Land Use Density Options

Residential Subclasses Impact

Recommendation

That the March 1, 2021, Financial and Corporate Services report FCS00131, be received for information.

Previous Council/Committee Action

At the October 16, 2020, Executive Committee meeting, the following motion was passed:

> That Administration report back to Committee with analysis and options to explore the impact of using residential subclasses adjusted for land use density.

Executive Summary

Further to the October 16, 2020, Financial and Corporate Services report CR_8022, Options to Adjust Tax Allocation Based on Infrastructure Efficiency, this report provides additional information about Council's ability to set separate residential property tax rates on any basis it considers appropriate. It outlines potential approaches and policy considerations, and provides impact analysis.

While subclasses could reflect actual costs of property types, or incentivize higher density development, there are risks that subclasses would create distortions in the real estate marketplace that could offset intended benefits.

This report is provided for discussion purposes. If Council wishes to proceed with residential subclasses, Administration recommends more analysis and consultation take place.

Report

Under the Municipal Government Act (MGA), City Council can create one or more residential subclasses, taxing each at a lower or higher rate than the others. The only legislated constraint is that the non-residential tax class can only be up to five times greater than the lowest residential tax subclass. Setting separate residential property tax rates based on land use density could be used to more accurately align actual costs to groups of properties, or as a tool to promote the City's long-term land use plans if the subclass tax rate differentials are sufficiently significant.

To reflect actual costs, a tax rate differential could be based on measurable differences between types of properties. Generally, lower-density property requires a larger infrastructure investment than higher-density property, though higher-density areas may have greater service expectations and requirements. This perspective was supported by Hemson report “City Plan Growth Scenarios Relative Financial Assessment”, which was prepared as part of The City Plan development. To promote long-term land use goals, a tax rate differential could be applied to incentivize higher-density property development. However, jurisdictional research indicates that tax differentials are only a minor consideration for property owners when choosing where to reside.

There are a number of potential considerations in applying land-use-density-based residential subclasses, including:

Efficacy

Local property tax policies affect property values within and among municipalities. The difference between property subclass tax rates would need to be reviewed each tax year to determine whether they are leading to Council’s intended outcomes.

If rate differentials are too high, residential properties with lower tax rates may increase in value, leading to properties with higher taxes rates becoming more affordable. For instance, lower tax rates in the denser urban core could further drive up the value of properties in the area. In turn, lower density, suburban areas may become more affordable, despite a higher property tax rate. A tax rate differential may only further exacerbate the tax difference between urban and suburban residential properties due to assessment changes.

Based on jurisdictional research, tax rate differentials between similar types of property do not significantly affect the behaviours of real estate buyers. Taxes can have some impact on where a purchaser chooses to live within a region (e.g., Leduc vs St. Albert vs Edmonton), but differentials do not typically impact decisions within a municipality itself. Council may still wish to consider subclassing as a method of cost allocation, but detailed analysis is required to determine the appropriate allocation and tax rate adjustment.

Stability

Categorization of properties into each subclass would be subject to challenges to the Assessment Review Board. With any policy decision, parameters cannot be designed to distinguish every possible variation of property. For owners within the ‘grey areas’ of the subclasses would reasonably seek the lower rate. Increased administrative resources would be required to manage and uphold the various subclasses to ensure tax revenue predictability.

Equity

Under the current system, similar residential properties of a similar value pay a similar amount of property tax. Introducing tax rate variation requires clear justification as to why one property should pay more than another. Any decrease in taxes for one group of property owners requires an increase for others (assuming there are no off-setting expenditure decreases).

Approaches

Three separate approaches were analyzed and considered for this report: market-based (status quo), location-based, and land-use-based.

- A market approach is the traditional, default means of property tax distribution where the type of property is taxed at the same rate. The impact of a property's location or its density is accounted for in its annual market value assessment. As areas of the city become more desirable, land values increase, making low density construction significantly less affordable and naturally incentivizing density. Assessment values reflect that market differential, and low density properties pay significantly more in property tax as the proportion of land to improvement value is quite high.

- A location-based approach augments the market approach by setting different tax rates for similar properties located in different areas of the city. For example, suburban neighbourhoods may have higher rates than those closer to the downtown core. This approach was not used as it is challenging to draw lines that can be considered fair and equitable.

- A land-use-based approach augments the market approach by setting different tax rates for properties of similar type. This approach is preferred over the location-based approach as it can align with the intended goal of incentivizing denser development without impacting equity (similar properties throughout the City could still be taxed at the same rate). The land-use-based approach is applied in the further analysis below.

Impact Analysis

For the purposes of this report, three options are considered using a 'land-use-based' approach:

1. Density Subclassing by Property Use within the Existing Residential Tax Class
2. Elimination of the Other Residential Differential
3. Density Subclassing by Property Use with Elimination of the Other Residential Differential

1. Density Subclassing by Property Use (Existing Class)

Administration uses assessment specific land use codes for categorizing and valuing property. There are 34 unique land use code classifications within the residential tax class. Properties within these land use codes were divided between those considered to be low density and those that were medium-to-high density.

Low density properties are typically those found within the RF1 to RF3 zones, representing 78 percent of the overall residential tax class (assuming the Other Residential subclass is ignored). Medium-to-high density comprises zones RF4 and above (typically starting with triplexes and row houses) representing the remaining 22 percent of the residential tax class. Based on these ratios, a one percent decrease in taxes for medium-to-high density properties would result in a 0.3 percent increase to low density properties.

Approximate Tax Impact to Reduce Medium-High Density Property by 1%

	Assessment Share	Tax Impact
Low Density Property	78%	+0.3%
Medium-High Density Property	22%	-1.0%

The above is provided for illustrative purposes only; Administration recommends additional analysis and consultation if Council chooses to explore subclassing.

2. Elimination of the Other Residential Differential

Under City Council's authority to divide the residential class into subclasses, Edmonton has long held a differential rate for properties with four or more dwelling units on a single title and parcel. This rate is referred to as "Other Residential". It includes rental accommodations like fourplexes and high-rise apartment complexes, but excludes condominium buildings with multiple, independently titled units in a single building.

The rationale for implementing the Other Residential rate was that rental complexes function as a business. The general arguments favour higher taxes on businesses are as follows:

(1) These properties are income producing as compared to owner-occupied homes that do not typically earn income off their property.
(2) As a business, apartment owners are able to deduct property taxes from their income taxes as a business expense, whereas owner-occupied homes pay tax with after-income tax income.
(3) Costs to business are transferred to others, in this case, renters. In the case of owner-occupied residential properties, the tax burden remains with the property owner.

Before 2005, the tax rate differential in Edmonton for Other Residential was 20 percent higher than the conventional residential rate. Then in 2005, City Council proposed eliminating the rate differential, phasing it out over four years, based on the argument that the higher tax rate was being transferred to renters. Council approved this direction and the tax rate differential was lowered from 20 percent to 15 percent above the conventional residential rate in 2006.

That same year, however, a strong rental market allowed owners of apartment complexes to increase their rents despite the tax reduction. These rental increases caused City Council to suspend the phase-out program. An outcome of the program was the understanding that rental rates were impacted more by market conditions than by tax policy. Today, the tax rate differential remains at 15 percent above the conventional residential rate.

There are two arguments in favour of eliminating the Other Residential rate. First, lower rates on high-density development may create incentives to support future high-density construction (i.e., high profit margins for rental accommodations). Second, as noted above, the higher Other Residential rate is ultimately transferred to renters, which may not be considered fair to those Edmontonians.

Should Council eliminate the Other Residential tax rate, the overall residential rate would need to increase by approximately 1.6 percent to achieve the same revenue.

<u>3. Density Subclassing by Property Use With Elimination of the Other Residential Differential</u>

Administration also analyzed the tax impact based on a density subclass if the Other Residential tax rate was eliminated, a combination of the options above. The proportion of the overall residential assessment classified as “low density” would decrease from 78 percent to 71 percent, meaning every 1 percent decrease for medium to high density properties would result in an approximate 0.5 percent tax increase for low density properties.

Approximate Tax Impact to Reduce Medium-High Density Property by 1 percent (assuming the elimination of Other Residential tax class)

	Assessment Share	Tax Impact
Low Density Property	71%	+0.5%
Medium-High Density Property	29%	-1.0%

Next Steps

This report is provided for discussion purposes. If Council wishes to proceed with adjustments to residential tax rates and subclasses, Administration would recommend more analysis take place to rationalize and communicate the potential changes to property owners.

Legal Implications

Under section 297(1) of the Municipal Government Act (MGA), the City assessor must assign one or more of four assessment classes to a property. Those classes include: (1) residential, (2) non-residential, (3) farmland and (4) machinery and equipment.

Section 297(2) indicates that Council may subsequently subdivide the residential class into subclasses on any basis it considers appropriate.

Section 354(2) requires a tax rate to be set for each assessment class and subclass under section 297.

Section 358.1 requires that the ratio between the lowest residential tax rate and the highest non-residential tax rate cannot exceed 5:1.

Corporate Outcomes and Performance Management

Corporate Outcome(s): The City of Edmonton has a Resilient Financial Position			
Outcome(s)	**Measure(s)**	**Result(s)**	**Target(s)**
Property taxes are fairly distributed in accordance with provincial standards and market value principles	Assessment to Sales Ratio (Res)	0.994 in 2019	0.95 - 1.05
	Coefficient of Dispersion (Res)	8%	</= 15%

Others Reviewing this Report

- S. McCabe, Deputy City Manager, Urban Form and Corporate Strategic Development
- B. Andriachuk, City Solicitor