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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>Jarvis 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. DROVDAL 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 is 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

