



# NEWS Release

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## Realty Taxes: What To Do When the Assessor Drops the Ball

In Ontario, before 1998, even though no separate property tax bills were issued to tenants in shopping centres and other multi-occupant commercial projects, separate assessments were issued by the assessment authority (the "Assessor") because business taxes were calculated on a tenant-by-tenant basis and were based on each tenant's separate assessment. Since these separate assessments formed the basis of business tax liability, the process of establishing the separate assessments was subject to checks and balances and rights of appeal existed for individual tenants. The Assessor determined the total assessment for each project by determining the rental values of each rental unit within the project. The total of those rental values was calculated, a vacancy factor was applied, and a capitalization factor was used to determine the total assessment for the project. This process provided a generally fair and reliable method for apportioning real property taxes to tenants.

### The Challenge

The process of apportioning realty taxes changed on January 1, 1998, when business taxes ceased to be imposed. Since that time there has been no need for individual assessments for specific rental units. This poses a challenge to landlords and tenants in net leases because the apportionment of real property taxes to individual rental units is now more difficult.

### Hierarchy Clauses

One common approach to apportionment is to include a clause in a lease that sets out a hierarchy of methods for determining a tenant's share of real property taxes. The clause states that, in the first instance, the tenant will pay its share of real property taxes based on a separate property tax bill. If there is no separate property tax bill, then the tenant's share would be based on a separate property tax assessment. (It is theoretically possible that, at some point, legislation might change so that separate tax bills or separate assessments do become available in Ontario.) If

there is no separate property tax assessment, then the tenant would pay a share of property taxes based on the information obtained from the Assessor (including "working papers") concerning the value attributed to the tenant's premises as compared to the total value of the project. As a last resort, if sufficient information is not available concerning the value attributable to the premises, the tenant would pay its proportionate share of the total property taxes on the project.

### Working Papers

Under the current system, the Assessor is not required to establish separate values for individual rental units; however, it usually does because it seems to be the best way of determining the total economic value of the project. The typical methodology for establishing an income stream based on market rental values for the project, applying a vacancy factor and applying a market capitalization factor has not changed. Generally, access can be obtained to the Assessor's working papers for each project and those working papers may indicate a value for each individual rental unit within the project or for groups of similar rental units. Arguably, in many cases, the tenant's share could be determined based on the working papers and the tenant would not be required to pay taxes based on a proportionate share where a hierarchy clause governs the apportionment.

However, because working papers can be unreliable there is an inherent problem with basing property taxes on them. The checks and balances that were in place before the removal of business taxes no longer exist, namely the tenant's ability to appeal. Assessors do make mistakes in determining rental values, particularly since the task of establishing current value assessments for each project places a heavy burden on the Assessors. Also, where an owner appeals property taxes and a settlement is reached, the Assessor often will not see any need to re-adjust the values that it established for individual rental units or groups of stores within the project to reflect the negotiated settlement. There is, therefore, substantial inherent risk that working papers will provide a distorted, inaccurate value for any particular rental unit.

## The Indigo Case

This fact was confirmed in a recent Ontario decision, *Indigo Books & Music v. Manufacturers Life Insurance Co.* In this case, the Court noted that the Assessor was not required to apportion assessments on a tenant-by-tenant basis. Also, where rental values for individual premises are calculated, they are not really intended to establish their rental values. Rather, the main purpose is to arrive at a value for the entire project. If a value for one rental unit is too high, but the value for another is too low, the end result for the overall assessment of the project may be negligible. In the Court's view, working papers are not always accurate or reliable. Previous Ontario cases have come to the same conclusion. Accordingly, in considering a clause that expressly allowed the landlord to determine whether the available information was sufficient to allow a proper apportionment, the Court held that it was reasonable for the landlord to deem the working papers information to be inadequate.

## Alternative Approaches

Given the fact that there does not appear to be a reliable, independent means of establishing the assessments for individual rental units, but recognizing that larger rental units do tend to attract lower rental values per square foot, a practical and fair means of apportioning taxes needs to be achieved.

One approach is simply to treat property taxes like any other expense related to the operation of the project and have each tenant pay its proportionate share of the total property taxes based on the rentable floor area of the rental unit as compared to the total rentable areas of the project. This approach is straightforward and easy to administer; however, it is an approach that tenants of larger premises usually resist. The rent per square foot of larger units tends to be lower than the rent paid per square foot for small units. Tenants of larger spaces argue that since their

premises attracts lower rents per square foot, it is unfair for them to pay a share of taxes that is the same per square foot as the other tenants of the project. Moreover, in shopping centres, these tenants argue that, as anchor tenants, they draw additional traffic to the shopping centre which benefits the smaller tenants.

Another simple approach is to allow the landlord to determine the assessment for each rental unit using the methodology employed by the Assessor in its assessment of the project, and having regard to the information obtainable from the Assessor (i.e., the working papers), **but subject to any necessary adjustments to correct errors.** Alternatively, the parties might agree to ignore the Assessor's working papers and to allow the landlord to make a determination by applying the same methodology as is employed by the Assessor for determining taxes on the project as a whole. These last two approaches entail the landlord determining rental values for the units in the project based on its own information. Tenants might be unwilling to give the landlord this latitude. It might be appropriate to have the determination made by an independent real property tax expert. The cost of the determination could be included in operating costs that are shared by tenants of the project on a proportionate share basis.

Where all else fails, the parties might resort to a clause that provides for property taxes to be determined by mutual agreement having regard to the methodology employed by the Assessor and, if the landlord and the tenant are unable to agree, then the matter would be determined by arbitration. This latter approach would be fair, but it would be cumbersome, expensive, time consuming and perhaps impractical.

Whatever approach is taken, it must be based on a good understanding of how commercial projects are assessed and should avoid the pitfall of assuming that the Assessor's working papers provide a reliable means of fairly apportioning taxes.



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