46th ANNUAL WICHITA PROGRAM APPRAISAL FOR AD VALOREM TAXATION
Of Communications, Energy and Transportation Companies

LEGAL UPDATE
Summary of Significant Cases 2015-16

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1. *AT&T Mobility LLC vs. Washington Department of Revenue,* **Washington Superior Court, Thurston County, September 18, 2015**

AT& T Mobility challenged a rule promulgated by the Washington Department of Revenue which limited the application of the state's exemption for intangible personal property. The relevant statute exempted all intangible personal property but the rule provided that the exemption applied only to property that could be "individually owned, used, transferred or held separately from other property." This is a limitation sometimes contained in definitions used by taxing agencies, and would eliminate such intangible assets as goodwill from eligibility for the exemption. The court held this limitation was not consistent with the broad grant of exemption -- that it defined only a subset of the eligible exempt property, and did not include intangibles that were intangible property but could not held separately from the other property (as with goodwill). AT&T Mobility also challenged provisions of the same rule stating that intangible personal property "should" not be measured "solely" by indirect techniques such as a residual approach or excess earnings methods, "to the extent possible." The court denied the request to strike that portion of the rule, reasoning that it only created a preference for using direct methods and only to the extent possible. The decision was not appealed by either party.

2. **Bureau of Indian Affairs Rule**

In 2013, the Ninth Circuit Court of Appeals held that a federal statute, 25 U.S.C. § 465, prohibited states and local governments from assessing taxes on permanent improvements on land held in trust for tribes by the federal government, even if the improvements are owned by non-tribal parties. *Confederated Tribes of the Chehalis Reservation, Thurston County Board of Equalization***,** 724 F.3d 1153 (2013). In 2016, the Bureau of Indian Affairs, finalized rules consistent with that case that included the following:

25 CFR 169.11 What taxes apply to rights-of-way approved under this part?

(a) Subject only to applicable Federal law:

(1) Permanent improvements in a right-of-way, <u>without regard to ownership of those improvements,</u> are not subject to any fee, <u>tax, assessment, levy, or other charge imposed by any State or political subdivision of a State</u> (emphasis added);

(2) Activities under a right-of-way grant are not subject to any fee, tax, assessment, levy, or other charge (*e.g.,* business use, privilege, public utility, excise, gross revenue taxes) imposed by any State or political subdivision of a State; and

(3) The right-of-way interest is not subject to any fee, tax, assessment, levy, or other charge imposed by any State or political subdivision of a State.

(b) Improvements, activities, and right-of-way interests may be subject to taxation by the Indian tribe with jurisdiction.

It appears that most states are implementing this rule, although it is not uniform. Washington has done so; the Oregon legislature enacted a statute that exempts such property unless owned by centrally assessed taxpayers. The rule, in combination with the statute and at least the *Chehalis* decision, logically would prevent state or local taxation of transmission lines, pipelines, railroad tracks, and, of course, casinos.

3. City of Seattle v. Department of Revenue, 357 Or. 718, 357 P. 3d 979 (2015)

The Taxpayers in this case were three municipal corporations located in Washington State, but which owned an interest in electrical transmission capacity over the Northwest's federally-administered power transmission grid, much of which is located in Oregon. The issue in the case was whether the Taxpayers' interest in that electrical transmission capacity could be taxed by the Oregon Department of Revenue as a property interest "held" by Taxpayers.

The Taxpayers, as part of their municipal functions, generated and sold electricity to local consumers, and also bought and sold electricity on a wholesale basis throughout the western United States. The Taxpayers relied on a system of power lines and substations stretching from the State of Washington to Southern California (the "Intertie"). The Taxpayers at issue had a "life-of-the-facility right to use" a specific portion of the system's excess transmission facility, as well as exclusive use of their respective megawatt shares of Intertie capacity, the option to purchase additional capacity, and, with the owner's consent, the right to sell their capacity rights.

The Court, citing its previous decisions in *Power Resources Cooperative v. Dept. of Rev*., 330 Or. 24, 996 P. 2d 969 (2000) and *PacifiCorp Power Marketing v. Dept. of Rev*., 340 Or. 204, 131 P. 3d 725 (2006), noted that there are two alternative bases for taxing facilities in Oregon that are used to generate and/or transmit electricity—either a taxpayer's possessory interest or the taxpayer's use. The Taxpayers argued that the Power Resources case had been wrongly decided, and that the rights at issue vested Taxpayers only with Scheduling Rights. Consequently, the Taxpayers asserted that their contracts were simply transmission agreements and that that limited degree of use was inconsistent with any kind of possessory interest.

The Oregon Supreme Court declined to overrule its prior decision in Power Resources, and held that the features of exclusivity and control of transmission capacity evidenced in the Taxpayer's agreements—the rights to assign their capacity rights, to engage in certain capacity transfers with other capacity owners and to sell their capacity rights outright—established the taxability of the Taxpayer's shares in the Intertie under the Power Resources doctrine.

4. *City of Valdez v. State of Alaska and North Slope Borough and Fairbanks North Star Borough, ____ P.2d ____ (Alas. Sup. Ct. April 29, 2016)*

This case involved matters of procedure: a Department of Revenue regulation provided that the State Tax Assessment Review Board's (STARB) jurisdiction was limited to valuation matters, and that matters affecting other issues of "taxability" (such as classification as "oil and gas property") were the province of the Department. The statute provided that the STARB's jurisdiction applied to "assessments" of oil and gas property.

The court started out by refusing to give deference to the Department's expertise in adopting the rule. While deference is normally given to rulemaking within the expertise of an agency, this rule did not cover matters of valuation or taxation but instead dealt with administrative procedure, and the agency was no more an expert in that area than the courts. On the substance of rule, the court noted that the term "assessment" means more than valuing property, but also includes the initial identification of the property for taxation. The rule was also not consistent with the legislative history of the statute governing appeals of "assessments," or with the purpose of the appeal statute, which was to compress the time line for assessment appeals. A separate appeal of "taxability" to the Department could take years. The court struck the rule as beyond the scope of the statute.

5. ETC Marketing, Ltd. v. Harris County Appraisal District, 476 S.W. 3d 501 (2015) (Texas Court of Appeals)

The Taxpayer is a natural gas marketer, which buys, sells, and markets natural gas. ETC has an affiliate, Houston Pipeline, which operates an intrastate natural gas pipeline. Houston Pipeline owns and stores natural gas in a reservoir in Harris County. When ETC Marketing purchases natural gas, it is immediately entrusted to Houston Pipeline and stored in its reservoir, ultimately for transportation to purchasers throughout the pipeline system. The natural gas within the reservoir owned by various marketers is physically commingled, and gas destined for sale in Texas is physically comingled with gas destined for sale in interstate commerce. The natural gas that any particular marketer offers for sale is not separately identifiable. The Taxpayer took the position that all of its gas stored in the reservoir was for interstate commerce, because its business plan was to sell all of the gas to out-of-state customers. There was, however, no legal requirement that the gas be sold only in interstate commerce. The case was decided by the Court on the issue of whether the gas was entirely exempt from taxation because it was in interstate commerce. The Court concluded that even if the stored gas was in interstate commerce, the Taxpayer had presented no compelling legal argument that the gas was immune from local taxation.

The Court analyzed the case under the Commerce Clause to the United States Constitution, which grants to Congress the sole power to regular interstate commerce. The Commerce Clause has been interpreted by the United States Supreme Court to include a "dormant" commerce clause, an implicit prohibition on a state's imposition of discriminatory burdens on interstate commerce. Analyzing the case under the test annunciated by the U.S. Supreme Court in Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977), the Court of Appeals of Texas ruled that all four prongs of that test were met, and that the taxation of the stored gas was constitutionally permissible.

First, the Court ruled that there was a substantial nexus to the taxing state in that the Taxpayer had offices and employees in Harris County and elsewhere in the State of Texas, and the natural gas at issue was purchased in Texas and was stored up to several months at a time in the reservoir. Secondly, the Court ruled that the tax was fairly apportioned. The Court focused on the fact that the relevant provisions of the Texas statute impose taxes on tangible personal property that is located in a taxing district on the date of valuation "for longer than a temporary period." There was nothing in the record indicating that the Taxpayer attempted to store its gas in two different states at the same time, and thus its value could not be taxed by another jurisdiction at the same time. The tax reflected the in-state component of the storage of the entire volume of gas and was therefore externally consistent. Thirdly, the Court ruled that there was no discrimination against interstate commerce in that the tax placed no greater burden upon interstate commerce than the state places upon competing intrastate commerce. The Taxpayer was taxed only on that quantity of gas stored in Harris County on the date of taxation and as to which the Taxpayer had acknowledged its ownership. Finally, the Court ruled that there was a fair relationship between the services provided to the Taxpayer on account of its activities. It owned the gas while it was stored at the reservoir and it enjoyed the benefit of public services which facilitate gas storage, which in turn allowed it to accomplish its business objective.

There was a strong dissent in the decision, and this decision has been appealed to the Supreme Court of Texas.

6. Galveston Central Appraisal District v. Valero Refining – Texas L.P., 463 S.W. 3d 177 (2015) (Texas Court of Appeals)

The Taxpayer filed a petition for review of its 2011 property taxes claiming that the Galveston Central Appraisal District had appraised its property unequally and that the refinery's appraised value should be reduced to its "equal and uniform value." The jury found that some portions of the refinery had been unequally appraised, and refunds were ordered. The Appraisal District appealed.

The Appraisal District had assigned numerous separate account numbers to component parts of the refinery. In its petition Valero alleged that for five of the counts, the values were appraised in a manner that was neither equal nor uniform. The Taxpayer took the position at trial that the disputed portion of its refinery were comparable to similar portions of two other refineries, and that when the appraised values of those portions of the "comparable" refineries were appropriately adjusted, the median of the adjusted values was less than the appraised values of the equivalent portions of the Taxpayer's refinery. There was substantial testimony at trial as to the differences among the three refineries, and the appropriate adjustments to be made. The Taxpayer presented expert testimony to the effect that parts of the Taxpayer's refinery had been assessed at a higher value than the other two comparable properties; however, in arriving at at their opinion the experts excluded from their analysis pollution control equipment that was present at all three refineries. These exclusions were made notwithstanding the fact that pollution control equipment was part of each refinery, would be included in a market value appraisal, and would be included in a sale of the facility. The Appraisal District's witness opined that an "equal-and-uniform" appraisal calculation for a refinery must include the pollution control equipment because it is an integral part of the overall refinery, which cannot operate without the equipment.

The appellate court reversed the decision of the trial court and remanded the case for a new trial, on the grounds that the Taxpayer's experts' equal-and-uniform analysis was merely conclusory because they offered no explanation for excluding the pollution control equipment from their analysis other than that the Taxpayer had told them to do so.

The Appraisal District also challenged the sufficiency of the evidence regarding the comparability of one of the refineries used in the equal and uniform analysis. The Court ruled that such a challenge failed because there was "more than a scintilla of evidence" that the refineries were sufficiently comparable. The Court noted that any differences pointed out by the Assessment District could be accounted for through a properly conducted adjustment process.

7. *Genon Mid-Atlantic, LLC v. State Dept. of Assessments & Taxation*, 2015 WL 9875283 (Md. Tax 2015)

This case involved 2009 and 2010 personal property assessments on property owned by a non-regulated coal plant. The Taxpayer's position was that its coal plant was at a competitive disadvantage as it was much less efficient than both other coal plants and natural gas plants. The Taxpayer contended that buyers and sellers valuing generating facilities would have used the plant's future potential earnings to determine an appropriate purchase price. In addition, the expert witnesses for the Taxpayer contended that the purchase price would have been impacted by various market factors, including the decline of natural gas prices, environmental uncertainties, and the fact that coal plants were becoming obsolete; as a result, coal plants were not being sold and new coal plants were not being planned. As stated by the Tax Court, the underlying premise of the Taxpayer's case was that these alleged fundamental changes negatively impacted the plant's future potential earnings.

The Taxpayer presented a replacement cost study replacing the coal plant with a gas plant rather than a coal-fired plant. The Court disagreed that a gas plant replacement represented the highest and best use, and found that the Taxpayer's approach would require the plant to be valued at something other than its highest and best use. The Court stated that there was simply no credible evidence that the plant should or would be retired. The Taxpayer had invested hundreds of millions of dollars in the plant for pollution control equipment, which made it more valuable than non-compliant coal plants.

With respect to the income approach taken by the Taxpayer's appraiser, the Court disagreed with the deduction of unfavorable lease payments, solely from the standpoint of a lessee. The Court also found that the Taxpayer's appraiser adopted questionable revenue and fuel cost projections, which were not based on the projections made internally by the Taxpayer. He also failed to use the independent goodwill impairment studies done specifically for the plant by its outside accountant and incorporated into the company's 10Ks. Ultimately, his projections used consistently lower revenue than what the company had projected at the relevant times.

The Court also found that the CAPEX deductions in the DCF approach significantly reduced net cash flow, and that the appraiser did not capture revenue that would have been available because of these expenditures.

The Court found that a 5% risk factor which was added to the overall discount rate was not supported by the evidence.

In reviewing the taxing jurisdiction's evidence, the Court found that statutory law and regulations both require original cost less depreciation to be used, and that the state's witness had properly determined that the highest and best use of the subject property was a continuation of the existing coal-fired generation plant. The Court also credited the witness's income approach based on income and expenses as provided by the Taxpayer, her cost approach based on publicly reported construction costs of five new plants fueled by coal, and her market approach that relied on sales of coal-fired plants. The Court agreed with the witness's criticism of the Taxpayer's appraisal, finding that there was no convincing evidence to replace a coal plant with a gas plant in the cost approach where there was nothing obsolete about the plant's coal technology.

8. Hewlett-Packard Co. v. Benton County Assessor, et al., 357 Or. 598, 356 P. 3d 70 (2015)

The real estate at issue in this case was the Taxpayer's 178-acre manufacturing and research campus. The property was built as a single-purpose, owner-occupied facility. The issue before the Oregon Supreme Court was whether the Tax Court properly applied administrative rules governing property tax appraisal; in particular, the relationship between the terms "highest and best use" and "value of the loss," as those terms are defined in the Department of Revenue's administrative rules. As defined in those rules, a property's highest and best use is the most profitable use that a potential owner could make of the property. The value of the loss measures the negative value created by components of the property that prevent it from cost-effectively serving its highest and best use.

The Tax Court had held that of the numerous buildings on the campus, a potential owner would anticipate using only certain "core" buildings and would not anticipate using the "non-core" buildings. As a result, the non-core buildings were components of the property that prevented it from cost-effectively serving its highest and best use. The Tax Court therefore computed the value of the loss by calculating additional operating expenses that an owner would incur while operating the subject property—which has both the core and non-core space—as compared to the operating expenses that an owner would incur while operating a cost-effective version of the property consisting of only the core space.

The Department of Revenue had argued that the Tax Court should have calculated the value of the loss as if a potential owner would convert the non-core space into marketable rental space, which, according to the Department, would result in more value than leaving the non-core space vacant. The Supreme Court of Oregon rejected the Department's argument, stating that the argument presumes that the most valuable use of the non-core buildings is as marketable rental space, and that presumption is inconsistent with the Tax Court's analysis of the highest and best use of the property. The Department did not challenge the Tax Court's highest-and-best-use conclusion that the highest and best use of the property was as a single-tenant, owner-occupied research and manufacturing facility. As a result, the Supreme Court assumed that the highest and best use of the non-core buildings was to leave them unaltered, rather than to convert them to marketable space. The Taxpayer's expert had testified that converting the non-core space into income-generating rental property would result in a net loss, and that such a conversion was not financial feasible.

The Supreme Court held that the Taxpayer's expert, and therefore the Tax Court, properly applied the Department's rule defining "value of the loss," which is generally the present value of excess operating cost that an owner will incur as a result of inefficiencies in the property that prevent the property from cost-effectively serving its highest and best use. Under the Department's regulations, the value of the loss is a component of the depreciation analysis within the cost approach to value. In this case, the Taxpayer's expert determined that the property had a superadequacy—namely, the non-core space. Because the expert started with replacement cost, the Department's rules required a deduction using one of two potential methods for calculating the market loss: the cost to cure or the value of the loss. In this case the cost to cure would have been the cost to eliminate the non-core space and allow the property to operate in the same manner as replacement property, consisting solely of the core space. Between those two methods, the appraiser uses whichever method results in the smaller deduction. In this case, the Department conceded that the value of the loss was less than the cost to cure. The Court, noting that the Tax Court's finding of highest and best use had not been challenged, could not accept the Department's argument that a potential owner of the property would use it as a mixed-use manufacturing/rental property. Therefore, on the record before the Court, it ruled on the "narrow legal issue raised" that the Tax Court properly calculated the value of the loss.

9. Siete Solar, LLC v. Arizona Department of Revenue, 2015 WL 862672 (Ariz. Ct. App. Dec. 10, 2015)

This case concerned the formula method used in Arizona for valuation of commercial property. The formula provided that assessments of renewable energy property were to be determined by 20% of "depreciated cost of the equipment." The taxpayer argued that the term "cost" should be interpreted to mean the net cost after tax credits or cash grants that are common for wind and solar investments. It also argued that when the statute was amended to make that clear, the amendment should be seen to have clarified the intent of the previous statute, not to change it.

The court held (surprisingly) that the term "cost" was unambiguous and referred to the original out-of-pocket cost not reduced by the grants or credits. The court found it relevant that the grants or credits were not in effect when the statute was enacted. And the court held that because 14 years had elapsed from the time the statute was enacted originally to the time it was amended to allow for the credits and grants, it could not be seen as a clarification of the pre-existing statute but was a change that would not be applied retroactively.

10. Sprint Telephony PCS, L.P. v. State Board of Equalization, 238 Cal. App. 4th 871 (2015) (Court of Appeals)

This case dealt with a procedural issue regarding the assessment and refund procedure applicable to certain state-assessed property owned by entities that typically hold property in multiple counties. Under California procedure, such entities must first file a petition for reassessment against the state Board of Equalization. If the Board grants a reassessment petition by reducing the property's assessed value, it enters the revised valuation on the tax roll for the fiscal year in which the determination is made or for the following fiscal year. A taxpayer then files an action seeking a refund on taxes they paid on property assessed by the Board of Equalization. The statutes provide that for a telephone company to file such a judicial tax refund action, it must first file a petition for reassessment with the Board stating in the petition that the petition is intended to serve as a claim for a refund. In this case the Taxpayer filed a petition for reassessment but did not "check-the-box" indicating that the petition was also intended to serve as a claim for a refund.

The Court held that although requiring a telephone company to state in its reassessment petition that it is claiming a refund as a prerequisite for filing a judicial tax refund action serves only limited practical purposes, the requirement is plain and compulsory. The Court affirmed the trial court's dismissal of the Taxpayer's action for a refund.

11. ***State of Alaska v. BP Pipelines (Alaska) Inc., 354 P.3d 1053 (2015).***

This case is the latest and perhaps final (for a while) case to decide disputes over the value of the Trans-Alaska pipeline. This case concerned the 2007-2009 tax years. The court had ruled on similar issues for the 2006 tax year. 325 P.2d 478 (Alaska 2014) (*BP Pipelines I).* Its holding here was similar to *BP Pipelines I,* and included the following:

- The range of values between the parties was very wide. The taxpayers asserted the values should be around $1 billion for each year, while the municipalities contended the values were around $14 billion. The Department had valued the property at $4.578 billion for 2007, $7.166 billion for 2008 and $7.715 billion for 2009. The Supreme Court upheld higher values determined by the trial court in a trial de novo (that lasted 9 weeks): $8.941 billion for 2007; $9.644 billion for 2008; and $9.249 billion for 2009.

- A key issue in both cases was the standard of value. The taxpayers contended the value should be determined by reference to fair market value -- the amount the pipeline be sold for independently of the rest of the integrated oil extraction and distribution system -- and that it should be valued consistent with tariff restrictions imposed by regulation. However, the Court again held that Alaska law applies a "use value" concept, focused on the value of the property to its current owner and based on its existing use. For similar reasons, it refused to find obsolescence because of regulatory constraints, because those regulations did not affect the owners in their current use. It criticized the income shortfall method, although that criticism was not necessary to its holding.

- The Court upheld a reduction in value because of minimum throughput limitations, essentially a form of functional obsolescence, and for low throughput compared to a higher capacity. The latter was based on economic obsolescence, not functional obsolescence/superadequacy, because the extra capacity was required by contract. On a technical point, the court agreed with the taxpayers that the adjustment could be applied (through a "scaling" technique) to all property, not just the pipeline itself.

- The Court also sided with the taxpayers on the issue of whether the excess capacity had value, because spikes in production were not anticipated in which such extra capacity could be utilized.

- The Court upheld the lower court's refusal to hold that the 2006 litigation controlled the outcome of the later years' valuations. It based this holding on the complexity of the litigation and the potential for changes in the relevant facts.

- On an interesting note subsequent to the decision, the parties agreed on a value of $8 billion to be applied through 2020, so this cycle of appeals will be paused until then.

12. ***Federal Energy Regulatory Commission Decision #544, 153 FERC 61233, 2015 WL 7442869 (FERC Nov. 20, 2015)***

This decision illustrates the imperfections in the rate-setting, regulatory process as a means of allowing utilities to include all expenses in the cost of service to be passed on to ratepayers.

One feature of this rate case was the request by the utility -- the same Trans Alaska Pipeline System discussed in the previous case summary -- to allow as part of its cost of service for setting rates the additional property taxes that were payable as a result of the 2006 decision that preceded the foregoing case. FERC denied the request. It held this was a one-time expense that is not recoverable in a rate-setting environment where the cost of service is meant to be forward-looking. The taxes were to be recovered from rates effective at the time they were assessed. The recovery was also not justified by the argument that this was an extraordinary event; FERC held that "the failure to accurately estimate taxes is not an extraordinary event."

13. Wheelabrator v. City of Bridgeport, 133 A.3d 402 (Connecticut Supreme Court, Feb. 2, 2016)

This case concerned the valuation of a waste-to-energy facility for three assessment years. The court started by reversing the holding of the trial court that the taxpayer lacked standing to appeal for two of the years because it was only a lessee of that property and, as lessee, it had failed to follow the required procedures for lessees to appeal property tax assessments.

The court next addressed the trial court's holding that a discounted cash flow method was improper. The trial court noted problems with the method, including the fact that it valued the entire business and not just the physical property, and also commented on the many assumptions that must be made, concluding that the method is an "exercise in financial haruspication." (The Supreme Court noted that a haruspex is "a diviner in ancient Rome basing his predictions on inspection of the entrails of sacrificial animals…..") The court considered the trial court's ruling as a ruling that the method was improper as a matter of <u>law</u> (not just for the facts of this case), and reversed, reasoning that

> … we can perceive no reason why those approaches should be categorically barred. Indeed, in the present case, expert witnesses for both sides, whom the trial court characterized as "experienced and knowledgeable," testified that the income approach, and, more specifically, the discounted cash flow approach, was the *best* method for valuing the property, because that is the method that market participants would use to determine the price that they would pay for the property.

The court also addressed the argument that one of the appraisers should not have been allowed to testify because he was not licensed in the state. The court held that might go to the weight to be given the expert's testimony, but did not affect its admissibility.