



Identifying and Proving Excess and Intangible Costs: British Columbia Experience

By

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*This is a general overview of the subject matter and should not be relied upon as legal advice or opinion.
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CANADIAN PROPERTY TAX ASSOCIATION
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IDENTIFYING AND PROVING EXCESS AND INTANGIBLE COSTS
BRITISH COLUMBIA EXPERIENCE

Prepared for March 10, 2003 CPTA Conference
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“An item of incurable functional obsolescence caused by a superadequacy is a property component that exceeds market requirements. It represents a cost without any corresponding increment in value, or a cost that the increment in value does not meet.”

The Appraisal of Real Estate, 11th Edition, pp. 387 and 391

INTRODUCTION

The author has been asked to comment from the legal perspective on the treatment of intangible and excess costs in property assessment in British Columbia. This paper is not intended to be an exhaustive review of all such costs in assessment, but is instead a general overview of what the author considers to be the most topical issues facing assessors and B.C. taxpayers (particularly those with industrial and utilities properties) today.

This paper is set out in two parts:

1. a general overview of principles of valuation in B.C. (to help put in context the treatment of specific types of costs), and
2. a general discussion of specific costs that must be accounted for (whether as additions to or reductions in value), including:

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- costs to be accounted for in land value such as site preparation and environmental and archaeological remediation costs, and
- costs to be accounted for in improvement value, including interest during construction and goods and services tax (additions to value), and developer's profit, goodwill and excess operating costs (reductions in value).

PART 1 - OVERVIEW OF VALUATION PRINCIPLES

The *Assessment Act*, R.S.B.C. 1996, c.21, and a host of regulations and manuals prescribed under that Act, govern the valuation (cost and depreciation) of all manner of properties in B.C.

Valuation principles depend on the class of property (property is classified for tax purposes under the *Prescribed Classes of Property Regulation*). Some are valued using prescribed costs or rates, the balance are valued on traditional appraisal principles within the parameters prescribed in s.19 of the *Assessment Act*.

Cost does not necessarily equal value. The manner in which allowances are made to reflect indirect or excess costs as additions to, or reductions from, value depends on the valuation scheme for the property in question.

The next section of this paper sets out principles of valuation for "market" and for "prescribed" assessment methods.

“Actual Value” from Prescribed Costs or Rates

Major Industrial and Utility properties are valued at “actual value” using prescribed costs or rates. Except in limited circumstances (eg. an appeal on specific grounds from Commissioner's rates), prescribed costs and depreciation factors are generally not open to review before the Board. Therefore it is important for stakeholders to consult with BC Assessment in the process of creating or adjusting these costs and factors before they are prescribed annually to set taxes in the following year.

(i) Class 4 - Major Industry

Under s.20² of the Act, the Major Industrial Properties or MIPS Manual prescribes by regulation costs for industrial improvements that are “part of” plants including smelters, pulp and paper mills, etc.

The *Depreciation of Industrial Improvements Regulation* prescribes depreciation rates for these categories of plants.

Industrial lands are valued at “market value” under s.19 of the Act, using the factors set out in that section for all market value appraisals, but as “part of a going concern”.

² Section 20(1) of the Act defines the "cost of industrial improvement" as the cost of replacing an existing industrial improvement with an improvement that

- (a) has the same area and volume as the existing industrial improvement,
- (b) serves the same function that the existing industrial improvement was designed for or, if the existing industrial improvement is no longer used for that function, serves the same function that the existing industrial improvement now serves, and
- (c) is constructed using current, generally accepted construction techniques and materials for the type of improvement being constructed..."

On an interesting note, the Property Assessment Appeal Board and Courts have taken a somewhat inconsistent approach to the interpretation of this provision. On the one hand, in the context of requiring that a wood stave pulp mill water supply be valued under the MIPS Manual using costs for steel piping, the Board (in a decision affirmed by the B.C. Supreme Court in *Fletcher Challenge Canada Ltd. v. Assessor of Area #04 – Nanaimo Cowichan, December 14, 2000*, Stated Case 448) rejected the notion that s.20 reflects traditional appraisal principles embodied in the replacement cost approach.

Shortly afterwards, in finding that interest during construction must be determined on the cost of an entire industrial plant (as opposed to individual improvements as they are constructed) the Board relied in its May 21, 2002 decision in *Westcoast Energy Inc. v. Assessor of Area #15 et al*) on appraisal theory of construction financing in interpreting the scope of s.20.

One is left as a result of these two decision when it is appropriate to rely on appraisal theory and when it is not appropriate to rely on appraisal theory in interpreting s.20 of the Act.

Whatever the basis of costs in the MIPS Manual, these costs are depreciated at prescribed rates for various categories of "plants" set out in the *Depreciation of Industrial Improvements Regulation* (B.C. Reg. 379/88). From discussions with industry professionals, it is the author's understanding that these depreciation rates are intended to reflect physical, functional and economic obsolescence to the extent these are relevant to the types of improvements in question. The make-up of these depreciation rates would presumably be available to user groups in consultation with BC Assessment. Major industrial improvements depreciate to a prescribed maximum of 80%, with an additional 10% closure allowance for "permanent" closure on written application to the assessor by November 30 of the year preceding the next taxation year.

(ii) Class 2 - Utilities

Under s.21³ of the Act, Commissioner's rates are prescribed by regulation for Utilities improvements (eg. pipelines, railway track in place, transmission and distribution lines, fibre optic cables, telephone access lines, etc.).

³ Prior to May, 2002, the actual value of telecommunications, railway, pipe line and electrical transmission and distribution infrastructure (and the rights of way on which these systems sit) were prescribed by Commissioner's rates under s.21 of the Act, as follows:

“Valuation for certain purposes not actual value

- 21(1) The actual value of the following must be determined using rates prescribed by the commissioner:
- (a) the pole lines, metallic or fibre optic cables, towers, poles, wires, transformers, conduits and mains of a telecommunications, trolley coach, bus or electrical power corporation, but not including substations;
 - (etc.)
- (2) In prescribing rates respecting improvements referred to in subsection (1)(a) to (c), the commissioner
- (a) must base the rates on the **average current cost** of the existing improvements,
 - (b) may, within the rates, make an allowance for physical depreciation,
 - (c) may express the rates in terms of an amount
 - (i) per customer served by the improvements, or
 - (ii) per kilometre of the improvements that may vary according to
 - (A) the size of the improvements,
 - (B) the capacity of the improvements,
 - (C) the type of use or extent of use of the improvements, or
 - (D) the location of the improvements, and
 - (d) may prescribe different rates or a reduction in rates for improvements that should, in the opinion of the commissioner, be valued differently from other improvements of the same type by reason of
 - (i) lack of use for a period specified in the regulation;
 - (ii) in the case of railway track in place, use at less than its annual rated capacity, or

(iii) other special circumstances that are specified in the regulation and relate to the construction or installation of the improvements.

(3) For the purposes of subsection (2), **“average current cost”** means the cost to construct or install the **existing improvements**

(a) including all materials, labour, overhead and indirect costs, and

(b) assuming the improvements were to be constructed or installed

(i) on July 1 in the year previous to the year in which the assessment roll is prepared, and

(ii) at a location that has average construction and installation difficulty.”

On May 30, 2002, Bill 54 was enacted, amending section 21 of the Act as follows:

(a) in subsection (2), adding the following paragraph:

(b.1) **may, within the rates, make an allowance for a decline in the cost of constructing or installing a similar improvement of the same or similar functional utility;**

(b) by repealing subsection (3) and substituting the following:

(3) For the purposes of subsection (2):

“average current cost” means the cost to construct or install the existing improvements

(a) including all materials, labour, overhead and indirect costs, and

(b) assuming the improvements were to be constructed or installed

(i) on July 1 in the year previous to the year in which the assessment roll is prepared, and

(ii) at a location that has average construction and installation difficulty;

“functional utility” means the ability of an improvement to meet market standards,

and

(c) in subsection (6) by striking out “with subsection (2)(a) or (b), or both”, and substituting “with one or more of subsection (2)(a), (b) or (b.1)”.

In addition, sections 21(4.1) and (4.2) were added to permit the phasing in of substantial changes in rates.

It is the author's understanding that BC Assessment views Bill 54 as enabling BC Assessment to account for functional obsolescence in Commissioner's rates. The author is of the view that, while the language used to describe functional obsolescence is unusual, the amendment provides that allowance. Failure to account for physical or functional obsolescence in rates is an error that can be appealed to the Property Assessment Appeal Board under the amendment to s.20. These amendments have not yet been brought before the Board for interpretation.

These rates are required to reflect the “average current cost” of existing improvements, as though built “at a location that has average construction and installation difficulty”⁴.

The Commissioner may (and indeed, since there are appeal provisions from the rates, must) account in these rates for physical depreciation and, in light of a recent amendment of the s.21, functional obsolescence.

Utilities rights of way are valued using separately prescribed land value rates.

Utilities lands not valued by Commissioner’s rates must, like industrial lands, be valued at market value “as part of a going concern” (s.19 *Assessment Act*).

(iii) Electrical Power Generation Facilities

Under s.20.1 of the Act, electrical power generation facilities including dams and power generators which are part of the Utilities (as opposed to Major Industry) class are, like Major Industrial improvements, valued using costs prescribed by regulation in the Electrical Power Generation Group Manual (EPG)

These costs are depreciated at rates prescribed in a corresponding regulation. Maximum depreciation rates are significantly lower than MIPS depreciation rates.

Market Value

The balance of properties (land and improvements) not valued using prescribed costs or rates must be valued at actual value taking into consideration the factors set out in s.19 of the *Assessment Act*:

- (a) present use
- (b) location
- (c) original cost
- (d) replacement cost

⁴ In the author's opinion, the purpose of defining the costs of linear improvements in terms of an "average current cost" is to ensure that extraordinary (in some cases excess) costs do not become a part of the rate for particularly types of systems. This is to some extent reflected in the decision of the B.C. Supreme Court in *B.C. Tel v. B.C. Assessment Commissioner*.

- (e) revenue or rental value
- (f) selling price of the land and improvements and comparable land and improvements
- (g) economic and functional obsolescence, and
- (h) any other circumstances affecting the value of the land and improvements (this includes lease restrictions other than the fact that a lease has a finite term).

The assessor may rely on one or more of the market or comparable sales approach, the income approach, or the cost approach. The choice of the most appropriate approach will depend on factors including the type of property, the age of the improvements, and the use which is made of the property.

Prior to the introduction in the mid - 1980's of the Class 4 – Major Industry regime for large industrial plants under what is now s.20 of the *Assessment Act*, the discounted cash flow approach was widely used to determine the value of major industrial operations like pulp and paper mills. The Board favoured this approach, which more directly accounted for obsolescence, over the cost approach, particularly where the subject property suffered from significant economic obsolescence. This approach is still relevant for determining the value of Class 5 – Light Industrial facilities, which are valued at market rather than on the MIPS Manual.

The cost approach requires an estimate of reproduction or replacement cost and deduction from this of all relevant forms of depreciation. This is set out in more detail below.

Replacement and Reproduction Costs and Forms of Depreciation

Generally, **reproduction cost** is the cost of construction at current prices of an exact duplicate or replica, using the same materials, construction standards, design, layout, and quality of workmanship and embodying all of the deficiencies, and obsolescence, of the subject property.

Conversely, **replacement cost** is the cost of construction at current prices of an improvement having utility equivalent to the improvement being appraised, but built with modern materials and according to current standards, design and layout.

The Board has found on a number of occasions that all direct and indirect costs must be included in either costing approach. A brief discussion of ***interest during construction*** and ***developer's profit***, costs which must be accounted for in the cost approach, is set out later in the paper.

Generally, the replacement cost approach leads to the same value as the reproduction cost approach with allowances for functional and economic obsolescence. Taxpayers will usually prefer to have their facilities valued using replacement costs, particularly where the facilities suffer from obsolescence.

To arrive at an estimate of actual value from a reproduction or replacement cost approach, all relevant forms of depreciation must be deducted from the replacement or reproduction cost estimate. The three forms of depreciation are:

1. **physical depreciation** (both curable and incurable); which is the wear and tear on improvements caused by the effects of age or the reduction in economic life.
2. **functional obsolescence** (both curable and incurable), which is the adverse effect on value resulting from imperfect design. This may consist of excess construction or the capitalized cost of ongoing excess operating costs. In determining whether functional obsolescence exists, one asks whether a new system would be built less expensively today, to perform the same task it was originally designed to perform. The difference in cost between the two systems represents functional obsolescence. A brief discussion of the treatment by the Property Assessment Appeal Board of ***excess operating costs*** in the allowance for functional obsolescence (inutility) is set out below.
3. **economic or external obsolescence** (locational obsolescence), which is the diminution in value as a result of the diminished utility of the improvement due to negative influences from outside, including reduced or negative economic factors that are more than temporary. In determining whether economic obsolescence exists, one asks whether there has been a significant, sustained decrease in market demand for the very service the existing system provides, and if so, whether a smaller, less expensive system would be built today to meet the reduced demand.

PART 2 – SPECIFIC TYPES OF COSTS

As set out above, cost does not necessarily equal value. Some intangible costs are additions to value, while others are reductions in value. The following is an overview of those costs the author considers of greatest interest to property owners in British Columbia at present.

A. FACTORS AFFECTING LAND VALUE

The following is a brief summary of several types of “costs” that affect land value. The first is site preparation, the second is environmental and archaeological remediation costs, both of which are required to be taken into account as factors in valuing land.

(i) SITE PREPARATION

The cost of preparing a site (particularly an industrial site) for construction (often involving clearing, grubbing, grading, etc.) is a significant capital expense in any development project.

(a) Industrial Lands

For industrial lands, the assessor generally adds a premium for site preparation to the market value of the bare land to determine the overall land value. The site preparation premium may be based either on the actual costs of site preparation or on the costs to prepare another comparable site, adjusted for various factors to reflect differences in topography, etc.

Since some costs in the MIPS Manual expressly include what appear to be aspects of site preparation, it is important to ensure there is no double-counting of costs in the site preparation premium.

(b) Utilities Rights of Way

The rights of way for pipelines, railway track in place, fibre optic cable, etc. are valued using separate Commissioner’s rates. It is the author’s understanding that these rates are generally based on market values of adjoining lands.

In *B.C. Tel (now TELUS) v. British Columbia Assessment Commissioner*, the appellant challenged both the creation of individual rates for each fibre optic cable system based on their unique construction costs (as contrary to the requirement to determine costs at a location of average construction and installation difficulty), and also the inclusion of costs of site preparation (blasting, clearing, grubbing, excavation, trenching, etc.) of rights of way in which fibre optic cables were installed in the rate used to value the fibre optic improvements.

The appellant said that these were site preparation costs included in the right of way rates, and should not be double-counted in the improvement rate.

The Board (and on Stated Case, the B.C. Supreme Court) found that all systems built at various locations in the province must be taken into consideration in determining the location that has average construction and installation difficulty. However the Board (and

Court) found that it was appropriate to include site preparation costs in the rate for improvements, because this was one way of distinguishing between systems built at different locations with different costs of installation difficulty.

It is interesting to note that on the one hand, site preparation costs are treated as part of land value for industrial properties, while on the other hand, site preparation costs are treated as part of improvement value for utilities property.

(ii) ENVIRONMENTAL AND ARCHEOLOGICAL COSTS

To date, the focus of most Board and Court decisions in B.C. has been on the impact on land value of environmental clean up costs. However in a recent decision the Board grappled with the interesting, and novel, question of how to account for impact on value of a property being included in the provincial registry of protected archaeological sites.

I deal first with environmental issues, then with the Board's recent archaeological impact decision.

(a) Environmental Contamination

In *Assessor of Area #10 - Burnaby / New Westminster v. Haggerty Equipment Co. Ltd.*, (Stated Case 396, May 9, 1997, B.C.S.C.) the 1994 and 1995 Courts of Revision determined the value of a 2.1 acre former garbage incineration site in New Westminster to be \$428,000 and \$830,000 respectively.

The appellant's expert witness testified that the "unimpaired value = impaired value – stigma – cost to control". The Board applied the formula "unimpaired value = impaired value – allowance for risk assessment/risk management".

Based on the evidence of several expert witnesses the Board concluded that although no remediation may ultimately be required to control groundwater contamination, there could be some economic risk to a prospective buyer of the property and such a purchaser would reduce their bid for the property by the cost of a risk assessment/risk management analysis (amounting to an average of \$428,000 in costs) to investigate, monitor and eventually control groundwater contamination.

The Board reduced the assessed value of the property in both roll years by deducting this allowance from the unimpaired actual value of the property.⁵ The Board disallowed any

⁵ The Board found as follows:

"The costs of a risk assessment/risk management approach, which the Board finds a prudent purchaser would make allowance for, are set out below:

deduction for, among other things “stigma” (a subjective discount in value related to the difficulty in marketing “dirty lands”) because it was unsupported by cogent evidence. ⁶

Capital Costs	\$ 60,000	to \$ 90,000
Initial inspection and monitoring	\$ 3,790	to \$ 56,850
Longterm inspection/monitoring	\$ 6,605	to \$ 6,605
Deferred capital cost of groundwater system		to \$217,315
	\$155,225	
Deferred ongoing operation	-	to <u>\$152,767</u>
and maintenance	<u>\$106,937</u>	
Total	\$332,557	to \$523,537

The total cost for a risk assessment/risk management approach to the subject property including costs for the possibility of groundwater contamination are, therefore, \$332,557 to \$523,537. The average of this range is \$428,047. The other deductions to unimpaired value made by Mr. Collins including the allowance for notification and education, emergency response, legal costs, future clean-up cost, and stigma are not accepted by the Board as they are unsupported by the evidence. The Board accepts \$428,000 as the allowance which a reasonable purchaser would make against the unimpaired value of the subject property.

The Board finds the actual (market) value of the subject property as of July 1, 1993, to be:

Unimpaired value	\$930,000
Less allowance for risk assessment/ risk management	<u>\$428,000</u>
Actual value	\$502,000

The Board finds the actual (market) value of the subject property as of July 1, 1994, to be:

Unimpaired value	\$970,000
Less allowance for risk assessment/ risk management	<u>\$428,000</u>
Actual value	\$542,000

The Board will attribute value to the improvements using the depreciated replacement cost calculated by Mr. Collins in his Cost Approach, namely \$416,000 as of July 1, 1993, and \$405,000 as of July 1, 1994, and will attribute the residual to the land resulting in a land value as of July 1, 1993, of \$86,000 and as of July 1, 1994, of \$137,000.”

⁶ This leaves open the prospect of seeking a reduction in value both for objective remediation costs and subjective “stigma”, based on cogent evidence. The Board has yet to grapple with this.

On further appeal by stated case the Court held that the Board erred in determining the actual value of the property by considering only what a prudent purchaser would take into account in bidding for the property, and not taking into account that the vendor might require the actual risk of contamination to be determined instead of accepting a reduction in value based on risk alone.

The Court concluded that the Board erred by speculating, in the absence of evidence to support a finding of a reasonable expectation (i.e. greater than a 50% probability), that a purchaser and vendor would deduct the groundwater contingency costs from the unimpaired value of the property. The Court found that to simply average various remediation cost estimates and deduct that cost from the unimpaired value of the site was “sheer speculation”.

The Court noted that while the Board had the power to independently assess the actual contamination risk of the property and adjacent properties to perform its duty to determine the actual value of the property, it did not have the resources to retain an expert to do so, and could not impose that cost involuntarily on the parties.

The Court remitted the case to the Board to reconsider its findings on the contamination issue. As an aside, the case contains an interesting discussion of the Board’s “inquisitorial” rather than “adversarial” process, a distinction which is beginning to have significant impacts on the conduct of assessment appeals at the Board level, the ability of taxpayers to withdraw appeals which have been commenced, and on the onus of proof required of the parties before the Board.

In another case of interest, *Allard v. Assessor of Area 12 - Tricities / Fraser Valley* (unreported, July 4, 1997, Vancouver No. A962945, B.C.S.C.), the issue before the Court was whether the Board should have taken into account the fact that open ditches in the vicinity of the property carried water which was contaminated. The Board had confirmed the initial assessment. The appellant’s appraiser did a sales analysis which tended to support the assessment but he concluded that the value was actually 1/2 that value because the sales evidence was of transactions where the vendor and purchaser didn’t know of the contamination. The Board found that it could not conclude that the subject property was contaminated, or if it was, that it would impact on the market value of the property in relation to other properties. On stated case, the court noted that there was some evidence to support the Board’s conclusions and seemed impressed by the fact that there was no comparable sale of which would have been subject to contamination and from which a discount could be calculated.

The Board dealt with remediation costs in the context of a large scale commercial development property in the June 30, 1998 decision in *Assessor of Area #09 – Vancouver v. Concord Pacific Developments Ltd. (City of Vancouver Intervener)*. The Board was faced with the task of valuing approximately 161 acres of vacant residential and commercial developments lands on the north shore of False Creek in Vancouver which had formerly

been the 1986 Expo lands owned by the Province. The former industrial lands required extensive remediation to remove industrial waste for residential development. At the time the province sold the lands to Concord, Concord obtained an indemnity from the Province for remediation costs. The parties and Board agreed that despite this indemnity, remediation costs must be deducted from land value in the subdivision development approach to valuation.

The Board was given expert evidence of estimates of remediation costs for each of the parcels of land. Reports prepared by an independent expert prior to the assessment appeal for the purpose of remediating the lands estimated the range of costs to remediate each parcel to varying standards depending on their ultimate use (eg. park, commercial, residential). The landowner asked for a deduction representing the maximum possible remediation cost (“worst case scenario”) on the basis that any prudent purchaser would assume the worst in discounting the purchase price for remediation. The assessor estimated remediation costs attributable to individual parcels selected for development under the most probable development scenario. Both parties agreed to call, for the Board’s benefit, the expert responsible for administering the clean up program, who gave evidence of various remediation cost scenarios depending on the development ultimately pursued. The Board rejected both the “worst case” and “best case” scenarios of the parties, and accepted the independent expert’s evidence, deducting from land value the estimated cost to remediate less what had already been spent.

In a more recent decision, the Board and B.C. Supreme Court dealt with remediation costs in the valuation of a downtown Vancouver (Chinatown) automobile parkade situated on a site used between the 1800’s and the early 1950’s as a coal gasification plant in *Vancouver Chinatown Merchants Association v. Assessor of Area 9 – Vancouver* (May 10, 2002 Stated Case 458 B.C.S.C.). To account for the presence of hazardous materials, the Board added a premium of 1.5% to the capitalization rate to reflect rate of return to compensate for additional risk of contaminated site compared to uncontaminated site. This was affirmed on appeal by Stated Case.

Although there is clearly scope for significant reduction in industrial land value to reflect remediation costs, it is the author’s experience that, not surprisingly, many industrial land owners would prefer to forego this in light of the political and legal implications of "raising a red flag" about the extent of contamination on a site. Landowners seem less reluctant to seek deductions where the fact of contamination, and perhaps even the order of magnitude of remediation costs, are already known (eg. if bonds must be posted as security for clean-up costs).

(b) Archeological Remediation

In its April 12, 2002 decision in *Gary Hackett v. Assessor of Area #9 – Vancouver*, the Property Assessment Appeal Board faced the question of how to account for the impact of risk of archeological remediation for development of property on the value of the property. This is an increasingly important question for property owners who find that their property is part of a provincial registry of protected archeological sites under the B.C. *Heritage Conservation Act*, which prohibits any development without extensive investigation and approvals.

In *Hackett*, the owner of properties adjacent to or within boundaries of Marpole Midden, a pre-European contact archaeological site on Southwest Marine Drive in Vancouver, claimed that the presence of the midden was a significant feature negatively affecting value, and should be accounted for through a premium in the market income capitalization rate used to value the property.

The Board found that the property was affected by a negative market factor, namely being within boundaries of an important archaeological site and impacted by the constraints on development found in the Heritage Conservation Act. Nobody could redevelop the sites without performing an Archaeological Impact Assessment (“AIA”) and any potential purchaser would consider this a factor in the purchase price.

However the Board found that without definitive evidence, such as an AIA for each property, it would be speculative and arbitrary for the Board to reduce the value of the properties to reflect the cost of archaeological mitigation. The Board rejected the estimates of remediation costs unsupported by AIAs. However the Board found that the market would factor both the cloud of uncertainty and the costs of mitigation into any decision to redevelop the properties. So long as the current use of the property remained its highest and best use, there was no need to remediate the properties, because the midden materials were essentially benign, unless and until the midden was disturbed. The Board found that, in this respect, archaeological remediation differs in principle from environmental contamination, which may be required to be cleaned up if it is affecting adjacent properties, even in its current use.

The Board ultimately accounted for the cloud of uncertainty associated with the risk of having to remediate by selecting 9%, at the high end of the range of income capitalization rates (although commenting that with better evidence, the risk premium might have been higher). The Board also accepted BC Assessment's standard deduction of \$15,000 to reflect the cost of an AIA for each property, which was based on a policy rather than an individual assessment of the cost for each property.

B. FACTORS AFFECTING IMPROVEMENT VALUE

The following is a brief summary of several types of “costs” that affect improvement values. Interest during construction and goods and services tax are indirect costs required to be taken into consideration in valuing property. Developer’s profit, business value or goodwill and excess operating costs are costs that must be deducted in valuing a property.

(i) INTEREST DURING CONSTRUCTION

In a line of decisions⁷ in the 1970’s and 1980’s (prior to introduction of Class 4 – Major Industry and prescribed costs and depreciation rates for industrial plants), the Board and Courts were asked to consider the treatment of interest during construction (IDC) as an element of the cost approach. Generally, the Board and Courts found that IDC (the assumed interest which an investor would have to pay on money he was putting into the construction of a facility before it came into operation⁸) was properly included in the cost of new construction, and therefore assessable. In the Ridley Terminals case (footnote 8), the Court found that the Board erred in law in failing to include IDC in the cost of the facility. These cases remain relevant to the valuation of Class 5 – Light Industry, and other non-Class 4 properties which must be valued on market principles including the cost approach.

As to Class 4 – Major Industry properties, with the introduction of Class 4 – Major Industry in the 1980’s, the MIPS Manual was prescribed under (now) s.20 of the *Assessment Act* for costing industrial improvements. Division 10 (Miscellaneous) of the MIPS Manual contains a table of IDC factors. In its May 21, 2002 decision *Westcoast Energy Inc. v. Assessor of Area #15 et al*, the Board was faced with an argument by the appellant either that IDC was not properly included in the “cost of an industrial improvement” prescribed under s.20 of the Act, or if was properly included, must be applied to the cost of individual industrial improvements (which would result in a smaller IDC factor and lower plant cost), as opposed to the cost of the entire plant (which would result in a larger IDC factor and higher plant cost). The appellant said that the definition of “cost of industrial improvement” under s.20 did not include notional “soft” costs traditionally included in replacement cost appraisals.

⁷ See *B.C. Forest Products Limited v. Assessor of Area #03 – Cowichan Valley* (Stated Case 185, B.C.C.A.), *B.C. Timber Ltd. (Westar Timber Ltd.) v. Assessor of Area #25 – Northwest* (Stated Case 201, B.C.S.C.), *Crown Forest Industries v. Assessor of Area #06 – Courtenay* (Stated Case 210, B.C.C.A.), *Assessor of Area #25 – Northwest v. Ridley Terminals Inc.* (Stated Case 214).

⁸ *Crown Forest Industries v. Assessor of Area #06 – Courtenay* (Stated Case 210, B.C.S.C. per Southin J. at p.1183)

The Board disagreed, finding⁹ that appraisal theory and the ordinary meaning of “cost” required inclusion of all direct (“hard”) and indirect (“soft”) costs including IDC. The Board also found, again drawing on appraisal theory, that Division 10 of the Manual must be interpreted as requiring application of IDC at a uniform rate to the entire cost of the plant as opposed to individual improvements as built.

(ii) DEVELOPER'S PROFIT

Developer’s profit is another indirect or “soft” cost required to be accounted for in the appraisal of value of a property as a deduction against value.

In *Assessor of Area #09 – Vancouver v. Concord* (*infra*), and in *Assessor of Area #09 – Vancouver v. 350942 B.C. Ltd.* (June 19, 1997, Stated Case 397, B.C.S.C.), the Board accepted a 25% deduction for developer’s profit as one of the deductible costs against value in the subdivision development approach to valuing a large vacant property. The Board also allowed additional deductions of 6% administration and 3% selling costs.

In 350942 B.C., the Board declined to allow a deduction for developer’s profit (“cost to complete”) in the income approach to valuing a thirteen story office building. On appeal by Stated Case, the Court found this was an error of law, and that “cost to complete” is as relevant in the income approach as in the replacement cost approach to value. The Court also rejected the assessor’s argument that developer’s profit should not be deducted where, as here, the owner was acting as the developer.

(iii) GOODS AND SERVICES TAX

The Board has grappled with the question of whether goods and services tax (GST) should be accounted for in value on a number of occasions.

In *Tall Timber Golf Course v. Assessor of Area #15 – Langley / Abbotsford* (December 5, 1997, B.C.S.C.), the Board accepted the evidence of the assessor that, not having deducted GST from comparable prices in valuing a golf course, it would be inconsistent to deduct GST with respect to the subject course. The golf course owner appealed by Stated Case on the ground that GST collected by the course should not be included in its income because it collected the tax as a quasi-trustee for the Federal

⁹ It is the author’s understanding that while requirements to state a case from this decision were filed with the Board, the Board did not file the stated case with the Court.

Government and must remit the tax to the government. The Court declined to address the question on the grounds it was a question concerning treatment of evidence by the Board, and therefore not a question of law.

In a line of cases known as *Wedley v. Assessor of Area #08 – North Shore / Squamish*, August 18, 1998 Stated Case 410, B.C.S.C., leave denied to B.C.C.A., the Board held (after being ordered by the Courts to reconsider its decision to include GST in valuing property), that GST should not be taken into consideration in valuing the property. The issue arose again, with the opposite result, in the Board's April 16, 2002 decision *Gladys Mitchell v. Assessor of Area #08 – North Shore / Squamish Valley*. The appellant bought a condo, which the assessor valued based on the purchase price including 7% GST. The Board found that it was not bound by its previous decision (Wedley) because it is a question of fact in each case whether GST is properly included in value.

The Board reviewed expert economic, appraisal and statistics evidence which showed an increase in the prices on resales of new properties when compared to resales of used properties, which was very close to the net GST payable of 4.48%. Although the Board could not find that GST was the cause of this, the Board was satisfied that it was the only reasonable explanation, and that the payment of net GST on new properties is a market factor that is taken into account directly by a purchase in making a decision whether to buy a new or used property.

In the result, the Board found that the best indicator of the market value of a new property is the net GST inclusive price, and upheld the assessment taking GST into account. The Board has advised the author that no Stated Case appeal was taken from this decision.

(iv) GOODWILL

The Board and Courts have held that business value / goodwill is non-assessable. As the cases indicate, the practical issue lies in proof of business value as a deduction.

In *AJR Enterprises Ltd. v. Assessor of Area 9 – Vancouver* (November 6, 1997, Stated Case 401, B.C.S.C.), the Board and Court agreed that goodwill is non-assessable. The issue was whether the Board erred in using industry comparable rentals, as opposed to the actual income experience of the subject property less the value of non-assessable, as a method of determining value net of goodwill. The Board and Court found that use of industry comparable rents was appropriate, and that this was a more reliable way of ensuring no value was included for goodwill.

In *Avalon Motor Hotel Ltd. v. Assessor of Area #08 – North Shore / Squamish* (May 20, 1998, Stated Case 409, B.C.S.C.), while finding there probably was business value associated with the subject hotel, the Board declined to make a deduction for this given

speculative evidence. On appeal by Stated Case, the Court affirmed the Board's decision, finding that the Board would have erred had it made the deduction for goodwill after finding it was speculative.

**(v) FUNCTIONAL INUTILITY / SUPERADEQUACY / EXCESS CAPACITY
AND DEDUCTION FOR EXCESS OPERATING COSTS**

In a line of decisions in the 1970's and 1980's (prior to introduction of Class 4 – Major Industry and prescribed costs and depreciation rates for industrial plants), the Board and Courts were asked to consider the treatment of excess operating costs in the valuation of industrial facilities by the cost or income approach. Generally, the Board and Courts found that where faced with proof that prudent buyer would replace an existing facility (eg. mill) with a newer, more streamlined facility, it was appropriate to make a deduction in the context of an allowance for functional depreciation or inutility for the capitalized cost of ongoing excess operating costs.

In *B.C. Forest Products Limited v. Assessor of Area #03 – Cowichan Valley* (December 14, 1983, Stated Case 185, B.C.C.A.) the Court held that it was appropriate for the Board to reduce the replacement cost new by an allowance for excess operating costs in a mill that, through functional inutility, would require a new owner to bear ongoing excess operating costs over its remaining life. The functional obsolescence allowance had been determined by multiplying the annual wage cost per excess worker in a mill by the number of excess men to determine an annual excess cost, reducing this by 50% to reflect that the next cost to the mill operator would be after income tax, multiplying the adjusted cost after income tax for a factor to reflect the remaining years of life of the mill, then capitalizing this. Physical depreciation was then applied. The owner appealed on the grounds that the Board erred in applying the functional obsolescence allowance for excess costs before applying physical depreciation, thereby reducing the allowance for excess operating costs by the amount of physical depreciation. The B.C. Supreme Court found there was no error, but on further appeal, the Court of Appeal (with the consent of the parties) ordered this to be corrected.

In the next iteration of this case, *B.C. Forest Products Limited v. Assessor of Area #03 – Cowichan Valley* (November 2, 1984, Stated Case 193, B.C.S.C.), the Court held that where the uncontradicted and agreed evidence is that the subject property had excess operating costs and that a prudent purchaser would take this into consideration, excess operating costs should be deducted from the replacement cost to find actual value.

In *B.C. Timber Ltd. v. Assessor of Area #8 – Trail* (February 8, 1995, Stated Case 199, B.C.S.C.), the Board declined to allow a reduction in replacement cost of a pulp mill and sawmill for excess operating costs on the ground that the functional inutility giving rise to the excess operating costs were curable (based on evidence that the owner had plans to

reduce the costs). On appeal by Stated Case the Court found the Board had erred in law by characterizing the costs as curable, and that they must be deducted. So long as the excess operating costs continued (regardless of plans to reduce them), they must be taken into account as incurable.

Likewise, in *B.C. Timber Ltd. v. Assessor of Area #25 – Northwest* (April 1, 1985, Stated Case 201, B.C.S.C.), and *Crown Forest Industries Ltd. v. Assessor of Area #6 – Courtenay* (August 8, 1995, Stated Case 210, B.C.C.A.), the Court found that the Board erred in law in failing to deduct excess operating costs in the cost approach. In *B.C. Timber*, the parties agreed these costs existed, but simply differed as to their quantum. The Court held it was the Board’s duty to determine quantum and make the deduction.

In *Assessor of Area #25 – Northwest v. Ridley Terminals Inc.* (January 20, 1986, Stated Case 214, B.C.S.C.), the Board declined to value the subject coal terminal based on the price a hypothetical investor would be prepared to pay for the terminal based on its maximum capacity (unused at the time of the assessment) of 12 million tons of coal per annum, and instead valued it based on the price a hypothetical investor would be prepared to pay based on the terminal’s present actual throughput of 6.6 million tons per annum.

On appeal by Stated Case by the assessor, the Court upheld the Board’s decision, finding that it was open to the Board to determine that the hypothetical prudent investor would, at the assessment date, have considered increased throughput to maximum capacity speculative.

With the introduction of prescribed costs and depreciation factors under the Class 4 – Major Industry regime, it is no longer open to the assessor of property owner to “tailor” an appropriate allowance for excess operating costs (where functional obsolescence exists) for a specific industrial plant. Instead, to the extent functional inutility exists in a subject mill, this can only be accounted for through the application of the generic depreciation rate prescribed for all mills in that category of industrial plant. It is incumbent on stakeholders to consult with B.C. Assessment to ensure that there is an adequate allowance for all forms of depreciation in the MIPS depreciation rates (and also, for that matter, in the allowances for depreciation required to be accounted for in Commissioner’s rates prescribed under s.21 of the Act).

The most recent pronouncement of the Board (and Court) on functional obsolescence and excess costs is *Assessor of Area #05 – Port Alberni v. McDonald’s Restaurants of Canada Ltd* (October 11, 2002, Stated Case 462, B.C.S.C.). The property involved was a McDonald’s drive-through restaurant in Parksville. The Board found that one-half of the kitchen area and part of the storage area (approximately 2,250 square feet) was super

adequate¹⁰ and obsolete and treated the restaurant, on a replacement cost approach, as having only 4,000 square feet for restaurant purposes, thereby making a deduction for excess costs attributable to functional inutility. On appeal by Stated Case the assessor questioned the Board's finding of functional obsolescence. The Court dismissed the appeal, accepting the Board's finding that the functional inutility was permanent rather than temporary, based on a fundamental change in food delivery and cooking technique.

SUMMARY

While for the most part, Major Industrial and Utility property owners must rely on generic prescribed costs and depreciation rates (which are generally not open to appeal) being set at levels that reflect a reasonable allowance for indirect and excess costs, assessments of properties required to be valued on market principles must account, on an individual basis, for the types of special costs discussed in this paper.

Although the principles for accounting for special costs in value are well established before the Board, it is incumbent on the property owner seeking reductions in value for such costs as environmental and archaeological remediation, goodwill, developer's profit and functional inutility to marshal cogent evidence, generally through carefully documented expert reports, before the Board. In light of the significance of these reductions, this is generally going to be a worthwhile expense.

¹⁰ The Court at p.3214 accepted the following characterization in The Appraisal of Real Estate 11th Edition characterization of functional obsolescence:

“Functional obsolescence is a loss in value that may be caused by a deficiency or a superadequacy” (pp. 387 and 391)

“An item of incurable functional obsolescence caused by a superadequacy is a property component that exceeds market requirements. It represents a cost without any corresponding increment in value, or a cost that the increment in value does not meet. This form of functional obsolescence is considered incurable because it is not economically feasible to cure it. In most applications of the cost approach, the need to estimate the functional obsolescence attributable to an incurable superadequacy is eliminated by using replacement cost instead of reproduction cost; superadequacies are not replicated in a replacement cost estimate. Nevertheless, whether replacement cost or reproduction cost is used, any extraordinary expense of ownership associated with the superadequacy must be quantified and deducted as a penalty from the value of the property.” (p.391)

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