

Report to Corporate Services Committee

To: Chair and Members
Corporate Services Committee

From: Anna Lisa Barbon, Deputy City Manager, Finance Supports

Subject: Optional Small Business Subclass Summary and Analysis

Date: July 26, 2021

Recommendation

That, on the recommendation of the Deputy City Manager, Finance Supports, this report on the optional small business subclass BE RECEIVED for information.

Executive Summary

The purpose of this report is to provide an overview of the optional small business subclass as announced in the 2020 Ontario Budget and described in Ontario Regulation 331/21 and an analysis of implementation options. Should staff be directed to pursue the introduction of a small business subclass, a further analysis and consultation based on a graduated tax rate system with a discount rate of ten percent will be pursued.

Linkage to the Corporate Strategic Plan

Council's 2019 to 2023 Strategic Plan for the City of London identifies "Leading in Public Services" as a strategic area of focus. The information contained in this report would assist in developing future tax policy which aligns with Council priorities of the Strategic Plan that would "maintain London's finances in a transparent and well-planned manner to balance equity and affordability over the long-term".

Analysis

1.0 Background Information

1.1 Previous Reports Related to this Matter

Corporate Services Committee, March 1, 2021, Consent Items 2.3 and 3.0, 2021 Tax Policy Expectations

Corporate Services Committee, April 19, 2021, Consent Item 2.12, Year 2021 Tax Policy

1.2 Tax Policy Guiding Principles

The guiding principles for the City of London's Tax Policy in past years have been equity, economic development, transparency, and administrative efficiency.

1.3 Ontario Regulation 331/21 Summary

The 2020 Provincial Budget announced that municipalities will have the option to provide a property tax reduction to eligible small business through the adoption of a new small business subclass. As of January 13, 2021, the Province has passed the necessary amendment to the Assessment Act. The legislated rules governing the small business subclassed are established in Ontario Regulation 331/21, passed May 6, 2021, with a deemed effective date of January 1, 2021.

Council may pass a by-law that opts to have the small business subclass apply to the commercial and/or industrial property tax classes. This by-law must define the conditions for properties to be included in the subclass and establish the rate of the reduction for the subclass. The reduction can be set up to 35% of the municipal rate for the property class. If implemented, the municipality must appoint an employee to be the “Program Administrator” who shall provide the assessment corporation with a list of properties, or portions of properties, approved for inclusion in the subclass for a taxation year and, also, make the list available for public inspection by electronic means.

The by-law may specify that the subclass only applies to a portion of the municipality such as a Business Improvement Area (BIA). The by-law may also establish different criteria for the subclass in different portions of the municipality.

The Regulation outlines land eligible for inclusion in the subclass as well as notable exclusions such as those in the parking lot or vacant land property class, vacant properties, and large industrial properties.

The Regulation also identifies the process specific to the small business subclass for a request for reconsideration or an appeal, including the appointment of a municipal employee as the “Appellate Authority.”

Administration of the subclass, including audits, and adjudication of any appeals is the responsibility of municipal staff.

As many small businesses are tenants in a portion of a large building, the regulation allows for municipalities to pass a by-law requiring that savings are passed on to the tenant as a condition of eligibility in the subclass. While it is not yet determined how this would be enforced, a complaint-driven process may be implemented.

The Province will consider matching municipal property tax reductions with education property tax reductions to provide further support for small businesses. To qualify for matching, municipalities would notify the Minister of Finance of the decision to adopt the subclass and submit the relevant municipal by-law, provide an estimate of total tax relief to small businesses, and provide confirmation of consultation with the business community. The Minister would then review each submission and determine whether to match municipal reductions on a case-by-case basis.

2.0 Discussion and Considerations

2.1 Small Business Subclass Implementation Considerations

Based on the details of Ontario Regulation 331/21, there are multiple factors which will require consideration and decisions on as follows:

- 2.1.1 Will the City of London implement the small business subclass for the commercial property class, the industrial property class, both classes, or not at all?
- The overall commercial property and industrial property classes make up approximately 23.3% of the overall amount of property taxes levied, with the commercial property class accounting for \$142.7 million and the industrial property class accounting for approximately \$14.1 million. The Ontario Regulation provides the municipality the ability to include all eligible commercial and/or industrial properties in the new small business property subclass.
 - The Ontario Regulation provides the municipality the ability to include all commercial and/or industrial properties (except for properties classified as large industrial, parking lot, or vacant/excess land) in the new small business property subclass.
 - Consistent with reports presented by other cities, given the significantly lower number of industrial properties, focusing exclusively a small business

subclass within the broader commercial class would have the most impact on small businesses.

2.1.2 How the Small Business Subclass will be defined?

- Small businesses are not formally defined by the Province in either the *Municipal Act, 2001* or the *Assessment Act* in relation to property taxation. Municipalities will be tasked with establishing the criteria used for identifying small businesses to be included in the optional small business subclass. Depending on which criteria is used, inclusion in the subclass will be application-based, which would be more complex and require significantly more administration work and related costs, or criteria-based, which would be data driven, automatic, and would result in less administration work and costs.

2.1.3 How would the tax reduction be funded?

- Consistent with other property subclasses, municipalities can fund the small business subclass either by absorbing the cost through a levy decrease or by funding it through a property tax shift to other classes. To which property tax classes will the property tax reduction for properties eligible for the Small Business Subclass shift? i.e. residential, multi-residential, farm, industrial, and/ or the remaining commercial properties not meeting the criteria?

2.1.4 Timing Updated Municipal Property Assessment Corporation (MPAC) data?

- At the time of this report, MPAC has not confirmed whether coding changes for properties eligible for the Small Business Subclass will be included on the year end tax roll for 2022 assessment purposes. Should the municipality want the eligible properties on the year end roll, it is suspected that these would need to be defined no later than mid September. The Ontario Municipal Tax and Revenue Association (OMTRA) has requested clarification from MPAC on several topics related to the implementation of the small business subclass. This includes the deadline date that a municipality must provide a list of eligible properties in order to have these properties returned with the small business subclass classification on the year end roll for 2022, and what the process will be for alternative means of reclassifying eligible properties.

2.1.5 Will the subclass apply to all properties in the municipality or be restricted to specific geographic areas such as Business Improvement Areas?

- The City may choose to specify that the subclass only applies to a portion of the municipality such as properties located in a Business Improvement Area (BIA). This approach would add administrative complexity and would not be equitable for all commercial properties in the City. Additionally, limiting eligibility to properties located in a BIA may result in applications for more BIAs within the City which would add an administrative burden to the Tax Office and other departments.

2.1.6 Administration costs

- Incremental costs associated with the implementation of the small business subclass include system programming, human resources, and additional processes. The City will need to appoint a “Program Administrator” and an “Appellate Authority” which means additional hiring may be required. If eligibility for the subclass includes information not available on the assessment roll, an application-based process would be necessary and would require additional resources. Creation of this subclass could necessitate major software changes depending on how the class is defined, monitored, and maintained. These costs would add to the Tax Office annual operational costs and to the overall tax levy.
- Appeal process development and administration – appeals are currently administered by the Assessment Review Board (ARB) and there is no existing internal capacity to review the types of appeals which will be

generated by the small business subclass. Establishing an internal appeal process will require time and financial resources.

- Audits will be needed to verify that the land continues to meet the criteria established for eligibility in the small business subclass. These costs would be much higher if application-based criteria were implemented.
- Education and Managing complaints – resources will be required to educate the public on the rules for the new subclass. It is probable that the addition of a small business subclass will result in an increased volume of complaints to be fielded by the Tax Office, including complaints from tenants not receiving the reduction.

2.1.7 Community Engagement

- Input from the public is a condition of the province matching the reduction through education property taxes and should be sought to ensure the intended benefit to small businesses is likely to be achieved through implementation of a small business subclass. Feedback should be obtained from property owners who would benefit from a small business subclass as well as those who would experience an increase in taxes due to a tax shift. The City may also wish to engage with stakeholders from the Chamber of Commerce and business improvement areas. As this is a new optional subclass for all of Ontario, it is important to also consult with other large municipalities to gain insight and develop a common approach.

2.1.8 Enforcement to Support Tenants

- Municipalities may choose to require in municipal by-law that landlords pass the tax reduction to tenants as a condition of eligibility in the subclass. Since tenant information is not included in the assessment roll, a process allowing tenants to file a complaint may be implemented. Any complaint claiming a landlord is not passing the tax reduction on to tenants would trigger an audit of the subject property. If the Program Administrator determines that an owner of land included in the small business subclass has not complied with eligibility requirements, including passing on tax reductions to tenants, the land shall cease to be included in the subclass retroactive to the beginning of the taxation year in which the determination was made.

2.2 Discount Rate for Small Business Subclass

- From a historical perspective, maintaining an assessment roll that accurately differentiates small businesses from other business properties is a complex administrative process. Prior to 1998, a Business Occupancy Tax (BOT) was used to attribute the business assessment to each property based on the type of business occupant. The BOT, which was administratively inefficient and questionable from an equity perspective, required a great deal of administrative work for MPAC and for local municipalities. The major tax reform implemented by the Province in 1998 eliminated the BOT by applying an average BOT percentage to all business properties and mitigating assessment change impacts by using a capping system. The effective rate of reduction deemed appropriate for the BOT was 5-8%, on average. As the small business subclass would also be implemented to tax properties based on the type of business occupant, it is recommended that a similar reduction rate be used for the optional small business subclass and that it be no greater than 10%.

2.3 Tax Office

- There are data points provided by MPAC that are readily available for use as criteria for the small business subclass. Property codes define the primary use of a property. Using these codes as criteria, it can be determined which property use definitions lend themselves to a small business definition.
- The Current Value Assessment (CVA) for each property is provided by MPAC and is used, in conjunction with the property class rates, to calculate the

- property taxes annually. Use of CVA to determine eligibility for the small business subclass would be objective and would be administratively efficient.
- This type of appeals process has not previously involved municipal staff. Currently, property owners may apply to the municipality or MPAC for a tax reduction. Once a decision is made, if the property owner wishes to appeal, the Assessment Review Board (ARB) acts as the independent adjudicative tribunal as established under the *Assessment Act*. Upon adoption of a small business subclass, municipalities are required to appoint an Appellate Authority to hear appeals about whether or not the property should be included in the subclass. As municipal staff has no experience adjudicating this type of appeal, a hiring or training process and related costs would be needed. Appeals related to assessed value would continue to be directed to the ARB.
 - The *Municipal Act, 2001* provides municipalities with enforcement powers related to collection of tax arrears including charging penalty and interest on overdue taxes and registering properties for tax sale if arrears exceed two years. Enforcement of property owners sharing tax reduction with tenants is not specifically mentioned. Civic Administration would need to work through how the enforcement of savings being passed through to tenants would be achieved.

3.0 Financial Impact/ Considerations

3.1 Budget Impacts

Creating a small business subclass with a lower tax rate will result in a reduction in tax revenue from eligible properties. Although, the Province has passed Regulation 331/21 to allow municipalities to adopt a small business subclass, there is no provincial funding provided which means the subclass must be revenue neutral. This can be achieved by reducing the overall tax levy, by shifting the cost to all other classes, including residential, or by shifting the cost within the broader commercial class using revenue neutral ratios. Since this would be a subclass of the broader commercial class, the recommendation is to shift any reduction within the commercial class.

The most recent communication from MPAC indicated that any coding changes related to a small business subclass would be captured using supplemental billings in 2022 which would result in tax write-offs. The changes will need to be implemented on the year-end roll to allow for a tax shift in 2022. Ongoing discussion with MPAC is required to verify whether this will be possible.

Additional budget impacts are the costs associated with implementing and maintaining the small business subclass. The extent of these costs will vary depending on the criteria and approach used to define the subclass.

4.0 Key Issues and Considerations

4.1 Small Business Subclass Options

4.1.1 Income Thresholds

- Using total annual sales revenue for identifying small businesses would require an application-based approach. The Tax Office does not collect information related to sales revenue by business nor is the current Property Tax System able to maintain the information for these data points. The purchase of new software or enhancements to existing software would be necessary. Obtaining this data would be cumbersome and the potential for appeals would be high as applicants attempt to demonstrate that their annual sales fall within the established criteria. Additionally, the sales data would need to be validated annually to ensure properties still qualify for inclusion in the subclass. The use of total annual sales as criteria for eligibility for the small business subclass is not recommended as it would be administratively

burdensome for potential applicants, difficult to operationalize, and costly to the City.

4.1.2 Number of Employees

- Another application-based approach for identifying small businesses is number of employees. While it may be possible to obtain data identifying the number of employees from the London Chamber of Commerce, data for non-members would be unavailable. The current Property Tax System is not setup to maintain the information for these data points. Obtaining this data would be cumbersome and the potential for appeals would be high as applicants attempt to demonstrate that their number of employees fall within the established criteria. Using number of employees as criteria would not be administratively efficient and, since data is not available for all businesses, not equitable for all commercial property owners. For these reasons, using number of employees as criteria for inclusion in the small business subclass is not recommended.

4.1.3 Small Business Type

- Small businesses may be defined by type of business using business licensing data available from the City Licensing Office. There are limitations to this data since only the types of business listed in By-law L.-131-16 require a license. It is also possible that some of the businesses issued a license would be large restaurant or retail chains and not small in nature. The Current Property Tax System is not setup to maintain this type of data so an application-based approach would be necessary. Using type of business as defined by business license is not recommended as it would not be equitable to all commercial properties and the process would be administratively inefficient.

4.1.4 MPAC Property Codes

- A criteria-based approach would utilize data points available to the City such as MPAC property codes which define the primary use of a property. Using these codes as criteria, it can be determined which property use definitions lend themselves to a small business definition. However, the use of a property does not necessarily identify whether the occupant is a small or large business. While this data is available through MPAC, it has not been confirmed how accurately the codes define use nor how current the codes are. Additionally, there is a potential for increased appeals if MPAC property codes are used to identify eligibility as inclusion or exclusion may be considered subjective in nature. For these reasons, the use of MPAC property codes as criteria is not recommended.

4.1.5 Current Value Assessment (CVA) Threshold

- Small businesses may be defined using a CVA data which is already supplied by MPAC. Using an amount of \$500,000 as a threshold, any commercial property with a CVA lower than that amount would be eligible for the small business subclass. Approximately 2,349 properties would be eligible using this threshold with an approximate total of \$2,869,000 shifted to the broader commercial class.
Using CVA as criteria is relevant to identify small businesses since the market value of a commercial property is determined based on the income approach. The income that the property generates is determined and then capitalized using an applicable multiple based on an appropriate interest rate. The value is determined based on income generating capabilities.
Use of a CVA threshold as criteria would be automatic and not subject to interpretation which should reduce the volume of appeals. As stated earlier, any appeals based on assessment will continue to be heard by the ARB which eases the administrative burden on City staff.

A potential concern with using these criteria would be that properties with a CVA of \$501,000 would not be eligible while properties with a CVA of \$499,000 would. This raises the question of whether this policy would be equitable for all property owners and could lead to an increase in assessment appeals in an attempt to meet the CVA threshold.

4.1.6 CVA with Graduated Tax Rate System

- Use of a graduated tax rate system could alleviate the concerns related to equity and help to mitigate the incentive for assessment appeals. Using the same threshold, the first \$500,000 of CVA would be eligible for the small business class while any CVA above \$500,000 would be taxed at the broader commercial class tax rate. Since all commercial properties are included, this approach is equitable.

Using a graduated tax rate system would result in approximately 4,163 properties being fully or partly eligible for the small business subclass with an approximate total of \$4,510,000 shifted to the broader commercial class. This CVA data is already available from MPAC and modelling is available through OPTA to help calculate the potential impact of the subclass while reducing the administrative burden.

There is currently an electronic tax roll available to the public which includes CVA data. The availability of this data allows for a high level of transparency. The use of CVA with a graduated tax rate system as criteria for the small business subclass is administratively efficient, equitable, and transparent. If the optional small business subclass is adopted, this is the recommended criteria for defining small businesses.

4.1.7 Geographical Areas

- Limiting eligibility for the small business subclass to properties in a geographical area would add a layer of intricacy that would result in adding another level of administrative complexity for both application-based and criteria-based approaches. Approving only a portion of the City for the small business subclass would not be equitable for all commercial properties in the City. Additionally, limiting eligibility to properties located in a BIA may result in applications for more BIAs within the City which would add an administrative responsibility to the Tax Office and other Service Areas. It is not recommended that eligibility for the small business subclass be limited to geographic areas such as Business Improvement Areas.

4.1.8 Keep Status Quo

- A Tax Policy objective has been to promote economic development by reducing the business class ratios since 2011. These lower ratios, along with the 2021 reduction in education rates, continue to provide property tax relief to all commercial properties. From an equity standpoint, to date all businesses have been treated equitably. By introducing a small business subclass, subject to the approach used, businesses would not be treated equitably as the discount realized by the small business subclass would be offset by an increase to the other businesses not categorized as a small business. Further, the most administratively efficient option is to maintain the status quo and choose not to adopt the optional small business subclass. Providing targeted support to small businesses may be achieved with a higher level of success through means other than a property tax subclass.

4.2 Other Municipalities

- Based on analysis and conversations to date, other major municipalities in Ontario are bringing forward a program in late fall.
- Ottawa has roughed out a program however it has not been finalized and more details will be available in the fall

- A report prepared for The Toronto Financial District Business Improvement Area, titled “Options for Toronto: Current & Best Practices in Canadian Small Business Property Tax Relief,” recommended an application-based model for small business aid while acknowledging administration and enforcement challenges. The fallback option recommended the use of graduated tax rates with enhanced thresholds over time.

Conclusion

Ontario Regulation 331/21 outlines the rules and requirements for implementation of the optional small business subclass. Municipalities must establish criteria for eligibility, provide a list of eligible properties to MPAC, appoint staff to administer the program and respond to appeals, and participate in public consultation.

It is advised that should the optional small business subclass be introduced, a criteria-based approach rather than an application-based approach be utilized. More specifically, a graduated tax rate system is the most viable option. Regardless of the chosen criteria, the decision to implement the small business subclass will result in additional implementation and operational costs, as well as a time commitment from software support, tax office staff, and partner organizations such as MPAC.

Should direction be provided to pursue the graduated tax rate system approach, a deeper analysis, identification of potential impacts, including number of eligible properties, positive and negative impacts on property owners, and associated costs will be provided along with an implementation plan in a future report.

“that staff BE DIRECTED to conduct further analysis and consultation based on the assumption that criteria for inclusion in a small business subclass, if adopted, will use a graduated tax rate system with a discount rate of ten percent.”

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