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T. EATON COMPANY LIMITED

v.

ASSESSOR OF AREA 09 -- VANCOUVER

British Columbia Court of Appeal (CA014519) Vancouver Registry

Before the HONOURABLE MR. JUSTICE HINKSON,
the HONOURABLE MADAM JUSTICE SOUTHIN and
the HONOURABLE MR. JUSTICE TAYLOR

Vancouver, February 9, 1993

Brian J. Wallace for the Appellant
Peter W. Klassen for the Respondent

Reasons for Judgment April 8, 1993

This appeal concerns the assessment for 1989 local taxation purposes under the Assessment Act, R.S.B.C. 1979 Chapter 21, on the Eaton's department store in downtown Vancouver.

The company appeals the dismissal by Mr. Justice Holmes of its appeal by case stated from a decision of the Assessment Appeal Board which upheld (with a minor variation not now in issue) a valuation for 1989 assessment purposes of some $53,000,000 on that part of the Pacific Centre at Granville and Georgia Streets which is occupied under lease by the Appellant, T. Eaton Company Limited, for the department store operation.

The Appellant contended before the Board and before Mr. Justice Holmes that the valuation exceeds "actual value" as properly arrived at under the statute, and is also inequitable in relation to the assessment on the Hudson's Bay Company store premises immediately across the street.

THE ISSUES

Before us the company raises in essence the same four grounds of appeal argued below:

1. That the assessed value reflects speculative considerations with respect to possible alternative uses of the store premises.

2. That the assessed value assumes, without evidence to that effect, that change in permitted use could occur by agreement between the owner and the City.

3. That the assessed value does not bear a fair relation to the value at which similar property was assessed.

4. That the assessed value ignores important elements of functional and economic obsolescence.

The first two grounds are concerned with provisions as to use of this portion of the premises contained in the agreement between the developers and the City of Vancouver under which the Pacific Centre was built 20 years ago; the third involves comparison with the Hudson's Bay assessment; and the fourth has to do with the fact that the upper two floors of the store are used neither fully nor for their intended purpose.

> Consideration of the issues raised requires some understanding of the "income approach" by which this and other commercial properties are valued for assessment purposes.

Valuation by this technique involves determination of the annual net rental income which, with the exercise of proper management skill, could be derived by a hypothetical prudent owner through leasing the premises to appropriate tenants, and then using that assumed annual net income stream as a basis for arriving at the cash price which could be expected to be obtained in an arms-length sale of the title, in fee simple free of encumbrances, to a hypothetical prudent investor.

This process of converting anticipated annual net rental income into a capital value for assessment valuation purposes involves, as a critical factor, the selection of a reasonable "capitalization rate". The rate to be used is generally arrived at by analysis of rental income receivable and purchase prices paid, in respect of commercial properties in the same area which have actually changed hands in recent sale transactions, adjustment being made to accommodate any relevant differences between those properties and the property being assessed. There the property to be assessed has characteristics which seem likely to render it less valuable for assessment purposes than the properties involved in the recent sales, the difference can be accommodated by adopting a higher capitalization rate than otherwise indicated. The higher the capitalization rate chosen, the lower will be the value ascribed to the property being valued, and a small difference in the discount rate used may lead to a substantial difference in the resulting assessment valuation.

In the case of the assessment under appeal the Assessor derived market rental value from the rental in fact being paid for the premises and from the rental rates per square foot being paid for other department store premises in the City, and applied a capitalization rate derived from certain recent market sales of modern downtown office buildings.

THE 'SPECULATIVE VALUE' ISSUES

The first two grounds of appeal have to do with the answers given by Mr. Justice Holmes to the following questions of law asked in the case stated:

> 1. Did the Assessment Appeal Board err in law in failing to adjust the capitalization rate applied to the Eaton's store on the basis that it is restricted under covenant to its present use?
>
> 2. Did the Assessment Appeal Board err in law in applying the same capitalization rate to the Eaton's store as applied to the rest of the Pacific Centre complex notwithstanding the restriction on the Eaton's store to its present use?

The judge answered these inter-related questions in the negative, holding that the Board was entitled to conclude, as it did, that the stipulation as to use contained in the 1968 agreement between the developers of the centre and the City should be considered neither "restrictive" nor "permanent".

The covenant referred to requires that the portion of the premises here in question be used as a retail department store operated by the T. Eaton Company. While the agreement provides that

this stipulation may be changed by mutual consent at any time, it is acknowledged in the present proceedings that this could happen only with the approval of City Council.

In its submission before the Board the company took the position that the 8 per cent capitalization rate, derived from recent sales of downtown commercial rental property, which had been used in assessing all parts of the Pacific Centre, ought not to have been applied to the department store portion, because of the existence of this requirement as to use contained in the development agreement. The company contended that the covenant constitutes a unique restriction on use and redevelopment which has to be reflected in "actual value" for assessment purposes. An expert who testified for the company before the Board contended that a 9 per cent rate ought to have been used instead, to reflect the existence of this provision. He said that the covenant renders that part of the property less valuable for assessment purposes than other downtown commercial properties, presumably including those properties involved in the sales from which the 8 per cent capitalization rate had been derived.

Before us Mr. Wallace, for the Appellant, called in aid the long established principle of assessment law that "speculative" values, while potentially relevant to the determination of "value to the owner" for expropriation purposes, have no place in a valuation of property for local taxation purposes: Great Western and Metropolitan Railway Company v. Kensington Assessment Committee, [1916] 1 A.C. 23 (H. of L.); Stock Exchange Building v. City of Vancouver, [1945] 2 D.L.R. 663 (B.C.C.A.); Sun Life Assurance Co. of Canada v. City of Montreal, [1950] S.C.R. 220; Bramalea Ltd. v. British Columbia (Assessor of Area 9 - Vancouver) (1990), 76 D.L.R. (4th) 53 (B.C.C.A.).

Perhaps the most helpful statement of the principle in this context is that of Mr. Justice O'Halloran, giving judgment for the court in the Stock Exchange Building case (at p. 665):

> "Actual cash value" clearly contemplates the value represented by the price obtainable in a sale by a willing vendor to a willing purchaser both alive to commercial realities, for cash and not upon extended or unsecured terms. Cf. Grampian Realties Co. v. Montreal East, [1932] 1 D.L.R. 705 (S.C. of Canada). To my mind it relates to bona fide investment as distinct from speculation. So described and understood "actual cash value" in s. 39 reflects nothing more or less than "actual cash value", "fair market value" or "actual value", the latter term being employed in the general Municipal Act, R.S.B.C. 1936, c. 199, s. 223(1).

Mr. Justice O'Halloran thereafter lists some of the factors to be relied on, where present, in arriving at an appropriate valuation of commercial property, including market sales data, the revenue-producing record over a period of years, and "the present value of prospects within the immediate future".

Thus, in valuing properties of this sort, the Assessor must assume that the hypothetical prospective purchaser of the fee simple is a prudent investor, and not a speculator.

The position taken by the Appellant is that while the agreement committing the department store premises to their present use could be changed with the approval of City Council, there can be no certainty that any change would be approved, and that the provision should be treated as having the same effect as a zoning bylaw restriction. Any possibility of change, the Appellant contends, must be regarded as a matter of speculation, and has therefore to be excluded for assessment valuation purposes. In this regard the Appellant points to the Hudson's Bay Company store assessment, for which purpose the Assessor used a 9 per cent capitalization rate, and did so in part because a "heritage designation" had been imposed on the property by the City, effectively to prevent future change in use.

In its decision the Board notes that the Assessment Authority's appraiser had derived the 8 per cent capitalization rate from "market evidence available at or near the valuation date of newer major office buildings in the same investment bracket as the subject property". It appears to be common ground that all commercial buildings constructed in recent years in the downtown area have been built under "development permits" which stipulate not only the structure to be erected but its permitted use. Mr. Mulberry, the City's Chief Legal Officer, testified that a change in permitted use as stipulated in a development permit, provided it conforms with the applicable zoning, can be authorized by the Planning Department, whereas an application for change in permitted use under the development agreement covering the Pacific Centre would have not only to be processed by the Planning Department but to go before City Council itself. The Board noted that the agreement specifically contemplates that the stipulated "limitations and uses, or any of them, may be amended from time to time". The Board did not agree that the covenant requiring continued operation of the Eaton's department store on the premises was "either restrictive or permanent". The Board said:

> It can be changed by agreement. While this may require the consent of the City of Vancouver (and/or the Legislature of the Province of British Columbia), there is not the least suggestion before the Board that consent of either would not be forthcoming.

It was agreed before us that while the agreement is authorized by an Act of the Legislature [Vancouver Enabling Act 1968, S.B.C. 1968 Chapter 72] there would in fact be no need for statutory approval of any such amendment to the agreement.

Mr. Justice Holmes found that there was evidence on which the Board was entitled to reach that conclusion.

The Appellant contends in its factum that the Board and the judge erred "in considering and relying on speculative evidence concerning possible changes in the permitted use of the subject property", and that in finding that "the restrictive use of the subject property could be changed by agreement, the learned chambers judge failed to consider the impact of that restrictive use on the actual value of the property". I take this to mean that the Board fell into error of law in adopting a capitalization rate derived from sales of properties subject to development permit restrictions on use and applying it to a property subject to restrictions on use contained in a development agreement capable of amendment only by City Council.

The Board must, I think, have meant that the stipulations as to use contained in the agreement are not "restrictive" in the sense that they do not restrict the full use of the premises for their highest and best use, that is to say as a department store. It was, of course, the reasonable market rental value of the premises for that purpose which formed the basis of the assessment valuation. I conclude that the Board found the terms as to use not to be "permanent" in the sense that the agreement contemplates that they could be amended, as could terms as to use governing downtown commercial property which is subject to the terms of a development permit. It seems that the Board did not regard the fact that City Council approval had to be obtained, rather than only that of the Planning Department, as a factor of significance. That seems to me to have been very much a finding of fact.

Mr. Wallace urged on us that the fact that such an amendment might occur cannot be taken into consideration, because this would involve speculation.

If it were shown that the recently developed downtown commercial properties which were the subject of the sale transactions from which the Assessment Authority derived its capitalization rate had been purchased by speculators engaged in some sort of redevelopment scheme dependent on a change in use being approved, then the use of the resulting capitalization rate to value the Eaton's store would no doubt be objectionable under the principle mentioned above.

But no such suggestion was made. It seems to me that the Board was entitled to accept the capitalization rate as fairly representing the sort of return being sought by investors in what the Board found to be "the same investment bracket as the subject property".

I am unable to find the introduction of any speculative element into the assessment valuation which the Board upheld.

It seems to me to have been based on value to an investor contemplating continuation of the present condition and use of the property, and to have involved the use of data derived from market sales of properties which the Board found, as a matter of fact, to be reasonably comparable for the relevant purpose of determining an appropriate capitalization rate.

THE 'EQUITY' ISSUE

The Appellant's third ground of appeal has to do with the matter of "equity" (sometimes in this context referred to as "equitability") with the Hudson's Bay Company store assessment, which involved the 9 per cent discount rate.

Here the Appellant relies on the principle underlined in the decision of this court in the Bramalea case (above), that the taxpayer is entitled to an assessment which is equitable in relation to assessments on similar properties, as well as one not in excess of actual value as properly arrived at under the statute. The Appellant takes the position that there is no such difference between its property and that of its competitor across the street as would justify a one-percentage- point differential in the capitalization rate used. In this regard the Appellant emphasizes, again, that there is an agreement limiting its premises to their present use, and argues that this puts it on the same footing as the Hudson's Bay store which has been designated by the City as a `heritage' building.

The Board found the difference to be justified by the fact that the Hudson's Bay building has higher operating costs because of its age--over 75 years, as opposed to 20 years in the case of the Eaton's store--and because of the nature of its architecture, and by the existence of the heritage designation. Nothing was said before us concerning the consequences of the `heritage' designation which would enable us to compare them with the significance of terms of the development agreement restricting use of the Eaton's premises. Nor were we told what would be the likely impact on value in the market of any higher operating costs caused by the age and distinctive architecture of the Hudson's Bay Company store. It was not, however, suggested that the Board lacked evidence on these points, nor that these were matters of which the Board could not take cognizance by reason of its general knowledge and experience.

I conclude that the finding of the Board that the one-percentage-point differential in capitalization rates could be justified by these differences between the properties was a finding of fact falling within the Board's jurisdiction which cannot be challenged on appeal by case stated.

FUNCTIONAL OR ECONOMIC OBSOLESCENCE

The final ground of appeal is concerned with the top two floors of the Eaton's store, which were added 10 years after the original construction, apparently in order to meet a deadline laid down by the City, and which the Appellant says have been used neither fully nor for their intended purposes.

The company's original plan was to use the seventh floor for regional office purposes and the sixth floor as additional retail space. Soon after these floors were completed, however, the company decided to centralize its office functions in Eastern Canada, so that only a small part of the seventh floor has in fact been used for office purposes, the rest being used for "bargain

basement" sales purposes. The sixth floor is used for sporting goods, hardware and major appliances, but the company's evidence was this merchandise could have been displayed and sold as effectively within the original five floors.

The company contended before the Board that an allowance for obsolescence should have been made in determining the rental value assigned to these two floors, because they are not being fully utilized for their intended purpose.

The Board noted that the Appellant's expert witness had sought an allowance based on a definition which explains "functional obsolescence" as a reflection of loss of value brought about by factors such as "overcapacity, inadequacy and changes in the art" or "inability of a structure to perform adequately the function for which it is currently employed". It held that if the floors were vacant, or were being used for storage only, the Appellant might have a complaint, but concluded:

> The addition was put on this building by Eaton's so that the sixth floor could be used for merchandising and the seventh floor for offices. These floors are currently being operated by Eaton's today for these functions. While the market projections may not have unfolded as projected, still the addition is serving the purpose for which it was constructed. A lesser income than anticipated does not necessarily equate to functional obsolescence.

Mr. Justice Holmes agreed with this conclusion, adding that failure to vacate the space "gives strong support to the view that the under utilization is temporary rather than permanent".

On its appeal to this court the company asserts that the Board and the trial court judge were in error in suggesting that less than optimum use of property, even if temporary, cannot amount to obsolescence, and that to hold that the space had to be vacated in order to establish obsolescence involved too stringent a test. The Appellant emphasizes the fact that section 26(3) of the Assessment Act includes, among relevant factors in determining value, "economic and functional obsolescence and any other circumstances affecting the value of the land".

The concept of obsolescence can, of course, be relevant only to the extent that it assists in arriving at the value which could be realized in a sale of the property of the sort which would establish actual value for assessment purposes. Where the assessment is arrived at on the "income" or "revenue" approach, as noted above, the question which first has to be asked is what is the best rental income that a prudent owner could obtain from the premises. If the premises are such that they would most profitably be leased to a single tenant, then the question becomes what is the best rent that one tenant could reasonably be expected to be willing to pay for the whole premises.

In arriving at that figure the Assessor had to look at what tenants are paying per square foot for such premises and decide whether these premises are too large to be leased at the `going' department store floor space rate per square foot, and, if so, what lesser rent would they command.

The matter cannot, of course, be decided by looking only at what use is in fact made of the premises by the present tenant, and it must be borne in mind that it is not uncommon for tenants to rent more space than they can, for the time being, fully utilize. It seems to me that the Board took the view in the present case that the Appellant had opted for this course when it decided to secure additional space while it could, and that it has since made some, if less than optimum, use of the space. This, it seems to me, is what the Board means when it says that generation [by the tenant] of "a lesser income than anticipated does not necessarily equate to functional obsolescence". The question for the Board was whether the rental revenue which the Assessment Authority assumed for the premises is that which a prudent investor would expect to

be able to generate from them, and in deciding this the extent of the actual present use is only one factor.

I conclude that the Board meant that while the store premises may be larger than the Appellant requires at the present time, the excess space should not be regarded as unmarketable at the rental rate adopted. That is a conclusion which has not, in my view, been shown to involve any error of law.

CONCLUSION

It follows that I would dismiss the appeal.

THE HONOURABLE MR. JUSTICE TAYLOR

I AGREE:

THE HONOURABLE MR. JUSTICE HINKSON

I AGREE:

THE HONOURABLE MADAM JUSTICE SOUTHIN