

# MICROFILM DIVIDER

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ROLL NUMBER

DESCRIPTION

1204

2001 HOUSE FINANCE AND TAXATION

HB 1204

2001 HOUSE STANDING COMMITTEE MINUTES

BILL/RESOLUTION NO. HB 1204

House Finance and Taxation Committee

Conference Committee

Hearing Date January 22, 2001

Tape Number	Side A	Side B	Meter #
1	X		3,199
Committee Clerk Signature <i>Jamie Stein</i>			

Minutes:

**REP. AL CARLSON, CHAIRMAN,** Opened the hearing.

**REP. LARRY KLEMIN, DIST. 47, BISMARCK,** Introduced the bill to provide some concession about whether it would be appropriate to include a specific definition of commercial rental property while relating to the true and full value, which is part of the real property tax law. And whether the income capitalization approach to this evaluation should be the primary method used for this property in North Dakota. He stated in many communities there are difficult times for property owners, increased expenses, and they must meet those expenses in order to continue to operate their commercial rental property. Real property taxes must be fair and uniformly administered across the state. As with agricultural property, the tax should be based on the values that are as close as possible to market value. There is currently, no clear guidance in North Dakota law, as to how to value commercial rental property for tax purposes. This bill requires the use of the income capitalization approach to valuation of commercial rental property

in most cases. There are other approaches to the valuation of property, some of these include the cost approach and the sales and comparison approach. There is also a replacement cost approach. The income capitalization approach is using estimated rents and expense ratios. What the income capitalization approach is in simple terms is, you take the net operating income and divide it by the capitalization rate and you get market value. The capitalization rate itself, is something to be determined. Sometimes you use direct market evidence, there are investor surveys that are done, local surveys, national surveys.

Rep. Klemin went on to explain the bill. Also explained the amendments which were submitted to the bill.

**REP. SCHMIDT** Inquired whether cities, schools and townships would be affected by this legislation.

**REP. KLEMIN** Stated he didn't know if you could tell what type of an effect it would be, it could very likely be revenue neutral.

**REP. WINRICH** A private owner of commercial rental property is not required to disclose their income tax information to the assessor are they?

**REP. KLEMIN** That is correct.

**REP. WINRICH** Then it would appear you are mandating the assessors to use this capitalization of income method, but the owner of the building may withhold, precisely, the information they need in order to use that method, isn't that a contradiction?

**REP. KLEMIN** That is why the amendment was proposed, I recognized that the local assessor may not have that local information available, so the amendment says that if that information is not available, then other methods of evaluation can be used.

**REP. WINRICH** If this is, in your judgment, the appropriate method to use for assessing property, wouldn't it be appropriate to authorize the tax commissioner to share that information with the assessors?

**REP. KLEMIN** That is certainly something this committee could consider, it is not part of the bill.

**REP. WINRICH** The other thing that seems to be absent here is, you are mandating the capitalization of income method of assessment, but nothing is said about the rate of capitalization. Is that in those uniform standards or how would the rate of capitalization for these methods be determined?

**REP. KLEMIN** There are a number of recognized general accepted methods for determining the capitalization rate. A few are direct market evidence, local and national investor surveys, there is a fairly complex method called band of investment analysis.

**REP. WINRICH** Apparently any one of those methods would be appropriate, in your judgment?

**REP. KLEMIN** I am not a professional appraiser, but I do know there are number of widely and generally accepted methodologies accepted.

**REP. WINRICH** It seems curious to me that living space is exempted, is there some reason why the capitalization income rate doesn't work on residential property?

**REP. KLEMIN** If the committee wanted to look at residential property, it could certainly be done. The focus of this bill is on commercial rental property, but would not exclude those properties which are used for apartments. Such as a main street building with apartments upstairs.

**REP. KROEBER** It appears the assessor will make a number of different assessments then find out which one is most appropriate, how will this effect the workload of the assessor? Once you determine this, what will be the most appropriate then, the highest taxed, the lowest taxed?

**REP. KLEMIN** I don't know what effect this would have on the workload of assessors, it will obviously have some effect, initially. It may be that many of the assessors are already using this methodology. They should have a lot of the data available already from their own records.

**REP. KROEBER** How will they determine then, which is most appropriate?

**REP. KLEMIN** That is part of the process now, if you look at a basic appraisal now, there would be a reconciliation made.

**REP. RICK BERG, DIST. 45, FARGO,** Testified in support of the bill. Stated this is a lot like ag land. If you have a quarter with alkali on it, you are taxed differently than a quarter that has no rocks and is very productive land. We have established in ag land, that is the fairest way to value taxed land. Commercial land is no different. Rep. Berg submitted a handout to the committee members to explain how this evaluation would work. See attached copy.

TAPE 1, SIDE B

Rep. Berg answered questions which were raised regarding the evaluation example.

**REP. DROYDAL** Coming from the rural area, where we have had a lot of difficulty in small towns, what happens in the case where a business sits empty for several years, how do they determine the tax on that?

**REP. BERG** If there is no income coming in, you can't use this method. You would then look at comparable sales, or what is the cost to build that building less depreciation.

**REP. DROYDAL** So this is not replacing what we have now.

**REP. BERG** That is right, it is not replacing anything we are currently doing, all we are saying, is if there is a dispute on value that the owner is uncomfortable, they can provide this information to try to resolve it, and it doesn't tie the assessor's hands to have to go with this process, but at least it is nother avenue.

**REP. LLOYD** It would appear to me that the building owner, in your example B, will raise the tenants payments schedule, because if he can deduct real estate taxes, why wouldn't he have them pay it instead. That is what he would have to do to remain competitive.

**REP. BERG** Compared his answer to two quarters of land. The free market is determining what the rent is and what the expenses are. The owner of any property is trying to maximize the dollars.

**REP. RENNER** Is it common for someone to rent a building and the renter pays the taxes?

**REP. BERG** Every market is different. in the Fargo market, I would say maybe half or thirty percent, the tenants are paying the real estate taxes.

**REP. RENNER** To get an accurate income, should you not add the taxes on top of the income?

**REP. BERG**, If you had two buildings for sale, for \$650,000, which building would you buy?  
The tenants in building B are paying a higher rent.

**REP. WINRICH** You compared the determination of the capitalization rate to determinations of similar rates in the assessment of agricultural land, but the century code specifically provides for a method of determining those rates, and in fact, charges a department at NDSU with that determination each period of time. Aren't we leaving a big gap here in comparison to agricultural land ls assessed, by not saying something about the determination of capitalization rate?

**REP. BERG** There are three parts to the capitalization rate, the value of the building, the net income and the percentage. If you know the value of the sale price of other properties and you know what their net income was, you can determine what their capitalization rate was.

If you took ten pieces of farm land that sold, and you know what the net income that farmer can get off of it, you can divide that by the price and come up with the capitalization rate. I would guess that is what NDSU is doing.

**REP. WINRICH** As I understand it, it also ties in with the price of commodities, etc.

**REP. BERG** As commodities go up the net income goes up, as commodities go down, the net income goes down.

**REP. WINRICH** Philosophically, the whole concept of the property tax goes back to a time when, basically, property was a primary indicator of wealth. Almost all property produced some sort of income, people that ran businesses, lived upstairs over the business. Where does the concept of fairness come in in comparing property that produces income with ordinary residential, which in most cases, no longer produces income?

**REP. BERG** If you believe in the philosophy, way back when, when people who were successful, owned property, and property generated income, what we were doing, was taxing that income. This is exactly, the same thing. We want to look at the income coming out of this property as a basis for taxation. There are three ways to evaluate property; a market approach, an income approach and a cost approach. If you have income, most appraisers, buyers and sellers, look at the income approach. If you don't have income, in a residential, they look at the market approach.

**REP. WINRICH** This has been expressed to me by constituents, that there is already an unfairness built into the system in comparison with assessing agricultural land and residential land within the city, because of the different basis.

**REP. HERBEL** Will this affect smaller communities the same as it does the metropolitan areas of North Dakota?

**REP. BERG** Depending on the market, where I see it happening is where you have a lot of sales. Some of these buildings in the smaller areas are making some money, but because they are valued, not using this, their value is probably a lot lower than it should be. The premise is that people would be taxed fairly on the income that they are generating out of their property.

**REP. SCHMIDT** The agricultural land value, the way they describe capitalization rate is simply interest rates that the federal land bank charges.

**REP. BERG** Well you can't.

**SCOTT STROMME, CITY ASSESSOR, BISMARCK**, Testified in opposition of the bill.  
See attached written testimony.

**REP. KROEBER** How do you feel this would affect your workload?

**SCOTT STROMME** It would increase, there is no way around that.

**BEN HUSHKA, CITY ASSESSOR, FARGO**, Testified in opposition of the bill. See attached written testimony.

**REP. CARLSON** What do you do in the case of a dispute, now, on a commercial property?

**BEN HUSHKA** We would ask for their income/expense information, we would go into the market place and try to find other properties that are in that class of the property we are dealing with. If they happen to be thirty percent vacant, and we find other similar properties that are only

ten percent, obviously, it wouldn't be a market situation. We try to analyse their actual situation as to how it relates to the market.

**REP CARLSON** Would you have the authority, today, to adjust his taxes based upon the income approach?

**BEN HUSHKA** Absolutely. The definition we have in place, under statute right now, does say we consider the earning or productive capacity, and that would be the income approach. Under the present code, we would assess it, based on what we found in the market, if you are at thirty percent, we base it on the current market rate.

**BILL SHALHOOB, DEVELOPER IN THE CITY OF BISMARCK,** Testified in opposition of the bill. I do have problems with this bill. The capitalization rate is a very subjective item. Commercial property is sold on a risk/reward basis, the higher risk there is, the higher the reward should be. If I am in a high risk building or piece of commercial property, I may say, as a commercial buyer, that I need more than a narrow range of return, based on the risk that I am going to have out there for my money. I feel very honestly, that I am entitled to an eighteen percent return. To say there is a narrow range of commercial property out there, is too regimented. The second thing this bill does, in terms of an operator doing it, there are a lot of numbers gains that can be played. This bill encourages me, as an operator, to play all kinds of expense gains. That would drive my net operating income down, and therefore, drive the value down, and therefore, drive my real estate taxes down. It would provide for uneven values to cities, because I could do this. Commercial property tax are supposed to be a payment of a service, fire and police and those kinds of things. The only problem with that is, they don't have anything to do with the income you have going. To go to a strict income approach, would really

provide for some uneven values in the city. In the smaller cities, if you look at the income coming from them, there would be almost no value for them. The blend used now, is fairer for property owners, then something that is based strictly on cap rate.

With no further testimony, the hearing was closed.

**COMMITTEE ACTION 2-07-01, TAPE #2, SIDE A, METER #218**

**REP. CLARK** Made a motion for a **DO NOT PASS**.

**REP. HERBEL** Second the motion. **MOTION CARRIED.**

**15 YES      0 NO      0 ABSENT**

**REP. WINRICH** Was given the floor assignment.

FISCAL NOTE STATEMENT

House Bill or Resolution No. 1204

This bill or resolution appears to affect revenues, expenditures, or fiscal liability of counties, cities, or school districts. However, no state agency has primary responsibility for compiling and maintaining the information necessary for the proper preparation of a fiscal note regarding this bill or resolution. Pursuant to Joint Rule 502, this statement meets the fiscal note requirement.

John Walstad  
Code Revisor

Date: 2-7-01  
Roll Call Vote #: 1

2001 HOUSE STANDING COMMITTEE ROLL CALL VOTES  
BILL/RESOLUTION NO. HB 1204

House FINANCE & TAXATION Committee

Subcommittee on \_\_\_\_\_  
or  
 Conference Committee

Legislative Council Amendment Number \_\_\_\_\_

Action Taken Do Not Pass

Motion Made By Rep. Clark Seconded By Rep. Herbel

Representatives	Yes	No	Representatives	Yes	No
CARLSON, AL, CHAIRMAN	✓		NICHOLAS, EUGENE	✓	
DROVDAL, DAVID, V-CHAIR	✓		RENNER, DENNIS	✓	
BRANDENBURG, MICHAEL	✓		RENNERFELDT, EARL	✓	
CLARK, BYRON	✓		SCHMIDT, ARLO	✓	
GROSZ, MICHAEL	✓		WIKENHEISER, RAY	✓	
HERBEL, GIL	✓		WINRICH, LONNY	✓	
KELSH, SCOT	✓				
KROEBER, JOE	✓				
LLOYD, EDWARD	✓				

Total (Yes) 15 No 0

Absent 0

Floor Assignment Rep. Winnick

If the vote is on an amendment, briefly indicate intent:

**REPORT OF STANDING COMMITTEE (410)**  
February 8, 2001 8:55 a.m.

**Module No: HR-23-2679**  
**Carrier: Winrich**  
**Insert LC: . Title: .**

**REPORT OF STANDING COMMITTEE**

**HB 1204: Finance and Taxation Committee (Rep. Carlson, Chairman) recommends DO NOT PASS (15 YEAS, 0 NAYS, 0 ABSENT AND NOT VOTING). HB 1204 was placed on the Eleventh order on the calendar.**

2001 TESTIMONY

HB 1204

**NORTH DAKOTA HOUSE OF REPRESENTATIVES**  
**FINANCE AND TAXATION COMMITTEE**

**Testimony of Ben Hushka**  
**Fargo City Assessor**  
**January 22, 2001**

Mr. Chairman and members of the House Finance and Taxation Committee, my name is Ben Hushka. I am the City Assessor for Fargo.

I am not taking an official position for or against this bill. I am merely here today to address some concerns I have as an assessment official regarding some of the problems I can see in administering it in its present form.

To start with, I would like to lay a brief foundation of the property tax valuation system we presently have according to the state constitution and statutes. I think that may help you in seeing where problems could arise for property owners, representatives, and assessors in the future should this bill pass in its present form.

- N.D.C.C. Chapter 57-02-03 states that, "All property in this state is subject to taxation unless expressly exempted by law."
- N.D.C.C. Chapter 57-02-04 defines real property, for the purposes of taxation, as land, improvements to the land, structures and buildings, and all rights and privileges thereto belonging.
- N.D.C.C. Chapters 57-02-11 and 57-02-34 state that the assessor shall determine the true and full value of each lot and the true and full value of each improvement or structure, separately, according to their value February first of each year.
- N.D.C.C. Chapter 57-02-27 defines the assessment percentages and the classifications of property for tax purposes. Those classifications are

residential, agricultural, commercial, and centrally assessed. This chapter also states that the assessor may not adopt a lower or different standard of value because it is to serve as the basis for taxation but, shall value each parcel of real property at a price he or she believes to be fairly worth in money.

- N.D.C.C. Chapter 57-02-27.1 sets the standard of value as the "true and full value" as defined in Chapter 57-02-27.2 for agricultural property and in Chapter 57-02-01 for all other classes of property.
- And finally, Article X, Section 5 of the North Dakota State Constitution states that, "Taxes shall be uniform upon the same class of property...".

My concerns are with administering subsection "b." of this bill. There are problems that could arise due to some serious administrative burdens this could put on local jurisdictions as well as multiple interpretations due to some ambiguities that could result in non-uniform application by assessment officials.

The language, "... value determined by capitalization of the income from the property ..." can be open to several interpretations and can also potentially impose a burden on local jurisdictions making it impractical or potentially impossible to enforce.

- The type of value to be determined is not defined as to whether "market value", "value in use", "investment value", or some other definition of value is to be arrived at.
- There is no requirement for property owners to submit income and expense information to the assessor. Likely, as is currently the case, only property owners who are suffering poor economic circumstance would submit information and be valued by this approach. All other similar properties would be valued according to the market.
- The specific income to be capitalized is not clearly defined in terms of the time frame of the income to be used. For example, it could be the income from the previous 12 months, at the time of making the assessment as of February first.

It could mean the income at a specific point in time according to leases and tenants in place at that time. It could also mean the income based on a fiscal or calendar period over a specified duration of time, in the past or projected into the future.

- Tenants and leases change over time. In the case of percentage leases where the lease calls for a base rent plus a percentage of gross business sales, the income on the property could constantly change. Assessors could be forced to annually reappraise and analyze this information for that number of properties defined as "commercial rental property", while being forced to ignore the remaining properties in their jurisdiction due to time constraints.
- Since only the income to the owner would be capitalized, in cases where the actual rent received on the property is below market rents, there would be a leasehold interest in the property that would not be valued. Also, if the owner occupied part of the building and didn't receive rent on that part or, if tenants are responsible for their own leasehold improvements, the value of those improvements would not be reflected in the rents or the value arrived at under this approach. N.D.C.C. Chapters 57-02-03 and 57-02-04 state that all rights and privileges to real property are taxable in the state.
- The Constitution of North Dakota calls for taxation to be uniform on the same class of property. If passed in its present form, this bill could create non-uniformity in taxes on the same exact property. Following, is a very basic example of the possible range of values and taxes on a property assuming 4 different scenarios:

ASSUMPTIONS	
Market Rent	\$10.00 per sq. ft. (annually)
Market Vacancy	5%
Market Cap Rate	10%
Leaseable Area	30,000 square feet

	Vacancy	Actual Rent	Actual Net Income	Capitalized Net Income	Assessor's Value	Annual Tax
Scenario 1	51%	\$10.00	\$147,000	\$285,000	\$2,850,000	\$ 66,800
Scenario 2	50%	\$10.00	\$130,000	\$150,000	\$1,500,000	\$ 35,200
Scenario 3	0%	\$8.00	\$240,000	\$240,000	\$2,400,000	\$ 58,300
Scenario 4	0%	\$12.00	\$360,000	\$360,000	\$3,600,000	\$ 84,400

Under Scenario 1, the least amount of actual income is being received due to the fact that it is only 49% leased out. It would not qualify, by definition, as "commercial rental property" under this act because 50% of the useable space is not leased out to tenants unaffiliated with the owner. Therefore, it would be valued at market value and pay almost double the tax than it would had only 1% more of the building been occupied. (The same methodology would apply in Scenarios 1 & 2 if the owner occupied that space rather than the space being vacant.)

The requirement, under this act, for assessors to appraise properties "in accordance with uniform standards of professional appraisal practice..." could be interpreted in a couple of alternate ways with each having significantly different implications.

- The terminology, "uniform standards of professional appraisal practice" as used in this act, could mean simply adhering to generally accepted appraisal practices or, it could be interpreted to mean complying with the document entitled "*Uniform Standards of Professional Appraisal Practice*", published annually by the Appraisal Standards Board of The Appraisal Foundation.
- "*Uniform Standards of Professional Appraisal Practice*" is a very comprehensive and somewhat complex document detailing rules and standards of how a state licensed or certified appraiser must develop and communicate appraisals to clients. Some analysis, reporting, and competency requirements in

these standards are not practically or financially possible in most assessment offices.

- Assessors must value every property in their jurisdiction every year. The level of detail and reporting required by the "*Uniform Standards of Professional Appraisal Practice*" would be physically impossible while attempting to provide efficient, cost effective government services.

Finally, I have a concern about the reference to the fact that methods of valuation other than the one described in subsection "b." of this act, could be considered if that method "... results in an unreasonable determination..." of value.

- Obviously, the concern here is that it would be very difficult to arrive at thresholds that would determine what "unreasonable" is. In addition to not spelling out what would be considered "unreasonable", the issue of who would determine that is also in question.

In conclusion, as an assessment administrator, I take no formal position for or against particular legislation. I feel I have the duty and responsibility to administer and carry out the legislation and policies created by those elected by the people. As far as this particular bill, I feel that all affected could be better served if some assessment officials could work with the sponsors on alternative wording. This could get them closer to their desired goal without imposing potentially serious administrative burdens and restrictions at the local jurisdiction level.

This concludes my testimony. Thank you for your attention and, if you have any questions, I will try to answer them.

## COMMERCIAL PROPERTY EVALUATION EXAMPLE

Building Size: 10,000  
 Rent per SF: \$12.50 (Building A)  
 \$11.50 (Building B)

<u>Income to Owner</u>	<u>Building A</u>	<u>Building B</u>
Annual Income	125,000	115,000
Vacancies	<u>5,000</u>	<u>5,000</u>
Gross Income	120,000	110,000
 <u>Expenses Paid by Owner</u>		
Real Estate Taxes	( 15,000)	( -0- )
Insurance	( 3,000)	( 3,000)
Repairs & Maintenance	( 5,000)	( 5,000)
Utilities	( 10,000)	( -0- )
Management Fees	( 6,000)	( 6,000)
Leasing Fees	( 3,000)	( 3,000)
Snow Removal & Grounds	<u>( 3,000)</u>	<u>( 3,000)</u>
Expenses	( 45,000)	( 20,000)
Net Operating Income	75,000	90,000
Capitalization Rate (CAP)	11%	11%
Property Value (75,000 / 11%)	\$681,818	\$818,182

\*Mortgage and interest payments are not included expenses in CAP evaluation.



**Testimony Before the House Finance and  
Taxation Committee**

**January 22, 2001**

**House Bill 1204**

**Scott D. Stromme, Bismarck City Assessor**

Mr. Chairman and Members of the Committee:

My name is Scott Stromme and I am the City Assessor of Bismarck. I am appearing in opposition to HB 1204 for the following reasons:

1. On lines 16 & 17 it talks about an "unreasonable determination". Who will make that decision?
2. On lines 19 & 20 it talk's about property which is at least 50% leased. In order to determine that, more measurements would be needed than presently required.
3. Our office has a difficult time getting good reliable income information. Many property owners and tenants tell us "It's none of your business!" Our office usually does get the information on a property in trouble.
4. What happens when the land only is owned by the landlord and a tenant would construct the improvements. The landlord does not receive any income from the improvements.

In closing the bill would be very, very difficult, if not impossible, to work with because of a lack of good income/expense information.

Thank you, for your time and attention.

*Scott D. Stromme, N.D.R.A.A., City Assessor*

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