

# **EVOLUTION OF PROPERTY TAXES PATHWAY TO SUCCESS**

## **CURRENT ISSUES: VALUING TELECOMMUNICATION AND ELECTRIC UTILITY PROPERTIES**

Thursday, August 21, 2003

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# **CURRENT ISSUES: VALUING TELECOMMUNICATION AND ELECTRIC UTILITY PROPERTIES**

*Prepared by Richard N. Poole*

## **Introduction**

Before we can even address this question, we must limit the ambit of our inquiry given the innumerable methodologies in place for the valuation of telecommunication facilities and electric utility properties.

Historically treated as regulated industries, the various legislative bodies dealing with these entities within their jurisdictions applied innumerable approaches to levy property taxes. The concept of unit valuation was well entrenched in many of the United States of America. A primitive replacement cost approach developing values from historic manuals applied in many jurisdictions. In Ontario, specific legislative provisions governed the treatment of these entities.

Rarely were traditional concepts of market value utilized as the assessment base for these types of properties.

Much has changed over the past several years as Legislatures throughout North America have moved to deregulate these historically regulated industries. As a result, market forces have come to play an increasingly important role.

As the Legislatures have wrestled with the concept of deregulation, so have they been forced to consider the impact of deregulation and market forces upon the property assessment base.

The purpose of this paper is to discuss these issues limited to the concept of dealing with the determination of an appropriate property tax base for the assessment of these facilities were they to be assessed within a generally accepted market value regime.

## **Determination of Market Value**

In order to determine market value for any of these facilities, some basic principles with respect to what constitutes the market value must be established. Traditional definitions target the concept of determining the market value of land assessed as being the amount that the land might be expected to realize if sold in the open market by a willing seller to a willing buyer.

The actual wording of any such definition varies slightly statute by statute, but the basic premise of market value remains constant.

Generally, therefore, the tools utilized to derive an appropriate assessment are those well known within the appraisal industry and involve the three traditional approaches to value.

Coupled with the appraisal approach is the consideration of an arm's length transaction of the property being valued as being the best indication of market value for assessment purposes.<sup>1</sup>

In the absence of reliable market data, the alternative approaches to value have become acceptable.<sup>2</sup>

Of the alternative approaches to value, a hierarchy of importance appears to have been established including the market approach using comparable sales; the income approach; and the cost approach. Jurisprudence establishes a distinct preference toward approaches other than the cost approach as the preferred method of valuing property.<sup>3</sup>

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<sup>1</sup> *Montreal v. Sun Life Assurance Co. of Canada*, [1952] 2 D.L.R. 81; *W. T. Grant Co. v. Srogi*, 52 N.Y. 2d 496, 438 N.Y.S. 2d 761 (1981)

<sup>2</sup> *G.R.F., Inc. v. Board of Assessors*, 41 N.Y. 2d 512, 393 N.Y.S. 2d 965 (1977); *Assessment Commissioner of the York Assessment Office v. Office Specialty Ltd. et al.* (1974), 49 D.L.R. (3d) 471

<sup>3</sup> *G.R.F., Inc. v. Board of Assessors*, supra; *Merrick Holding Corp. v. Board of Assessors*, 45 N.Y. 2d 538, 410 N.Y.S. 2d 565 (1978); *Allied Corp. v. Town of Camillus*, 80 N.Y. 2d 351, 590 N.Y.S. 2d 417 (1992)

It is often said that the cost approach to be utilized to determine market value for assessment purposes is usually the method of last resort to be used only in special circumstances directly related to the uniqueness of the structure being assessed and the general inability of converting the structure to other uses without the expenditure of great sums of money.<sup>4</sup>

As regulated industries, the preference to consider the utilization of the cost approach to value telecommunication facilities and electric utility properties was overwhelming, even in jurisdictions in which market value would have needed to be determined.

Because of the impact of deregulation and the availability of sales data arising from transactions particularly with respect to electric utility properties, the blind application of the cost approach must be reconsidered in establishing the appropriate assessment for these facilities.

### **The Relevance of Sales Data**

The need to determine market value in valuing telecommunications and electric utility properties immediately gives rise to a consideration of whether an actual sale of any such facility should be determinative of the market value for assessment purposes.

In considering the validity of such a transaction, it is important to determine whether within the jurisdiction which is subject to review the classification of assessable property is limited to real property. Certain jurisdictions establish the principle that intangible property is not subject to property assessment and taxation.

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<sup>4</sup> *Assessment Commissioner of the York Assessment Office v. Office Specialty Ltd. et al.*, supra; *People ex rel New York Stock Exchange Bldg. Co. v. Cantor*, 221 A.D. 193, 223 N.Y.S. 64 (1<sup>ST</sup> Dep't 1927), aff'd 248 N.Y. 533 (1928); *Lilco v. Assessor, Town of Brookhaven*, 202 A.D. 2d 32, 606 N.Y.S. 2d 598 (1985)

In those circumstances, the sale of an operating generating facility is the sale of an ongoing business requiring deductions from the sale price to be made to determine an assessable value.

California is one such jurisdiction.

Intangible assets may not be taxed under California law:

*Intangible assets and rights are exempt from taxation and...the value of intangible assets and rights shall not enhance or be reflected in the value of taxable real property.*<sup>5</sup>

In such circumstances, therefore, intangible assets and rights included in a sale price must be deducted for purposes of establishing an assessable value.

The issue is not as clear cut even as the statement suggests given that the jurisprudence suggests as well that in valuing tangible property, it may be appropriate to assume the presence of intangible assets or rights that might be necessary to put the property to beneficial or productive use provided that the value of the intangibles themselves are not included in the assessable value.<sup>6</sup>

These two concepts suggest that the taxable property shall be assessed only with respect to tangible assets, but that the presence of certain intangible assets or rights that might be necessary should not be deducted from the value of that tangible property.

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<sup>5</sup> *GTE Sprint Communications Corp. v. County of Alameda*, (1994) 26 Cal.App. 4<sup>th</sup> 992

<sup>6</sup> *GTE Sprint Communications Corp. v. County of Alameda*, supra, at page 1007

What does this mean for purposes of valuing electric utility properties? It is suggested that in order to value the generating power facility it must be assumed that as a going concern all the necessary intangibles are in place to allow the facility to be utilized for the purpose for which it was constructed but that the value of those intangibles themselves must be deducted from the resulting value.<sup>7</sup>

In circumstances, therefore, in which there has been a sale, the validity of the sale by reference to traditional tests must be undertaken. Thereafter, appropriate deductions must be made for those aspects of the sale price reflecting value beyond the tangible property should be subject to the assessment.

The identification of intangibles and the calculation of value attributed to them becomes the important task.<sup>8</sup>

In *County of Los Angeles et al. v. Edison International et al.*, supra, this issue was squarely addressed by the Superior Court of the State of California.

At issue was the payment of documentary transfer tax as a result of the sale of two gas-fired power plants.

The calculation of the tax due was in contestation having regard to the relationship of the purchase price of the facilities to the required statutory determination of the value of those facilities.

The legislative framework mirrored the requirements for determination of market value for real property taxation purposes.

In the face of the actual sale of these facilities, the court was faced with the identification of intangible assets included in the sale as well as the calculation of values that would flow from those intangible assets as a deduction in the sale price.

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<sup>7</sup> *Shubat v. Sutter County Assessment Appeals Bd.*, (1993) 13 Cal.App. 4<sup>th</sup> 794

<sup>8</sup> *County of Los Angeles, City of Long Beach and City of Redondo Beach v. Edison International et al.* (Superior Court of the State of California for the County of Los Angeles, March 22, 2002, as yet unreported)

The court determined that the purchaser was acquiring an ongoing business. The purchase was not simply of realty but of the ongoing business. It was contemplated by the asset sale agreement that the purchaser would operate the plants immediately.

The intangible assets identified as part of the business as a going concern included such items as in place work force, going concern value, and good will as enhancements to the value of the business and not the value of its real property.<sup>9</sup>

The court also considered the value of a Arapid market entry premium<sup>®</sup> as an intangible asset based on the entry barriers that exist in the energy production market.

Favourable financing was considered as an intangible asset.

Emission credits which could be said to be a right to pollute were considered an intangible asset.

A work force in place was considered an intangible asset.

The court concluded that intangibles must be valued and removed to obtain fair market value of the taxable property. Faced with the difficulty of analyzing and categorizing these intangibles, it defaulted to the cost approach even in the face of the arm's length transactions.

The residual valuation utilizing the cost approach avoided the need to value intangibles which the court had determined were included in the sale.<sup>10</sup>

The analysis of this jurisprudence indicates the difficulties surrounding the valuation of these facilities. Even by defaulting to the cost approach, additional issues remain.

### **Application of Cost Approach**

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<sup>9</sup> *County of Orange v. Orange County Assessment Board*, (1993) 13 Cal.App.4th 524

<sup>10</sup> *County of Los Angeles et al. v. Edison International et al.*, supra, at page 25

Given the uniqueness of the facilities which would need to be valued as a power plant, generally accepted cost valuations are subject to specific adjustment for the type of property being considered. These adjustments would require specificity both with respect to the item being valued and the location of the facilities. In circumstances in which the general construction market is more expensive than national averages, the calculation of an appropriate adjustment for the building of the unique facilities can become an issue.<sup>11</sup>

Similarly, site development costs need to be specifically scrutinized. Market data by which the site development can be ascertained for unique facilities is often lacking. In jurisdictions in which incentives are given for industrial development, underlying real estate values bear little relationship to the true value of the development site. In addition, unique requirements from a regulatory perspective may well impact significantly upon the development site value.

This is particularly true given the relationship of the development site value to the value as a going concern otherwise described. If it is assumed that the site development value as a going concern is to some extent an intangible value, then the consideration of the basic site development cost must in some way be linked to a calculation of that value.

The application of generic market data to the valuation of the specific site of the electric utility facility might be an answer to consideration of the appropriate real estate value for property tax purposes. This value would be somewhat less than a value specifically ascertained for the electric power facility including regulatory requirements otherwise not generally necessary within the industrial sector.

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<sup>11</sup> *County of Los Angeles et al. v. Edison International et al.*, supra, at page 18

Similar analysis is required to determine the value of permits for the development of any such facilities. Once again, the relationship of permit value to the value as a going concern may be somewhat divorced from the real estate value necessary to be ascertained for assessment purposes. On the other hand, permits and licenses which tend to run with the land<sup>12</sup> have often been considered as appropriate to be included in the value of real estate as identified.<sup>12</sup>

In any event, the cost of permits must be linked to generally accepted permit costs as opposed to those which might be site specific having regard to the regulatory requirements for electric utility facilities.

In determining a replacement cost value, reference must also be made to the value of emission credits that often flow from historical operations of these facilities. Emission credits of themselves could be said to be non-taxable intangible assets.<sup>13</sup> On the other hand, a power plant needs to meet environmental requirements, and therefore in establishing a replacement cost model, the issue of the additional costs associated with emission environmental requirements must be balanced against the value of emission credits in place at an electric utility facility as a going concern.

Either emission credits bear some value to the real property or, alternatively, in valuing the real property additional modelling might be required to establish the facilities as might be necessary to replace emission credits which exist at the subject facility.

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<sup>12</sup> *Re Restfulcare Inc. and Regional Assessment Commissioner, Region No. 23 et al.* (1986), 53 O.R. (2d) 673 (C.A.)

<sup>13</sup> *County of Los Angeles et al. v. Edison International et al.*, supra, at page 30

The target of any replacement cost valuation is to establish a model replacement facility measuring the costs associated with that replacement facility as opposed to consideration of the reproduction cost of the existing facility. For that purpose, comparative data might be required modelling the facility being valued to a recently developed replacement facility. In the absence of any such facility, subjective elements must be brought to bear by which components of the valued facility are established by reference to current development costs and super imposed upon the subject property.<sup>14</sup>

Dealing with such unique properties, it is important that we do not lose sight of the underlying goal of establishing the market value of the real property.

Of significant difficulty given that task is the measurement of depreciation and functional and economic obsolescence inherent in any existing facility. Some measure of the obsolescence can be established by reference to the replacement model from which the replacement cost might have been calculated. Additional reference to market conditions is necessary to establish the viability of the facility independent of a sale price directed to intangible values.

The measurement of depreciation both for chronological depreciation and economic and functional obsolescence becomes an exercise in itself. The measurement of the remaining economic life is linked so closely to economic forces recently unleashed by deregulation that a subjective analysis of that aspect of any valuation is the best tool available.

In the end, it is clear that with deregulation and the need now to give greater consideration to market value concepts, the task of valuing these facilities for property tax purposes becomes more daunting.

### **Conclusion**

The complexity of the valuation process necessary to establish the assessed value of these facilities puts into question some of the historic principles for the valuation of real estate for assessment purposes.

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<sup>14</sup> *Inland Steel Co. v. State Board of Tax Commissioners*, 739 N.E. 2d 201 (2000)

It has often been said that a recent sale of the property to be assessed and/or of comparable property is the most accurate way of arriving at market value for assessment purposes.<sup>15</sup> On the other hand, inclusion of such sales of commercial/industrial properties of non-real estate elements as described calls into question that fundamental statement. It must now be said that an arm's length sale of a particular property can only be said to be a starting point in appraising the property for property tax purposes.<sup>16</sup>

It cannot be said, however, in our view, that default to cost is the simple solution.

Cost is generally the method of last resort to be used only in special circumstances directly related to the uniqueness of the structures being valued. In the face of an arm's length market transaction, additional questions must be asked before that default to cost becomes the basis upon which properties can be valued.

Over time, the development of appropriate expert evidence categorizing sales of these facilities and extracting from sale prices intangible values not related to the real estate will give rise to the greater utilization of this approach, properly analyzed, as the starting point for determining the market value of these facilities.

The concepts addressed by the court in *County of Los Angeles et al. v. Edison International et al.*, supra, juxtapose the recent sale of those properties with the utilization of the cost approach as the basis of determining market value. In defaulting to cost, the court expressed concern as to the valuation principles required to establish the value of intangible assets to be deducted from the sale. The development of appropriate appraisal and assessment principles calculating these values should give rise to an alternative valuation procedure than that of the cost approach. Such a development can only assist in the determination of the correct assessed value by permitting the reconciliation of approaches one with the other to obtain fair and equitable assessments.

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<sup>15</sup> *Montreal v. Sun Life Assurance Co. of Canada*, supra; *W. T. Grant Co. v. Srogi*, supra

<sup>16</sup> *Guild Wineries v. Distilleries v. County of Fresno*, (1975) 51 Cal.App. 3d 182