MUNICIPAL
PROPERTY
ASSESSMENT
CORPORATION

METHODOLOGY GUIDE

VALUING COMMERCIAL PROPERTIES IN ONTARIO

Valuation Date: January 1, 2016

AUGUST 2016

MUNICIPAL PROPERTY ASSESSMENT CORPORATION

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The Municipal Property Assessment Corporation (MPAC) is responsible for accurately assessing and classifying property in Ontario for the purposes of municipal and education taxes.

In Ontario's assessment system, MPAC assesses your property value every four years. This year, MPAC is updating the value of every property in the province to reflect the legislated valuation date of January 1, 2016.

MPAC is committed to provide Ontario property owners, municipalities and all its stakeholders with the best possible service through transparency, predictability and accuracy in values. As part of this commitment, MPAC has defined three levels of disclosure of information in support of its delivery of this year's assessment update. This Methodology Guide is the first level of information disclosure.

This guide provides an overview of the valuation methodology undertaken by MPAC when assessing commercial properties for this year's update, ensuring the methodology for valuing these properties is well documented and in alignment with industry standards.

Property owners can access additional information about their own properties through aboutmyproperty.ca. Login information for aboutmyproperty.ca is provided on each property assessment notice mailed this year. Additional information about MPAC can be accessed at mpac.ca.

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1.0 Introduction

The Municipal Property Assessment Corporation (MPAC) – mpac.ca – is responsible for accurately assessing and classifying property in Ontario for the purposes of municipal and education taxation.

In Ontario, property assessments are updated on the basis of a four-year assessment cycle. In 2016, MPAC will update the assessments of Ontario's nearly five million properties to reflect the legislated valuation date of January 1, 2016. Assessments updated for the 2016 base year are in effect for the 2017–2020 property tax years.

The last Assessment Update was based on a January 1, 2012, valuation date. Increases between the 2012 assessed value and 2016 assessed value are phased in over a four-year period. Any decreases in assessment are applied immediately.

It is important to ensure that the valuation methodology applied is capable of providing a realistic estimate of current value at the relevant valuation date, which, in turn, enables all stakeholders to understand the valuation process and have confidence in the fairness and consistency of its outcome.

This Methodology Guide has been prepared for the benefit of MPAC assessors, property owners and their representatives, municipalities and their representatives, Assessment Review Board members, provincial officials, and the general public.

This guide outlines the valuation process to be followed by an assessor, including steps that require appraisal judgment. It is incumbent upon the assessor to make informed decisions throughout the valuation process when arriving at estimates in current value.

1.1 Properties Covered by This Methodology Guide

This Methodology Guide applies to commercial properties in Ontario with the following characteristics:

- They are multi-purpose buildings that typically include interior finish.
- Uses may include retail, food service, office or other general commercial uses.
- Special purpose features are limited.
- They can usually be converted to another use without extensive alterations.

The following MPAC property codes are used to categorize the common types of commercial properties in Ontario:

- 400 Small office building
- 410 Small retail
- 411 to 414 Restaurants
- 422 Auto dealership
- 435 and 436 Large format retail

It should be noted that these are general guidelines that vary depending on the specific circumstances of a particular property. It should also be noted that the aforementioned list of property codes is not exhaustive and only includes the most common codes.

An assessor may also make reference to additional Methodology Guides for properties that do not fall precisely within the description of one of the property codes listed above.

1.2 Legislation

The main legislation governing the assessment of properties in Ontario for property tax purposes is contained in the Assessment Act.[1]

The Act contains important definitions and states what property is taxable and how it should be valued. Section 19(1) of the Act requires that land be assessed at current value, which is defined to mean, in relation to land, “the amount of money the fee simple, if unencumbered, would realize if sold at arm's length by a willing seller to a willing buyer.”

1.3 Classification

MPAC’s role is to accurately assess and classify all properties in Ontario in accordance with the Assessment Act and its associated regulations established by the Government of Ontario. The classification of a property will determine which tax rate will be applied by the municipality or taxing authority. All properties are classified according to their use, and Ontario Regulation 282/98 of the Assessment Act sets out how various property uses are classified.

Commercial properties are generally classified in the Commercial Property Class in accordance with Section 5(1)1 of Ontario Regulation 282/98. It is important to note that the commercial

[1] Assessment Act, R.S.O 1990, c A.31: https://www.ontario.ca/laws/statute/90a31.

property class is the default classification and as such, includes properties that do not fall within any other property class.

If a portion of the property is used for other purposes, it may be necessary to value those components separately and sum the component values to achieve the correct total current value. It may also be necessary to apportion the total value of the property between the various uses to ensure that the appropriate tax rate is applied to the relevant parts of the property.

1.4 The Use of This Methodology Guide

This Methodology Guide is intended to:

- Ensure MPAC's assessed values for these properties are fair, accurate, predictable and transparent.
- Provide direction to assessors and clear explanations to municipalities, taxpayers and Assessment Review Board members.
- Ensure that MPAC's methodology for valuing these properties is well documented and aligns with industry standards.
- Explain the thought process/decision-making process that an assessor should undertake to apply the valuation methodology.
- Ensure a consistent approach to valuing these property types.
- Support MPAC assessors in conducting their due diligence in:
    - applying Ontario's legislation and regulations
    - adhering to industry standards for market valuation in a mass appraisal environment

It should be noted that this Methodology Guide is not intended to be a substitute for an assessor's judgment in arriving at a market value–based assessment (i.e., current value) for a particular property. However, given that the Methodology Guide explains industry standards for property assessment, conforms to valuation industry norms, and adheres to provincial legislation and regulation, MPAC assessors are expected to follow the procedures in the Methodology Guide and be able to clearly and satisfactorily justify any deviations from it.

1.5 Consultation and Disclosure

MPAC is committed to providing municipalities, taxpayers and all its stakeholders with the best possible service through transparency, predictability and accuracy. In support of this commitment, MPAC has defined three levels of disclosure as part of its delivery of the 2016 province-wide Assessment Update.

- **Level 1** – Methodology Guides explaining how MPAC approached the valuation of particular types of property
- **Level 2** – Market Valuation Reports explaining how the methodology outlined in Level 1 has been applied at the sector level for the purposes of each assessment
- **Level 3** – Property Specific Valuation Information available to property taxpayers, their representatives and municipalities

2.0 The Valuation Process

The valuation process always begins with a determination of the highest and best use of the subject property.

Any reliance upon this guide is made only after the assessor has determined that the highest and best use of the subject property is that of commercial use.

Assessors determine the value of a property using one of three different approaches to value:

- the direct (sales) comparison approach
- the income approach
- the cost approach

2.1 Outline

In the **direct (sales) comparison approach**, value is indicated by recent sales of comparable properties in the market. In considering any sales evidence, it is critical to ensure that the property sold has a similar or identical highest and best use as the property to be valued.

In the **income approach** (or, more accurately, the income capitalization approach), value is indicated by a property's revenue-earning power, based on the capitalization of income. This method requires a detailed analysis of both income and expenditure, both for the property being valued and other similar properties that may have been sold, in order to ascertain the anticipated revenue and expenses, along with the relevant capitalization rate.

In the **cost approach**, value is estimated as the current cost of reproducing or replacing improvements of the land (including buildings, structures and other taxable components), less any loss in value resulting from depreciation. The market value of the land is then added.

MPAC uses the cost approach to value many commercial properties. However, in locations (primarily GTA) where there are an abundance of sales, MPAC uses multiple regression analysis to implement the direct comparison approach to derive current values for commercial properties.

This approach determines the assessed value by means of estimating the replacement cost of the buildings and structures, adjusting that cost for any depreciation in the actual property being valued (which includes physical deterioration and obsolescence), then adding the value of the land.

The theory underlying the cost approach is to determine *value in exchange* by applying the *principle of substitution*, which means that no rational buyer will pay more for the property than that amount for which the buyer can obtain a property of equal desirability and utility, assuming no undue delay.

This current value framework includes the existing property owner as a potential purchaser. However, the value to the current owner can be no greater than the cost of a substitute property of equal utility.

When carefully applied by assessors, the cost approach is an appropriate method of determining current value.

This valuation method is widely recognised by experts in the appraisal profession.

The Main Steps of the Cost Approach

The cost approach derives a value by estimating the cost to replace the functionality and utility of a property, in this case, a commercial property. In broad terms this requires four main steps:

1. Determine the functionality and utility of the property (i.e., what the property can do and how well it does it).
2. Establish the cost to construct the improvements that can complete these functions.
3. Deduct all forms of depreciation (i.e., the difference between the cost as new and the amount the improvements would sell for as of the valuation date).
4. Add the current market value of the land to the depreciated value of the improvements.

2.2 Approach

There are three main phases in the valuation process used by MPAC:

- data collection
- analysis of the data collected
- valuation

2.3 Data Collection

The data required for general-purpose commercial property valuations come from a number of sources:

- MPAC conducts periodic inspections of commercial properties.
- MPAC also collects information about sales and transfers of commercial properties.
- There are a number of guides and other published information about commercial properties.

MPAC generally collects the following types of data for commercial properties:

- general data
- property description
- sales data
- construction data
- gross floor area

Confidentiality

As outlined above, it is important to be aware that, in order to enable MPAC to produce an accurate valuation of the property concerned, information needs to be obtained from a variety of sources.

This will include information from MPAC's records, from the owner or operator of the property, from the municipality in which the property is located, from the assessor's visit to the property, and from other sources.

All stakeholders in the property tax system have an interest in ensuring that the current value provided by MPAC is correct; in order to achieve this, it is necessary for all parties to cooperate in the provision of information.

It is appreciated that some of the information outlined above may be of a commercially sensitive nature. MPAC recognizes the need to ensure that any information provided to it is properly safeguarded and only used for the purpose for which it is supplied. Assessors must appreciate the nature of this undertaking and ensure data is treated accordingly.

If, after an appeal has been filed, MPAC receives a request for the release of actual income and expense information, or other sensitive commercial proprietary information, the usual practice is to require the person seeking the information to bring a motion before the Assessment Review Board (ARB), with notice to the third parties, requesting that the ARB order production of the requested information. The release of such information is at the discretion of the ARB and commonly accompanied by a requirement for confidentiality.

The Assessment Act outlines in Section 53(2) that disclosed information may be released in limited circumstances "(a) to the assessment corporation or any authorized employee of the corporation; or (b) by any person being examined as a witness in an assessment appeal or in a proceeding in court involving an assessment matter."

2.4 Data Analysis

Having carried out the data collection outlined previously, the assessor needs to analyze it and reach a conclusion regarding the appropriate valuation method to use and how it should be applied.

As already indicated, for the purposes of this Methodology Guide, it is assumed that the assessor will conclude that there is insufficient evidence available to enable either the direct comparison approach or income approach to be adopted. For that reason, the assessor will be adopting the cost approach and using the data collected to ensure that the cost approach is properly applied.

2.5 Valuation

Having undertaken the necessary steps outlined above, the assessor should now be in a position to apply the appropriate valuation methodology.

2.6 Validating the Results

Once the assessor has completed the valuation, it is necessary to carry out a series of checks to ensure that all relevant parts of the property have been included in the valuation, there has been no double-counting of any adjustments made for depreciation, the resulting valuation has been compared with any market evidence that may be available in relation to similar properties and the final valuation is in line with the valuation of other similar properties in Ontario.

3.0 The Valuation

3.1 Functionality and Utility

The value of a commercial property relates to its functionality. The better a property fulfils its required functions, the more valuable it is to the owner or prospective purchaser.

This principle requires that the utility of the property be established – a process that includes analysis of the highest and best use, as well as a determination of how well the property fulfils its desired functions, or current utility.

Establishing how well a property fulfils its desired functions requires knowledge of the property and the processes being carried out there.

It is also important that the assessor draw conclusions from the market to gauge how buyers and sellers react to the utility a commercial property provides.

3.2 Automated Cost System

MPAC has developed a system called the Automated Cost System (ACS) for use when a property is being valued by the cost approach. ACS ensures that a consistent approach is used by MPAC when valuing commercial or other properties valued according to the cost approach. The cost of labour, equipment and materials for each structural element of an improvement are all included in this data.

3.3 Replacement Cost

Replacement cost is the current cost of a similar new asset that has the nearest equivalent utility as the asset being valued.

3.4 Estimated Cost New

MPAC uses existing records and/or carries out an inspection of a property to collect physical and descriptive data about its existing land and buildings (i.e., age, size, use, etc.) to carry out the costing exercise.

MPAC uses ACS to determine the replacement cost of the commercial buildings and structures.

Having determined the replacement cost new of the property by applying ACS to the improvements (i.e., buildings, structures, etc.), the next step is to consider any adjustments to replacement cost new to reflect depreciation.

3.5 Depreciation

The difference between the cost of a new building (or other improvement) and the amount the market would pay for the improvements is the depreciation inherent in the building. Depreciation can be quite complex and any adjustments require knowledge, analysis and judgment to be accurate.

There are three classes of depreciation to consider:

- physical (resulting from wear and tear due to use and exposure to the elements)
- functional obsolescence (resulting from some defect in the existing property)
- external obsolescence (resulting from adverse factors outside the property)

Both physical and functional depreciation can be sub-divided into two types:

- curable (where it is cost effective to fix)
- incurable (where it cannot be fixed or cannot be fixed cost effectively)

All elements of depreciation affect the value of a property.

Depreciation can be quantified in a number of ways. It is important to identify all forms of depreciation present in order to help with the quantification process.

Identifying Depreciation Due to Age or Condition

All properties suffer physical decline as they age. The amount of depreciation applied depends on three factors:

- the useful life assigned to the building or structure
- the quality of the construction
- whether any variance to the effective age has been identified

Age-related depreciation is generally applied on the basis of the effective age of a building or structure. A brand new building has very little depreciation (if any), whereas a building or other improvement approaching the end of its useful life has a significant amount of depreciation.

Most commercial buildings would be assigned a typical expected useful life based on construction style. However, there are some uses that tend to shorten the life of a property due to greater physical wear and tear.

A determination of effective age is completed by an evaluation of the physical state and condition of the improvements. If the condition of the improvements is typical for the age of the structure, then no adjustments are required. If the improvements are worse than typical, then an age variance can be applied. Assigning an older effective age increases the depreciation. If the improvements have recently been upgraded or renovated, then the effective age can be decreased. This lowers the amount of age-related depreciation applied by the cost system.

Consideration also needs to be given to whether any repairs may be necessary or whether there is any deferred maintenance that may impact the value of the existing buildings or other improvements. When accounting for deferred maintenance, the assessor must ensure that the loss in value is not already being accounted for as age-related depreciation.

Identifying Functional Obsolescence

Functional obsolescence relates to some defect in the existing buildings or structures that make them less valuable than a modern equivalent. There are two main forms of functional obsolescence:

- The building size, construction and/or height are overbuilt for current requirements.
- Other elements of the property (e.g., design or layout) make it less efficient to operate than more modern commercial properties.

Identifying External Obsolescence

External obsolescence is a loss in value that results from factors that are external to the property itself and outside the control of the property owner.

However, commercial properties are less likely to be affected by external obsolescence than more specialized properties as it is expected that these properties could be used for a greater variety of commercial purposes rather than being limited to one use that may be affected by economic or other external factors relating to that particular purpose.

Quantifying Depreciation

The cost approach broadly takes physical deterioration into account; however, additional adjustments may need to be made in the valuation to reflect the property's defects, outstanding repairs and deferred maintenance.

The detailed information needed to calculate the impact of functional obsolescence may not be readily available. In these situations, the functional obsolescence may be recognized by a qualitative adjustment made by MPAC's assessor as to the impact it is likely to have on the current value of the property. This type of deduction can be applied as a percentage deduction to all or some of the improvements.

In terms of external obsolescence, MPAC uses a method called *allocation of market-extracted depreciation* to determine the adjustment that may be necessary for external obsolescence. MPAC assessors analyze all sales of similar commercial properties and determine the following at the time of sale: land value, cost new, physical deterioration and functional obsolescence. The outcome of this analysis is compared to the sale price to identify any external obsolescence. Using this method, MPAC assessors are able to use market evidence to adjust for any external obsolescence in preparing their assessed values.

Having made all appropriate adjustments to the replacement cost for depreciation and obsolescence, the resulting value will be an estimate of the contribution of the improvements to the current value of the subject property.

3.6 Valuing the Land

The land is valued as if it were vacant. Its current value is established through an analysis of market sales data. MPAC collects information about the sale of land principally zoned for commercial use and analyzes this data so it can be used to value all comparable land being used for commercial purposes. The value of the land is then added to the depreciated replacement cost of the buildings or other improvements to arrive at the current value of the property.

The following example provides a simplified outline of what the valuation may look like:

Reproduction cost new	$2,000,000
Excess capital costs (cost of overbuilt areas)	$0
Replacement cost new	$2,000,000
Cost-to-cure deferred maintenance	$0

Sub-total	$2,000,000
Physical depreciation (25%)	–$500,000
Replacement cost new less depreciation (RCNLD)	$1,500,000
Additional functional obsolescence	–$0
Sub-total	$1,500,000
External obsolescence (10%)	–$0
Depreciated value of improvements	$1,500,000
Land value	$750,000
Current value estimate	$2,250,000

3.7 Checking the Outcome

Having completed the valuation using the cost approach, MPAC's assessor will review the outcome to ensure that it is an accurate assessment of the current value of the property and is in line with the assessment of other similar commercial properties.

3.8 Conclusion

This guide sets out how MPAC assessors approach the valuation of commercial properties for property assessment purposes.

Although it outlines the general approach adopted, it does not replace the assessor's judgment and there may be some cases where the assessor adopts a different approach for justifiable reasons.

For further information about MPAC's role, please visit mpac.ca.

