was, should one, in relying upon the income approach to value, in attempting to determine economic rentals, take into consideration an item for tenant inducements? The appraiser for the assessor took the view that tenant inducements should not be taken into consideration when calculating the income of a building. The appraiser for the appellant estimated net income after making a rental survey of 10 properties and allowing for tenant inducements. The appellant submitted that the assessor should have considered that owners of office towers, in order to fill vacant space, were offering tenant inducements and should have allowed for this fact in establishing economic rent income. The Board rejected this submission and valued the subject building without making an allowance for tenant inducements. At page 17 of its decision the Board gave the following reasons:

The Board agrees with Mr. Klassen in that, if tenant's inducements were to be considered in arriving at the value of a building the following consequences would occur:

(a) The value of the building would become distorted.

(b) There would be inequity between buildings.

(c) To do so would be considering the "value to the owner."

(d) If the inducements consist of improvements -- this would be, in effect, capital infusion.

The Board notes in the Lordina Limited and Privest Properties Ltd. v. Assessor of Area 9 -- Vancouver (Stated Case 133 -- B.C. Assessment Authority Stated Cases), Mr. Justice A. G. MacKinnon found that the Board was correct in using contractual rentals, as opposed to actual

vacancies. He also found that the Board was correct in rejecting the contention that incentives offered by a developer to gain tenants should necessarily be deducted to arrive at actual value by the Income Approach.

In the instant appeal, the Board had before it evidence of the sales of two buildings, 1111 Melville Street (which had a vacancy rate of 35% at the time of the sale), and 1090 West Georgia Street (having a vacancy rate of 41% at the time of the sale), where the purchaser paid the same price (adjusted), per square foot of gross leasable area, as the Assessor has assigned to the subject (which would indicate that the market place does not take into account tenant inducements).

The Board, also, is of the view that, when it applies the vacancy rate prevailing in office buildings (in using the Income Approach to Value), this takes into consideration any tenant inducements. To apply prevailing vacancy rates and to make further allowance on top of this (for tenant inducements) would result in "double counting."

For these reasons the Board accepts the Assessor's calculations of gross income, in place of those suggested by Mr. Geddes.

IV

In part support of its conclusion rejecting the appellant's position, the Board agreed with the submission of counsel for the assessor that, if tenant inducements were to be considered, certain consequences would flow, including the value of the building would become distorted, there would be an inequity between buildings and a consideration of tenant inducements would be considering "value to the owner". Needless to say, Mr. Klassen's submission is argument, not evidence. The Board does not set out any rationale based on its own analysis of all the evidence as to why Mr. Klassen's consequences would necessarily flow from making an allowance for tenant inducements.

The Board does mention evidence of sales of two buildings which, although each building had a different vacancy rate, sold for the same price per square foot of gross leasable area and concludes, parenthetically, that this would indicate that the market does not take tenant inducements into account. No reason is given by the Board to support this conclusion.

Further, the Board expresses the view that when it applies the prevailing vacancy rate in office buildings, this takes tenant inducements into consideration. The Board says that to apply prevailing vacancy rates and to make a further allowance for tenant inducements would result in double counting. No evidence is cited to support this conclusion, and, in any event, in London Life Insurance Co. v. Assessor of Area 9 -- Vancouver, unreported, Vancouver Registry No. A872713, (June 29, 1988), I found that the Board erred in its interpretation of the Assessment Act by using the prevailing vacancy rate.

V

The Board does not specifically comment on the assessor's position that tenant inducements should not be taken into consideration. On the other hand, the Board had the evidence before it of Mr. Warburton, a leasing agent, who said that in the latter part of 1983 the market for tenants changed significantly in Vancouver and that after 1983 tenant inducements started to accelerate. There was the further evidence of the appellant's appraiser Mr. Geddes who considered that at the date of valuation an allowance for tenant inducements should be made in arriving at a proper figure for economic rent. Notwithstanding the existence of this evidence the Board accepted the assessor's calculations of income in place of Mr. Geddes.

In London Life Insurance Co. v. Assessor of Area 9 -- Vancouver, supra, I referred to the appraisal theory applicable to the income approach to value at page 6 as follows:

Counsel for the Respondent explained the principles and the appraisal theory applicable to the income approach to value. In the income approach to value an appraiser estimates the income a property will receive over its life, the expenses it will incur and discounts or capitalizes the net income over the remaining life of the property. In the discounted cash flow approach this is done by estimating for each year a net income and discounting the income stream to a present value. In the income capitalization approach a normalized income and normalized expenses are estimated and the resulting net income capitalized at a rate derived from the market. If a property is relatively short-lived no factor is applied to the capitalization rate and the income is capitalized in perpetuity. The subject property is relatively new and neither the appraisers nor the Board applied any factor to the capitalization rate in respect of any anticipated shortened life of the subject property.

A leading authority on assessing the market value of rental property is Re A. Merkur & Sons Ltd. and Regional Assessment Commissioner, Region No. 14 et al. [1978] 17 O.R. (2d) 339. At page 347 of the decision Steele, J. discusses the proper components to be considered when using the income method as follows:

As previously stated, I am of the opinion that the proper rental to be used is not the actual rent received, but the full rental value of the property in the year in question, including tenants' improvements. Evidence to this effect was not fully introduced before the Board. Obviously this figure must be a matter of opinion based on the numerous factors that relate to the property. Comparison should be made to rental values of similar properties, but they should not be slavishly followed in shopping centre cases because there may be numerous market forces that are peculiar to each individual centre. Proper vacancy and other allowances should be made. The actual percentage rents should be considered as a major factor in determining the peculiarity of the centre and as one factor in arriving at a proper full current market rent.

All operating expenses for the year, including proper depreciation and repairs, must be calculated and deducted in determining the net operating income. Again, part of these expenses will be a matter of opinion based on comparisons to other similar properties.

Each year's net operating income should not be taken in isolation. Evidence should be received as to the market consideration of several years' income and expense experience.

Perhaps the most difficult component is the capitalization rate. This will be a matter of opinion and may vary depending on whether the rents are fixed or based on a percentage of sales. Comparisons within the market place, with any necessary adjustments being made to sales that have not reflected full rental values, should be considered, as well as the risks inherent in the centre whose assessment is being considered. It should be borne in mind that most sales will reflect the value of the income stream to the vendor and not the full value of the entire property as required under the Assessment Act. However, there may be no better way of determining the capitalization rate for the full assessable value than by using the capitalization rate that the market applies to the income stream.

Properly then, when making a forecast of rental revenue for assessment purposes based on the income method, evidence of an economic factor in the market which may increase or decrease actual value should be considered. As expressed by Scott L. J. in Robinson Brothers (Brewers), Ltd. v. Assessment Committee for the No. 7 or Houghton and Chester-Le-Street Area of The County of Durham, [1937] 2 K.B. 445, at 469 and 471:

. . . (5) In weighing up the evidence bearing upon value, it is the duty of the valuer to take into consideration every intrinsic quality and every intrinsic circumstance which tends to push the rental value either up or down, just because it is relevant to the valuation and ought therefore to be cast into the scales of balance before he looks to see the resultant figure on the dial at which the pointer finally rests . . . (II) on such an inquiry every factor, intrinsic or extrinsic, which tends to increase or decrease either demand or supply is economically relevant and is, therefore, admissible evidence for the assessment committee or its valuer or the quarter sessions on appeal to consider.

In my view, when the income approach is used, evidence relevant to factors of revenue, vacancy, capitalization rate and any other allowance which may affect the value of the property, should be separately considered and then consistently applied. The Board can accept or reject, in whole or in part, such evidence as it sees fit. However, the Board has a duty to weigh all the evidence before it, especially, economic evidence of market conditions at the date of valuation.

In Lordina Limited and Privest Properties Ltd. v. Assessor of Area 9 -- Vancouver (Stated Case 133 -- B.C. Stated Cases), A. G. MacKinnon, J., held that the Board was correct in rejecting the contention that incentives offered by a developer to gain tenants should necessarily be deducted to arrive at actual value. In my view, that case is not inconsistent with the Board making an allowance for tenant inducements in the calculation of economic rent when the evidence before the Board supports such an allowance. Nor, in appropriate circumstances, is such an allowance inconsistent with the principles expressed in Re: A. Merkur & Sons Ltd., supra.

In my opinion, there was market and appraisal evidence before the Board upon which it could make a determination that an allowance for tenant inducements should be made. No proper basis is cited for disregarding this evidence. In the result, I find that the Board erred in law in not giving effect to the evidence of Mr. Warburton and Mr. Geddes on this issue.

Accordingly, my response to the questions set out in the case stated for the opinion of the court is that the answers to questions 1 to 5 is "Yes."