Montana Department of Revenue

Dan Bucks
Director

Brian Schweitzer
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MEMORANDUM

To: Revenue and Transportation Interim Committee (RTIC)

From: Dan Bucks, Director of Revenue

Date: February 16, 2012

Subject: Responses to December 9, 2011 Public Comment on Centrally Assessed Property

During the December 9, 2011 Revenue and Transportation Interim Committee, members of the public made some comments that require clarification.

Attorney Commenting at Request of Montana Taxpayers Association
First, an attorney—who noted that he had litigated tax cases against the department and had been asked by the Montana Taxpayer's Association to comment—stated that the department's direct capitalization rate is inherently flawed. The attorney concluded that the department's direct capitalization rate violated basic principles of finance because the department's cost of equity wasn't 300-600 basis points higher than the cost of debt. The attorney concluded that this was impossible, and, on that basis, he criticized the department's valuations. Unfortunately for the committee, the attorney confused fundamental financial analysis concepts and in doing so, misrepresented that a direct capitalization rate is a cost of capitol. It is not. This attorney essentially picked the wrong number on which to base his arguments, and his error makes both his analysis and his conclusions about the department's centrally assessed valuations incorrect.

A direct capitalization ratio is not the cost of capital, but is simply a ratio between earnings and stock prices—derived on either a company or industry basis. This ratio is then applied to current income to determine market value. The ratio is a mathematical variable long used in financial analysis for estimating market value based on current earnings. Contrary to the attorney's statements, debt rates can be higher than equity rates in the direct capitalization calculation.

The attorney confused the direct capitalization rate with a different financial variable, the discount rate, which is used to estimate the present value of an anticipated future stream of income. When the discount rate is calculated for an equity investment, it will typically be higher than debt rates, because equity bears the unsecured risk that the anticipated future income may not arise.

The Montana courts and the State Tax Appeal Board (STAB) have upheld the department's use of financial analysis in its valuations in recent litigation. In its decision involving valuations of PacifiCorp for 2006 and 2007, STAB discussed the department's use of direct capitalization rates as follows:

> Last but not least, the DOR has long used this capitalization rate calculation. Until last year, Montana cases have never questioned whether the direct capitalization method, with a capitalization rate study, was a 'commonly accepted method or technique' though the method has been in use in Montana for many, many years. Because we know that approximately 130 companies are appraised by the central assessment bureau each year over a minimum of ten years, and no legal challenge has been brought before last year, we must conclude that there is some level of common acceptance of the methods and techniques used in the DOR valuation."

PacifiCorp v. DOR, STAB Decision, p. 50, January 13, 2011.

It is instructive that in the above-referenced case, the taxpayer did not dispute the department's debt rate or the publically available information sources the department relied upon when calculating its direct capitalization rate. Rather, STAB was asked to examine other components of the department's direct capitalization rate for a two-year (2006 and 2007) period. After doing so, STAB affirmed the use of price/earnings ratios and agreed that the comparable companies used by the department were appropriate. Thus, every aspect of the department's direct capitalization rate was either not disputed by the parties, or disputed and resolved in the department's favor. Interestingly, the equity rates and debt rates for those two years at issue in STAB's decision did not contain the variance the individual suggested was required: 5.74% (equity) vs. 6.48% (debt) [2006] and 6.50% (equity) vs. 5.80% (debt) [2007].

After this STAB decision, the Montana Supreme Court also affirmed the department's financial analysis methods using direct capitalization rates derived from price and earnings data in another *PacifiCorp* decision involving that company's 2005 values.

In addition, historically over the last 85 years, debt rates were higher than equity rates approximately 40% of the time, and in the last ten years, debt rates were higher thant equity rates 50% of the time.

The attorney's public comment on department's valuations was entirely inaccurate in terms of established financial analysis principles, actual historical evidence and Montana case law.

Representative of Verizon

The second commentary that requires clarification involves statements made by Verizon's representative. Verizon's representative stated: *"Yet in Montana litigation it is my understanding that no wireless service provider has ever been successful in proving intangible value over 15%."* This is simply an untrue statement. Cellco Partnership, doing business as Verizon Wireless, has received intangible personal property exemptions of 55.6% and 51.1% for tax years 2010 and 2011 respectively. We can only assume that when Verizon's representative stated that no wireless service provider had received more than a 15% intangible personal property exemption in Montana, he had not checked his own

company's property tax records that show that Verizon has received an exemption more than three times that amount in 2010 and 2011.

This representative also sought to counter the department's contention that our market valuation methods have yielded substantial stability in centrally assessed valuations over several years. He stated that since 2006 his company's taxes had doubled "two or three times" and that that did not represent stability in their Montana taxes. What this representative did not say is that any changes in Verizon's taxes were, in fact, the result of factors other than the department's methods of determining market value. Those factors were primarily:

1. The change in their legislatively established class rate from 3% to 6% when the department reclassified their property between 2006 and 2007 from business equipment (Class 8) to central assessment (Class 13)—a reclassification the company no longer disputes.
2. Once the property assessment reporting went from local reporting to central reporting both Verizon and the department werebetter able to accurately account for Verizon's property.

Verizon's tax rate under the law rose from 3% to 6% after the department reclassified wireless telecommunications into Class 13 in 2007 following a formal legal review and confirmation of that conclusion by the Legislative Audit Division staff. Verizon and others initially disputed this reclassification, but after a district court upheld the department's decision, these companies did not appeal to the Montana Supreme Court. So the classification issue is now settled law. The tax change arose not primarily because of the department's market valuation of Verizon's property, but was due more so to application of the Legislature's tax rates after a reclassification that the company no longer disputes.

When Verizon began to report as a centrally assessed property in 2007, the accuracy and reliability of its information improved which allowed the department to more accurately determine market value

The comments by Verizon's representative simply do not correspond to the actual facts. Verizon's intangible personal property exemption is more than three times the amount that he contended had never been attained by any wireless company in Montana. The changes in its taxes since 2006 are not due primarily to the department's market valuation practices, but instead to the Legislature's decisions in setting tax rates and improved reporting by the company.

Representative of AT&T
The representative from AT&T commented that while formulas may not be the best way to go from an appraisal perspective to arrive, formulas can get close to what he referred to as "market value." He proceeded then to describe a formula for telecommunications companies—replacement cost new less depreciation (RCNLD)—that would result in a value for the property of those companies that would be a small fraction of market value as historically defined by law and litigation in Montana. Further, the practical operation of the RCNLD formula would effectively place the control of appraisal values in the hands of the telecommunications companies contrary to the Montana Constitution which places the

determination of appraisal values with the State, not the taxpayer. These comments have to be understood in context. The value that AT&T's representative is advocating is very different from the market value defined in Montana statute and confirmed in Montana litigation. Montana law has long dictated unit values for the entire enterprise for very good reasons proved by both experience and litigation. RCNLD may or may not be an accurate indicator of market value. The reason multiple indicators of value are determined is to arrive at a market value that the appraiser believes is accurate. Limiting the market value to RCNLD would be contrary to Montana law.

Also limiting the market value determination to a RCNLD approach leads to significant differences in Montana values. No wireless telecommunications provider actually treats its land, improvements, network and equipment as a severable portion of its company. Accordingly, valuing those assets as if severable from the other assets of the company leads to wholly arbitrary or artificial values. Any tax result that a wireless telecommunications provider desires can be achieved within the bounds of those assumptions.

The fact that the RCNLD method may inherently allow a company to achieve whatever tax results it desires raises the fundamental question of who controls the tax appraisal. The Montana Constitution places the determination of appraisal values with the State, not the taxpayer to ensure that those appraisals are equitable and possess integrity by being established independently of the taxpayers. However, RCNLD is not a method that can actually be employed by state appraisers in practice unless they had access to huge appropriations from the Legislature. RCNLD information is controlled by the company through with its own inventory of an enormous number of property items with values assigned by the company itself. For the state to establish RCNLD values independently would be cost prohibitive and may even exceed the taxes generated by the property at greatly reduced values arbitrarily produced by the RCNLD method.

This goal of a taxpayer to control its own assessment contrary to the Montana Constitution is further reflected in the paper distributed to the committee by the AT&T representative. That paper was written by an attorney who represents AT&T in litigation with the department. The attorney states on page 3 in reference to the department's intangible property exemption rules, that "Indeed, its (the department's) rules and practices make it difficult for the taxpayers to deduct exempt property from the unit value." The attorney's error is that it is not for the taxpayer to determine the amount of the value of the intangible property deduction to be subtracted from the unit value. If that were true, taxpayers would deduct whatever they wished and would improperly seize control of the final appraisal of their own property. Under the law, that deduction is one step in the appraisal process which is conducted by the department. It is contrary to the Montana Constitution for the taxpayer to determine any amounts to be added or subtracted within the valuation process. That authority is reserved to the state and under law is exercised by the department in the interest of the equity and integrity of the property valuation for all Montana taxpayers.

Response to Representative of Montana Taxpayers Association

The representative of the Montana Taxpayers Association discussed issues of interstate competition for investment and interstate comparisons of property taxes. On the matter of investment, information that the department has prepared in response to a member of the Revenue and Transportation Interim Committee on centrally assessed companies from 2005

through 2011 indicates that new investment by these companies—even though calculated for only 22 of over 120 companies—has been very strong over this period. Indeed, as of 2011, at least 35% of the current installed investment by centrally assessed companies has been made since 2005. Further, the economic literature over decades on the effect of state and local taxes on the location of any type of investment among states is mixed at best. However, in the case of centrally assessed companies that involve infrastructure investment intended to provide services to consumer in state, tap natural resources within a state, or transport goods or services across a state, those investments are least likely to be affected by tax considerations.

With regard to interstate property tax comparisons, the differences between the Montana's property tax system and the diverse systems of other states make any accurate or meaningful comparison exceedingly difficult if not impossible. The department will comment further on the problems of interstate comparisons in its presentations concerning centrally assessed property at the Revenue and Transportation Interim Committee meeting on February 16, 2012.