



Delta Air Lines, Inc.
Corporate Taxes
Department 852
Post Office Box 45852
Atlanta, GA 30320-5852

May 17, 2021

Utah State Tax Commission
Office of the Commission
210 North 1950 West
Salt Lake City, Utah 84134

Re: Proposed Rule R884-24P-62

Dear Commissioners:

Delta Air Lines, Inc. (“Delta”) appreciates the opportunity to submit these comments to the Utah State Tax Commission’s (“Commission”) proposed changes to Utah Admin. Code R884-24P-62 (“Rule 62”). We respectfully request the Commission consider the following.

First, Delta notes that the Commission is not proposing changes to Subsection (6)(c)—the portion of Rule 62 addressing property specific considerations for airlines—notwithstanding the 2017 enactment of Utah Code Ann. § 59-2-201(4) regarding the valuation of aircraft. We understand the Commission may consider airline-specific changes in a subsequent rule-making procedure. In anticipation of potential, subsequent changes to Rule 62 as they relate to Utah Code Ann. § 59-2-201(4), Delta will limit its comments at this time and reserve the right to comment on subsequent proposed changes more specific to airlines.

Second, proposed Subsection (1)(g) defines “unitary property” to mean “operating property that is assessed by the Commission [~~pursuant to Section~~] in accordance with Subsections 59-2-201(a)(i) through (iii).” Recognizing that the substance of this definition exists in current Rule 62, Delta disagrees that this is an appropriate definition of “unitary property.” The term “unitary property” is not defined by statute, and Subsections 59-2-201(a)(i) through (iii) only describe what property is to be assessed by the Commission—not which of these properties are to be valued using a unitary method. Whether property operates as a unit and should be valued as such to reach fair market value is a question of fact. The appropriate unit of property to be valued should be based on the facts of the particular property, including a consideration of the unit that would most likely change hands in the marketplace.

Rule 62 could accomplish the stated purpose of specifying consistent unitary appraisal methodologies and identifying preferred methodologies without defining unitary property per se. To the extent the Commission defines unitary property by rule, Delta does not believe it should be defined by whether the property has been designated by the Legislature for assessment by the Commission. As originally promulgated, Rule 62 defined “property which operates as a unit” and “unitary property” to mean “property that is functionally or physically integrated in operation and construction and functions as an economic unit or ‘one thing.’” Even prior to the

promulgation of Rule 62, the Commission had proposed, in 1996, the promulgation of R884-24P-54 as follows:

R884-24P-54. Property Subject to a Unitary Appraisal Pursuant to Utah Code Ann. Section 59-2-201.

A. For purposes of Section 59-2-201(1)(a), "property which operates as a unit" means property that is functionally or physically integrated in operation and construction, and functions as an economic unit. Such property is typically bought or sold as a unit and includes the operating property of railroad corporations, telecommunication corporations (including local and long distance companies), cable television companies, cellular telephone companies and paging companies, gas pipeline corporations, oil or gas transportation companies, and electric corporations.

To Delta's knowledge, this proposed rule was never finalized, presumably because the Commission undertook the promulgation of Rule 62. Without necessarily commenting on prior definitions, Delta recommends the Commission reconsider the definition of "unitary property" in its proposed changes to Rule 62.

Third, proposed Subsection (3)(b)(ii) provides as follows: "Documentation shall be obtained to allow for the valuation of intangible property described in Subsection 59-2-102(19)(a), and the value of the intangible property deducted from the unit value based on its proportional contribution to the unit." Delta suggests the Commission address *what* documentation shall be obtained to allow for the valuation of intangible property.

Fourth, Delta believes that there may be some omitted language in the second clause. Should the words "shall be" be inserted before the phrase "deducted from the unit value," consistent with similar language in Subsection (3)(b)(i)?

Delta appreciates your consideration of these comments.

Sincerely,



Joel Hartman
Managing Director - Tax



State of Utah

SPENCER J. COX
Governor

DEIDRE M. HENDERSON
Lieutenant Governor

Utah State Tax Commission

JOHN L. VALENTINE
Commission Chair

MICHAEL J. CRAGUN
Commissioner

REBECCA L. ROCKWELL
Commissioner

LAWRENCE C. WALTERS
Commissioner

SCOTT W. SMITH
Executive Director

May 17, 2021

John L. Valentine
Michael J. Cragun
Rebecca L. Rockwell
Utah State Tax Commission
210 North 1950 West
Salt Lake City, UT 84134

Re: Property Tax Division's Supplemental Comments to Proposed Administrative Rule 62

Dear Commissioners:

The Division appreciates the great effort the Commission has made, particularly former Commissioner Larry Walters, to address concerns interested parties have expressed about Utah Administrative Code Rule R884-24P-62 ("Rule 62"). The Division recognizes that due to the inherently subjective, imperfect, and sometimes conflicting valuation methodologies available to appraisers, it will be impossible to craft a rule that satisfies the concerns of all the parties appearing before the Commission. Nevertheless, the Division believes Rule 62 has helped provide consistent guidelines to the Division and taxpayers and aid the Commission in meeting its Utah Constitutional mandate to ensure property is assessed both uniformly and at fair market value.

In these comments, the Division does not reargue points it has already made, but instead addresses additional changes or renewed requests by taxpayers. And the Division does not address all of those changes or requests. Where the Division does not address a specific item, it does not mean the Division agrees with the requested changes, instead it refers the Commission to the comments it submitted, both before and after the proposed rule was distributed.¹

Following are the Division's responses to certain arguments made at the Commission's May 14, 2021 rulemaking meeting and in the Utah Taxpayers Association's May 12, 2021 written comments.

¹ For purposes of the record in this rulemaking proceeding, the comments the Division presented prior to the formal publication of the current proposed rule are attached as Exhibit A.

Subsection 3(b) – Deduction of Intangible Value

(1) the last clause of the first paragraph.

“The value of intangible property exempt under Section 59-2-1101 shall be deducted from unit value, consistent with the methods used to derive the unit value.”

Industry is concerned that the last clause is “ambiguous and inconsistent with Utah law.”² The Division believes the opposite is true.³ Because the amount and level of intangible property can vary from one valuation methodology to another, it is absolutely critical that the methods to remove intangible property are consistent with the methods used to derive the unit value. The most straightforward example of a mismatch would be to use a valuation methodology that values and removes intangible property from the unit at full market value when the unit value already excludes intangible property value, such as when a cost approach is used for the unit value. Mismatches are not only relevant when cost approaches are used, but may be present any time the valuation methods used to value and remove intangible property are different from the valuation methods used to value the unit, even if income, cost, or market approaches are used in both situations. For example, Rule 62’s current preferred yield capitalization income approach has built in restrictions that result in a lower value than would be obtained using an unrestricted business enterprise valuation income approach. In other words, Rule 62’s yield capitalization approach does not include the full market value of intangible property.⁴ The Division believes it is a mismatch to deduct intangible property at a full market value from such a unit value. Inconsistent methods between the unit valuation and intangible property valuation could be manipulated to have a higher or lower deduction of intangible property than would result from the use of consistent valuation methods. The Division therefore believes this clause should remain in the rule.

(2) Subsections (3)(b)(i) and (ii).

Industry proposes deleting the provision in subsections (ii) and (iii) that capitalized and non-capitalized intangible property be removed from the unit “based on their [or its] contribution to the unit.” The Division requests this language be retained. The principle of unitary valuation states that the value of a component of property depends upon its contribution to the whole. Determining the value of a unit’s

² Utah Taxpayers Association May 12, 2021 comments, p.2, § 1.

³ The cited *Union Pacific* court decision reflects the facts and circumstances present in that case. The Division does not support the proposition that consistency in valuation methods can be disregarded without fact specific justification.

⁴ See current version of the Rule at subsection 4(b)(ii) noting that the direct capitalization income approach can “capture the value of intangible property at higher levels than other methods.”

component property by methods other than those used to value the unit, or removing the value prior to the unit valuation, creates the risk of mismatches in valuation similar to the example provided above.

(3) Subsection 5(b)(i)(B)(II)(Aa) – Retention of Preference for the CAPM Model.

Industry proposes deleting the language that retains a preference for using the CAPM cost of equity model.

While the Division acknowledges that no cost of equity model is perfect, it believes that CAPM should remain as the preferred model under Rule 62 because it is the most widely accepted and used model to estimate the cost of equity in theory and in practice. Removing a widely accepted model as the preferred model will significantly increase the potential for litigation.⁵

- The CAPM model is the default model used in finance.⁶
- The CAPM is the model relied upon by a vast majority of CFO's when computing their company's cost of equity.⁷
- Dr. Damodaran compared the CAPM model to other cost of equity models and concluded that "[u]ltimately, the survival of the capital asset pricing model as the default model for risk in the real-world applications is a testament to both its intuitive appeal and the failure of more complex models to deliver significant improvement in terms of estimating expected returns. We would argue that a judicious use of the CAPM...is still the most effective way of dealing with risk in valuation."⁸
- Dr. Damodaran also points out: "The risk and return model that has been in use the longest and is still the standard in most real-world analyses is the CAPM."⁹

(4) Subsection (5)(b)(i)(C)(I) – Retention of default to inflationary growth.

⁵ Under R884-24P-62(4)(b)(iii) "Preferred valuation methods as set forth in this rule are, unless otherwise stated, rebuttable presumptions..." So, contrary to the Utah Taxpayers Association's concerns (p. 4, § 7), identifying the CAPM as the preferred cost of equity model will not lead to unequal treatment of taxpayers or failure to reach fair market value since CAPM does not need to be used if a party can show by a preponderance of the evidence that another model establishes a more accurate estimate of fair market value. And having a preferred cost of equity model supports the Utah Constitution's uniformity requirement.

⁶ ASWATH DAMODARAN, DAMODARAN ON VALUATION 31-35 (2nd ed. 2006).

⁷ J.R. Graham & R. Campbell, *The theory and practice of corporate finance: Evidence from the field*, 60 JOURNAL OF FINANCIAL ECONOMICS 187, 187-243 (2001). M.T. Jacobs & A. Shivdasani, *Do You Know Your Cost of Capital?*, HARVARD BUSINESS REVIEW, July-August 2012, at 1-2. CURRENT TRENDS IN ESTIMATING AND APPLYING THE COST OF CAPITAL 1-3 (Association for Financial Professionals 2011).

⁸ DAMODARAN, A., DAMODARAN ON VALUATION 35 (2nd ed. 2006).

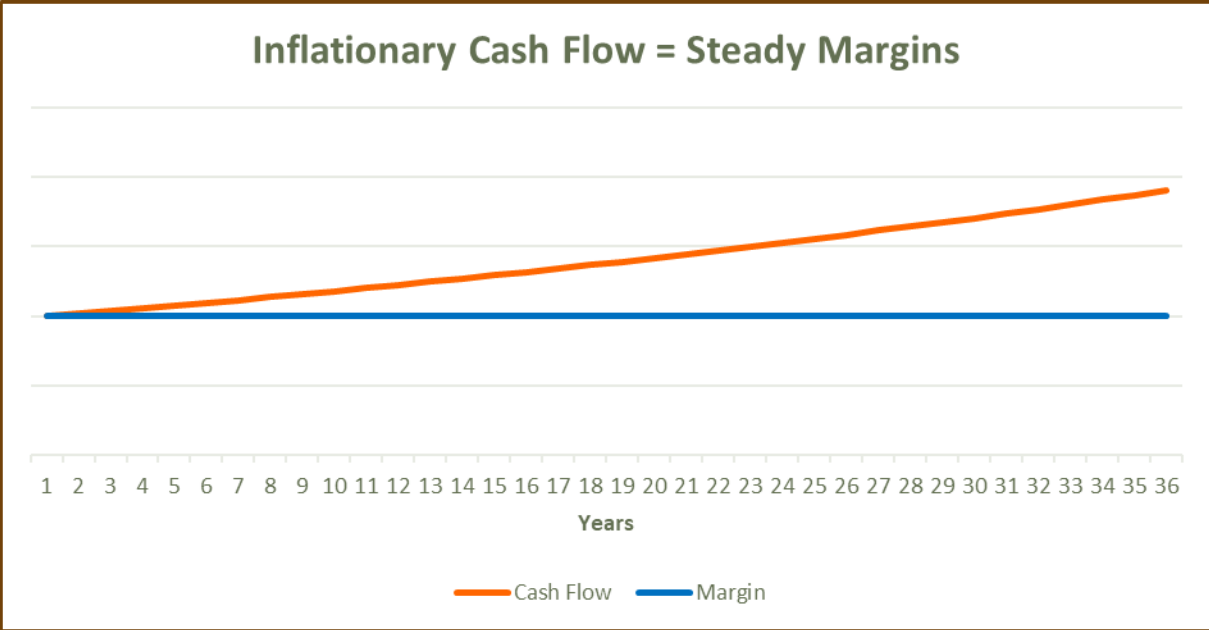
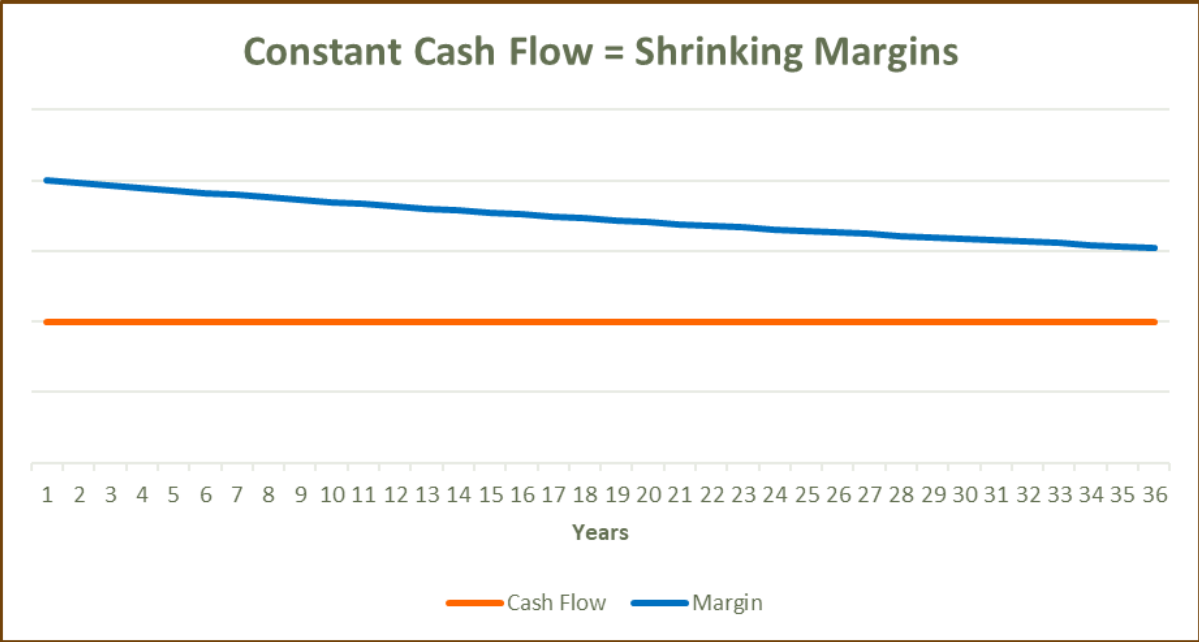
⁹ ASWATH DAMODARAN, APPLIED CORPORATE FINANCE 67, 75 (4th ed. 2015).

Industry asks the Commission to delete the provision preferring a specified expected long-term growth rate if there is insufficient information to determine a better growth rate. This appears to be an attempt to eliminate the use of a positive growth rate in the yield capitalization model or to use growth rates lower than the expected inflation rate. But Rule 62's directive to default to inflationary growth if another rate cannot be reasonably estimated is theoretically sound.

- It is reasonable to expect that cash flows over the long-term will at least “keep up with inflation” allowing the company to maintain its buying power. If this were not the case, eventually an operator's margins would erode, diminishing shareholders' value and leading to bankruptcy and eventually closure.
- While a group of assets operating as a going concern may experience short-term periods of higher or lower growth than inflation (even negative growth in some cases), a group of assets valued as a going concern must at least grow at inflation if it wants to continue to operate into perpetuity.
- For most going concerns, an appropriate long-term, perpetuity growth rate will fall somewhere between inflation and the overall growth of the economy. Rule 62's default to inflationary growth is reasonable if not conservative.

The Commission has upheld the use of inflationary growth for a long-term growth rate in cash flows in several appeals. For example, see Findings of Fact, Conclusions of Law & Final Decision, pp. 11, 18, 23, 37 *Appeal Nos. 13-1343, 13-1407, 14-1241, 14-1243*.

The following charts illustrate how a hypothetical company's margins change in an inflationary environment under two different cash flow growth scenarios. The first chart shows what happens to a company's margins if it only increases its revenues to offset increases in expenses and maintains flat cash flows (i.e. 0% cash flow growth). This results in decreasing margins over time and erosion in the cash purchasing power of the company and its shareholders. The second chart shows that inflationary cash flow growth results in a constant margin that maintains the cash buying power of the company and its shareholders.



No Growth in Cash Flows = Shrinking Margins					Inflationary Growth in Cash Flows = Constant Margins				
Inflation 1.86%					Inflation 1.86%				
Period	Revenue	Expenses	Cash Flow	Margin	Period	Revenue	Expenses	Cash Flow	Margin
1	\$10.00	\$9.00	\$1.00	10.00%	1	\$10.00	\$9.00	\$1.00	10.00%
2	\$10.19	\$9.19	\$1.00	9.82%	2	\$10.19	\$9.17	\$1.02	10.00%
3	\$10.38	\$9.38	\$1.00	9.64%	3	\$10.38	\$9.34	\$1.04	10.00%
4	\$10.57	\$9.57	\$1.00	9.46%	4	\$10.57	\$9.51	\$1.06	10.00%
5	\$10.77	\$9.77	\$1.00	9.29%	5	\$10.77	\$9.69	\$1.08	10.00%
6	\$10.97	\$9.97	\$1.00	9.12%	6	\$10.97	\$9.87	\$1.10	10.00%
7	\$11.17	\$10.17	\$1.00	8.95%	7	\$11.17	\$10.05	\$1.12	10.00%
8	\$11.38	\$10.38	\$1.00	8.79%	8	\$11.38	\$10.24	\$1.14	10.00%
9	\$11.59	\$10.59	\$1.00	8.63%	9	\$11.59	\$10.43	\$1.16	10.00%
10	\$11.80	\$10.80	\$1.00	8.47%	10	\$11.80	\$10.62	\$1.18	10.00%
11	\$12.02	\$11.02	\$1.00	8.32%	11	\$12.02	\$10.82	\$1.20	10.00%
12	\$12.25	\$11.25	\$1.00	8.17%	12	\$12.25	\$11.02	\$1.22	10.00%
13	\$12.48	\$11.48	\$1.00	8.02%	13	\$12.48	\$11.23	\$1.25	10.00%
14	\$12.71	\$11.71	\$1.00	7.87%	14	\$12.71	\$11.44	\$1.27	10.00%
15	\$12.94	\$11.94	\$1.00	7.73%	15	\$12.94	\$11.65	\$1.29	10.00%
16	\$13.18	\$12.18	\$1.00	7.58%	16	\$13.18	\$11.87	\$1.32	10.00%
17	\$13.43	\$12.43	\$1.00	7.45%	17	\$13.43	\$12.09	\$1.34	10.00%
18	\$13.68	\$12.68	\$1.00	7.31%	18	\$13.68	\$12.31	\$1.37	10.00%
19	\$13.93	\$12.93	\$1.00	7.18%	19	\$13.93	\$12.54	\$1.39	10.00%
20	\$14.19	\$13.19	\$1.00	7.05%	20	\$14.19	\$12.77	\$1.42	10.00%
21	\$14.46	\$13.46	\$1.00	6.92%	21	\$14.46	\$13.01	\$1.45	10.00%
22	\$14.73	\$13.73	\$1.00	6.79%	22	\$14.73	\$13.25	\$1.47	10.00%
23	\$15.00	\$14.00	\$1.00	6.67%	23	\$15.00	\$13.50	\$1.50	10.00%
24	\$15.28	\$14.28	\$1.00	6.55%	24	\$15.28	\$13.75	\$1.53	10.00%
25	\$15.56	\$14.56	\$1.00	6.43%	25	\$15.56	\$14.01	\$1.56	10.00%
26	\$15.85	\$14.85	\$1.00	6.31%	26	\$15.85	\$14.27	\$1.59	10.00%
27	\$16.15	\$15.15	\$1.00	6.19%	27	\$16.15	\$14.53	\$1.61	10.00%
28	\$16.45	\$15.45	\$1.00	6.08%	28	\$16.45	\$14.80	\$1.64	10.00%
29	\$16.75	\$15.75	\$1.00	5.97%	29	\$16.75	\$15.08	\$1.68	10.00%
30	\$17.07	\$16.07	\$1.00	5.86%	30	\$17.07	\$15.36	\$1.71	10.00%
31	\$17.38	\$16.38	\$1.00	5.75%	31	\$17.38	\$15.64	\$1.74	10.00%
32	\$17.71	\$16.71	\$1.00	5.65%	32	\$17.71	\$15.94	\$1.77	10.00%
33	\$18.04	\$17.04	\$1.00	5.54%	33	\$18.04	\$16.23	\$1.80	10.00%
34	\$18.37	\$17.37	\$1.00	5.44%	34	\$18.37	\$16.53	\$1.84	10.00%
35	\$18.71	\$17.71	\$1.00	5.34%	35	\$18.71	\$16.84	\$1.87	10.00%
36	\$19.06	\$18.06	\$1.00	5.25%	36	\$19.06	\$17.15	\$1.91	10.00%

(5) Assets in Existence on the Lien Date

The Division supports the removal of references to “assets not in place as of the lien date.” This phrase can be confusing and misleading in an appraisal context.

- While the Division does not support taxing assets that do not exist on the lien date, it believes that this phrase is often misinterpreted to mean that you cannot consider the additional market value for the property that does exist today, based on what can be done with that property in the future.
- Market value is largely based on the principle of anticipated future benefits. In other words, what would a willing buyer pay (or a willing seller accept) for existing property today based on what can be done with this existing property in the future (including expanding and adding new assets).
- For example, two pieces of land that are identical in physical attributes (acreage, grade, locational attributes, etc.), but that are zoned differently may have vastly different values because the zoning impacts what you can do to or with the property in the future. A vacant commercial or industrial property is likely to be more valuable than a vacant agricultural property because you can build income producing assets on the former (such as a hotel, restaurant, plant, etc.), but not on the latter.
- The increased present fair market value to the commercial property or industrial property compared to the value of the agricultural property does not mean that the value of a future hotel, restaurant, or plant that does not yet exist has been captured, it simply means that the market recognizes increased current value for the assets that exist presently (vacant land in this case) based on what you can do with it.
- Likewise, centrally assessed units that are located in high growth areas or are otherwise situated or located to take advantage of future investments to capture growth or efficiency opportunities are more valuable today than those that are not situated to do so.

Thank you once again for your consideration. If you have any questions regarding these comments please reach out to me.

Sincerely,



Lucas Hendrickson
Assistant Director
Property Tax Division
Utah State Tax Commission
801.297.3609

Exhibit A

DRAFT

Draft: ~~January 5~~ March 10, 2021

R884. Tax Commission, Property Tax.

R884-24P. Property Tax.

R884-24P-62. Valuation of State Assessed Unitary Properties Pursuant to Utah Code Ann. Section 59-2-201.

(1) Purpose. The purpose of this rule is to:

(a) specify consistent ~~mass~~ unitary appraisal methodologies to be used by the Property Tax Division (Division) in the valuation of tangible property assessable by the Commission; and

(b) identify preferred valuation methodologies to be ~~considered~~ ~~adopted~~ ~~considered~~ by any party making an appraisal of ~~an individual~~ unitary property.

(2) Definitions:

~~(a) "Asset impairment" means the balance sheet adjustment amount necessary to adjust fair market value of a company's tangible asset values is less than the value of those tangible assets as reflected reported in a company's books and records kept in the regular course of business to reflect the current fair market value of those assets.~~

~~(b)~~(b) "Cost regulated utility" means any public utility assessable by the Commission whose allowed revenues are determined by a rate of return applied to a rate base set by a state or federal regulatory commission.

~~(b)~~(c) "Fair market value" means the amount at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. Fair market value reflects the value of property at its highest and best use, subject to regulatory constraints.

(d) "Historical cost less depreciation" or "HCLD" is the net book value of operating assets as recorded on a company's books and records kept in the regular course of business, including any adjustments for asset impairment reported by the taxpayer.

(e) "Normal rate of return on assets" means the average ratio of net operating income to HCLD, excluding construction work in progress, for comparable firms within an industry.

~~(f) "Operating cash tax rate" means the sum of cash taxes paid and the change in deferred income tax liability attributable to operating assets, divided by cash flow.~~

~~(e)~~(f) "Rate base" means the aggregate account balances reported as ~~such by the~~ aggregate account balances by a cost regulated utility to ~~the~~ an applicable state or federal regulatory commission.

~~(d)~~(g)(i) "Unitary property" means operating property that is assessed by the Commission ~~[pursuant to Section]~~ in accordance with Subsections 59-2-201(1)(a)(i) through (iii).

~~(f)~~(ii) ~~[Unitary properties include:]~~ "Unitary property" includes:

Commented [LH1]: The Division believes "adopted" is the more appropriate language as proposed in the previous draft. The Division believes that all parties should adhere to the provisions of the Rule, whether during an original assessment or during an appeal. The Division does not support language that would constrain it to use preferred methodologies, but would allow taxpayer and/or county parties to deviate.

In other words, the Division believes the Rule's preferred methodologies should apply to all parties, but any party could challenge the preferred methods and use other generally accepted appraisal methods "if it can be demonstrated by a preponderance of the evidence that the proposed alternative establishes a more accurate estimate of fair market value."

Commented [LH2]: The Division believes there is still potential confusion in this language. It appears to say that an impairment adjustment should be made to net book value as reported on the balance sheet to get to fair value. The comment on line 19 appears to contradict, implying that an impairment adjustment beyond what is reported on the books does not need to be done.

The Division believes that HCLD should be the net book value of the operating assets as recorded on a company's books and records without additional adjustments for impairment or additional appreciation or assemblage/enhanced value. Appraisal appreciation/depreciation and enhanced and assemblage value are best reflected in other indicators of value.

(A) all property that operates as a unit across county lines, if the values must be apportioned among more than one county or state; and

(B) all property of public utilities as defined in Section 59-2-102.

~~[(ii) These properties, some of which may be cost regulated utilities, are defined under one of the following categories.]~~

~~[(iii) "Unitary property" includes the following categories of property:~~

~~(A) "Telecommunication [properties] property" [include] includes the operating property of local exchange carriers, local access providers, long distance carriers, cellular telephone or personal communication service (PCS) providers and pagers, and other similar properties.~~

~~(B) "Energy [properties] property" [include] includes the operating property of natural gas pipelines, natural gas distribution companies, liquid petroleum products pipelines, and electric corporations, including electric generation, transmission, and distribution companies, and other similar entities.~~

~~(C) "Transportation [properties] property" [include] includes the operating property of all airlines, air charter services, and air contract services, including major and small passenger carriers and major and small air freighters, long haul and short line railroads, and other similar properties.~~

(3)(a) All tangible operating property owned, leased, or used by unitary companies is subject to assessment and taxation according to its fair market value as of January 1, and as provided in Utah Constitution Article XIII, Section 2. Intangible property as defined under Section 59-2-102 is not subject to assessment and taxation.

~~(b) The value of intangible property exempt under Section 59-2-1101 shall be deducted from the reconciled each unit value indicator, consistent with the methods used to derive that indicator.~~

~~(i) Booked goodwill and other capitalized intangible value determined using accepted accounting standards and practices shall be identified and deducted from reconciled the- unit value based on their proportional contribution to the unit.~~

~~(ii) Documentation shall be obtained to allow for the valuation of intangible property described in Subsection 59-2-102(19)(a), and the value of the intangible property deducted from the reconciled unit value based on its proportional contribution to the unit.~~

~~(iii) The normal rate of return on assets for guideline companies shall be calculated and then compared to the actual return on assets for the subject company for the most current three to five year period. If this comparison indicates that the subject company's property earns a rate of return on assets that exceeds the normal rate of return on assets, and the higher than normal rate of return on assets is not attributable to real property location characteristics or the identification of an improvement to real property, the proportional deduction from reconciled unit value for intangible property shall be the subject company's rate of return on assets minus the normal rate of return on assets, divided by the normal rate of return on assets.~~

~~(iv) If a subject company has more than one type of intangible property, the proportional adjustment to the reconciled unit value is equal to the larger of:~~

~~(A) the sum of Subsections (3)(b)(i) and (ii); or~~

~~(B) Subsection (3)(b)(iii).~~

Commented [LH3]: The Division believes that intangible value must be removed from the unit or unit value indicator on the same basis that it was captured in the unit.

It believes that this can be accomplished by deducting the contributory value from the reconciled unit value (similar to the deduction that is made to remove motor vehicles from the unit), or by deducting the value from each unit value indicator consistent with the methods used to derive that indicator.

The Division is concerned that the language in this draft still requires the removal of some intangible value at a basis that is inconsistent with how it was captured in the unit.

Commented [LH4]: Should this be each unit value indicator (to be consistent with 3b)?

Commented [LH5]: Unit value indicator?

Commented [LH6]: Unit value indicator?

Commented [LH7]: The Division believes that the types of properties assessed on a unitary basis are "special use" properties, which are unique. It would be inappropriate to use a normalized rate of return to value unique properties. The Division is concerned that this normal rate of return method would result in setting a ceiling on value that is no greater than the "average" unit of property in the industry. This is inconsistent with accepted appraisal methodology ... [1]

Commented [LH8]: Again, the Division believes 59-2-102(16)(a)(ii)(A) requires that the above normal rate of return be attributable to an item included in 59-2-102(16)(b) in order for it to be considered exempt ... [2]

Commented [LH9]: It appears that this method still allows a company to be 100% intangible if its rate of return on assets is greater than 2x the normal rate of return. ... [3]

Commented [LH10]: This could lead to making a deduction for intangible property in situations where intangibles property has not be captured in the unit value (for example, in situations where weight was ... [4]

Commented [LH11]: Lines 67-70 require that the largest intangible adjustment should be made to the unit value rather than each unit value indicator. Requiring that the largest intangible adjustment b ... [5]

Commented [LH12]: The Division is concerned the current language has the following flaw: (ii) could include items already included in (i) and would double count value. Additionally, because (i) and (ii) are t ... [6]

71 (v) Intangible property shall be removed in the original assessment if such removal is
72 supported by information provided by the taxpayer with its return or is otherwise ~~known to obtainable~~
73 by the Division.

74 (4) General Valuation Principles. Unitary properties shall be assessed at fair market value
75 based on generally accepted appraisal theory as provided under this rule.

76 (a) The assemblage or enhanced value attributable to the tangible property should be included
77 in the assessed value. See *Beaver County v. WilTel, Inc.*, 995 P.2d 602 (Utah 2000). The value
78 attributable to exempt intangible property must, when possible, be identified and removed ~~[from value~~
79 ~~when using any valuation method and before that value is used in the reconciliation process]~~.

80 (b) The preferred methods to determine fair market value are the cost approach and a yield
81 capitalization income indicator as set forth in Subsection (5).

82 (i) Other generally accepted appraisal methods may also be used when it can be demonstrated
83 that such methods are necessary to more accurately estimate fair market value.

84 (ii) Direct capitalization and the stock and debt method typically capture the value of
85 intangible property at higher levels than other methods. To the extent intangible property cannot be
86 identified and removed, relatively less weight shall be given to such methods in the reconciliation
87 process, as set forth in Subsection (5)(d).

88 (iii) Preferred valuation methods as set forth in this rule are, unless otherwise stated,
89 rebuttable presumptions, established for purposes of consistency in ~~[mass appraisal]~~ the valuation of
90 unitary properties. Any party challenging a preferred valuation method must demonstrate, by a
91 preponderance of the evidence, that the proposed alternative establishes a more accurate estimate of
92 fair market value.

93 (c) Non-operating Property. Property that is not necessary to the operation of unitary
94 properties and is assessed by a local county assessor, and property separately assessed by the Division,
95 such as registered motor vehicles, shall be removed from the reconciled ~~[correlated]~~ unit value or
96 from the state allocated value.

97 (5) Appraisal Methodologies.

98 (a) Cost Approach. Cost is relevant to value under the principle of substitution, which states
99 that no prudent investor would pay more for a property than the cost to construct a substitute property
100 of equal desirability and utility without undue delay. A cost indicator may be developed under one
101 or more of the following methods: replacement cost new less depreciation (RCNLD), reproduction
102 cost less depreciation (reproduction cost), and ~~[historic]~~ historical cost less depreciation (HCLD).
103 Obsolescence shall be considered in any cost indicator, and adjusted for, if it exists. Obsolescence
104 shall be adjusted for in the original assessment if the obsolescence adjustment is supported by
105 information provided by the taxpayer with its return or is otherwise ~~known to obtainable by the~~
106 Division.

107 (i) "Depreciation" is the loss in value from any cause. Different professions recognize two
108 distinct definitions or types of depreciation.

109 (A) Accounting. Accounting depreciation ~~[Depreciation]~~, often called "book" or
110 "accumulated" depreciation, is calculated according to generally accepted accounting principles or

Commented [LH13]: Wording is somewhat vague. The Division is concerned that taxpayers will expect an intangible deduction even if it is not warranted.

Commented [LH14]: As previously stated, the Division believes that applying any adjustment (upward or downward) is inappropriate and renders the HCLD indicator meaningless.

However, if obsolescence "shall" be considered and adjusted for if it exists, should there also be a provision that appraisal appreciation and/or assemblage and enhanced value "shall" also be considered and added?

The issue is that all of these adjustments require market evidence such as cash flows or sales or else they have no meaning. If you have the cash flow and sales data, why not just rely on those indicators in the reconciliation process?

111 regulatory guidelines. It is the amount of capital investment written off on a firm's accounting records
112 in order to allocate the original or ~~[historic]~~ historical cost of an asset over its life. Book depreciation
113 shall be [is typically] applied to ~~[historic]~~ historical cost to derive HCLD.

114 (B) Appraisal. Appraisal depreciation ~~[Depreciation]~~, sometimes referred to as "accrued"
115 depreciation, is the difference between the market value of an improvement and its cost new.
116 Appraisal depreciation ~~[Depreciation]~~ is typically applied to replacement or reproduction cost, but
117 should be applied to [historic cost] HCLD if market conditions so indicate. There are three types of
118 appraisal depreciation:

119 (I) Physical deterioration results from regular use and normal aging, which includes wear and
120 tear, decay, and the impact of the elements. Measuring physical deterioration generally requires an
121 economic life analysis or similar analysis. In the context of unitary appraisal, properties are typically
122 valued based on the assumption that assets are replaced as they age and physical deterioration is
123 reflected in normal depreciation schedules.

124 (II) Functional obsolescence is a reduction in market value or usefulness in a property due to
125 inefficiencies or inadequacies of the property itself when compared to more efficient or less costly
126 replacement alternatives. The preferred method for measuring functional obsolescence is the
127 difference between net book value and RCNLD, in conjunction with a "cost to cure" analysis of any
128 remaining functional obsolescence. [caused by internal property characteristics or flaws in the
129 structure, design, or materials that diminish the utility of an improvement.]

130 (III) External, or economic, obsolescence is an impairment of an improvement due to negative
131 influences from outside the boundaries of the property, and is generally incurable. These influences
132 usually cannot be controlled by the property owner or user. The preferred method for measuring
133 economic obsolescence is a relative performance assessment among comparable firms or future cash
134 flow analysis. The relative performance assessment shall incorporate multiple measures of both
135 operating and financial performance in relation to comparable firms and may include historical trends.
136 Future cash flow analysis shall be based on a firm's estimated future cash flows if available.

137 (ii) Replacement cost is the estimated cost to construct, at current prices, a property with
138 utility equivalent to that being appraised, using modern materials, current technology and current
139 standards, design, and layout. The use of replacement cost instead of reproduction cost eliminates the
140 need to estimate some forms of functional obsolescence.

141 (iii) Reproduction cost is the estimated cost to construct, at current prices, an exact duplicate
142 or replica of the property being assessed, using the same materials, construction standards, design,
143 layout and quality of workmanship, and embodying any functional obsolescence.

144 (iv) ~~[Historic]~~ Historical cost is the original construction or acquisition cost as recorded on a
145 firm's accounting records. Depending upon the industry, it may be appropriate to trend ~~[HCLD]~~
146 historical cost to estimate current reproduction or replacement cost. [costs:] Only trending indexes
147 commonly recognized by the specific industry may be used to adjust historical cost. ~~[HCLD.]~~
148 Historical cost differs from HCLD in that HCLD has been adjusted for physical depreciation and asset
149 impairment determined using accepted accounting standards.

Commented [LH15]: To be clear, the Division believes that adjusting HCLD upward or downward for appraisal appreciation or depreciation is not appropriate.

However, if appraisal depreciation should be applied to HCLD if market conditions so indicate, should appraisal appreciation be applied to HCLD if market conditions so indicate? What about assemblage and enhanced value?

The Division is concerned that making these suggested adjustments will result in converting HCLD to one of the other indicators of value. The Division believes HCLD should stand on its own.

Commented [LH16]: The Commission commented on Feb 9th that "The Division doesn't think functional obsolescence is relevant for unit valuations. The Division believes any fun. ob. will be reflected in the income approach, but that makes the approaches too circular."

The Division believes that adjusting HCLD up or down creates the circularity.

Additionally, appraisal depreciation and obsolescence adjustments to any cost approach should only be made if the market recognizes it as causing a loss of value. This is particularly important when valuing a unit where individual components may suffer from obsolescence but there is not obsolescence to the unit as whole.

The Appraisal of Real Estate appropriately states, "Depreciation is a penalty only insofar as the market recognizes it as causing a loss of value...an appraiser should exercise caution not to penalize a property unduly in the cost approach." (Thirteen Edition pg. 393) Any market impact for functional obsolescence will be captured in an income approach.

Commented [LH17]: If accurate Future Cash Flow projections are available then any obsolescence would be captured in a properly developed income indicator and avoids circularity between the cost approach and an income approach.

(v) Replacement cost new less depreciation (RCNLD) may be impractical to implement for unitary property; therefore the preferred cost indicator of value ~~[in a mass appraisal environment]~~ for unitary property is HCLD. A party may challenge the use of HCLD by proposing a different cost indicator that establishes a more accurate cost estimate of value.

(b) Income Capitalization Approach. Under the principle of anticipation, benefits from income in the future may be capitalized into an estimate of present value.

(i) Yield Capitalization. The yield capitalization formula is $CF/(k-g)$, where "CF" is a single year's normalized cash flow, "k" is the nominal, risk adjusted discount or yield rate, and "g" is the expected long-term growth rate of the cash flow.

(A) ~~[Cash flow is restricted to the operating property in existence on the lien date, together with any replacements intended to maintain, but not expand or modify, existing capacity or function.]~~ Cash flow is calculated as net operating income (NOI) plus non-cash charges (e.g., depreciation and the change in deferred income taxes liability reported on the statement of cash flows), less capital expenditures and additions to working capital necessary to achieve the expected growth "g". Information necessary for the Division to calculate the cash flow shall be summarized and submitted to the Division by March 1 on a form provided by the Division.

(I) "Net operating income" or "NOI" means one of the following as determined by the appraiser: ~~[is defined as]~~

(a) net income plus interest; or

(b) operating income less operating income tax expense.

(II) Capital expenditures should include only those expenditures necessary to replace or maintain existing plant and should not include any expenditure intended primarily for expansion or productivity and capacity enhancements.

(III) Cash flow is to be projected for the year immediately following the lien date, and may be estimated by reviewing ~~[historic]~~ historical cash flows, forecasting future cash flows, or a combination of both.

(Aa) If cash flows for a subsidiary company are not available or are not allocated on the parent company's cash flow statements, a method of allocating total cash flows must be developed based on sales, fixed assets, or other reasonable criteria. The subsidiary's total is divided by the parent's total to derive the allocation percentage to estimate the subsidiary's cash flow.

(Bb) If the subject company does not provide the Commission with its most recent cash flow statements by March 1 of the assessment year, the Division may estimate cash flow using the best information available.

(B) The discount rate (k) shall be based upon a weighted average cost of capital (WACC) considering current market debt rates and equity yields. WACC should reflect a typical capital structure for comparable companies within the industry ~~and should be adjusted for the operating cash tax rate, and should be adjusted for inflation and the operating cash tax rate.~~

(I) The cost of debt should reflect the current market rate (yield to maturity) of debt with the same credit rating as comparable companies within the industry ~~the subject company~~.

~~(Aa) The cost of debt is be multiplied by one minus the operating cash tax rate, unless the cash flow is adjusted for cash taxes paid.~~

(II) The cost of equity is estimated using standard methods such as the capital asset pricing model (CAPM), the Risk Premium and Dividend Growth models, or other recognized models.

(Aa) The CAPM is the preferred method to estimate the cost of equity. More than one method ~~may shall~~ be used to correlate a cost of equity, ~~but only if the CAPM method is weighted at least 50% in the correlation.~~

(Bb) The CAPM formula is $k(e) = R(f) + (\text{Beta} \times \text{Risk Premium})$, where $k(e)$ is the cost of equity and $R(f)$ is the risk free rate.

(Cc) The risk free rate shall be the current market rate on 20-year Treasury bonds.

(Dd) The beta should reflect an average or value-weighted average of comparable companies and should be drawn consistently from Value Line or an equivalent source if Value Line is unavailable. The beta of the specific assessed property should also be considered.

(Ee) The risk premium shall be the arithmetic average of the spread between the return on stocks and the income return on long-term bonds for the entire historical period beginning in 1926. ~~Implied equity risk premium models may also be considered.~~ ~~[contained in the Ibbotson Yearbook published immediately following the lien date.]~~

(C) The growth rate "g" is the expected future growth of the cash flow attributable to assets in place on the lien date, and any future replacement assets and due to long-term inflation. ~~[attributable to assets in place on the lien date, and any future replacement assets.]~~

(I) If insufficient information is available to the Division, either from public sources or from the taxpayer, to determine a rate, "g" will be the difference in the yield on a 20-year Treasury bond and the yield on a 20-year Treasury Inflation Protected Security (TIPS) bond as of the lien date. ~~[expected inflationary rate in the Gross Domestic Product Price Deflator obtained in Value Line.]~~ The growth rate and the methodology used to produce it shall be disclosed in a capitalization rate study published by the Commission by ~~February 15~~ April 1 of the assessment year.

(ii) A discounted cash flow (DCF) method may be ~~[impractical to implement in a mass appraisal environment, but may be]~~ used when reliable cash flow estimates can be established.

(A) A DCF model should incorporate for the terminal year, and to the extent possible for the holding period, growth and discount rate assumptions that would be used in the yield capitalization method defined under Subsection (5)(b)(i).

(B) Forecasted growth may be used where unusual income patterns are attributed to

(I) unused capacity;

(II) economic conditions; or

(III) similar circumstances.

~~[(C) Growth may not be attributed to assets not in place as of the lien date.]~~

(iii) Direct Capitalization is an income technique that converts an estimate of a single year's income expectancy into an indication of value in one direct step, either by dividing the normalized income estimate by a capitalization rate or by multiplying the normalized income estimate by an income ~~[factor]~~ multiplier.

Commented [LH18]: The Division strongly disagrees with this change. It neither provides flexibility to the appraiser to determine which model or models are most appropriate nor does it provide for a consistent appraisal method to be used.

Commented [LH19]: The Division believes there are trade-offs between flexibility and consistency related to many of the provisions of Rule 62, including the 50% weighting provision of CAPM.

While removing the 50% CAPM weighting requirement will give appraisers more flexibility to use models that he/she deems appropriate, it will likely result more contention on an already contentious topic as it removes one of the "consistent unitary appraisal methodologies" from the Rule.

Similar flexibility arguments could be made related to the risk premium source and time period, the correct term of bond to use for the risk-free rate, the default growth rate, etc, but the Rule specifies specific methodologies to promote "consistent unitary appraisal methodologies."

Commented [LH20]: The Division believes that implied risk premium models may be relevant and actually employs such a model to be considered, but is concerned that this sentence will cause confusion on which CAPM model is actually preferred by the Commission. The current Rule lays out the preferred inputs for the "Rule 62" CAPM and requires 50% weighting, but then gives flexibility to use other reliable models for up to the other 50%. We believe the current Rule already provides this flexibility.

Commented [LH21]: While the Division does not support taxing assets that don't exist at the lien date, it believes that this phrase is often misinterpreted to mean that you can't consider the additional market value for the property that does exist today, based on what can be done with that property in the future. This phrase is unnecessary especially in light of the Rule's limitation on growth to inflationary growth.

Commented [LH22]: While the Division does not support taxing assets that don't exist at the lien date, it believes that this phrase is often misinterpreted to mean that you can't consider the additional market value for the property that does exist today, based on what can be done with that property in the future. This phrase is unnecessary especially in light of the Rule's limitation on growth to inflationary growth

(c) Market or Sales Comparison Approach. The market value of property is directly related to the prices of comparable, competitive properties. The market approach is estimated by comparing the subject property to similar properties that have recently sold.

(I) Sales of comparable property must, to the extent possible, be adjusted for elements of comparison, including market conditions, financing, location, physical characteristics, and economic characteristics. When considering the sales of stock, business enterprises, or other properties that include intangible assets, adjustments must be made for those intangibles.

(II) Because sales of unitary properties ~~[are]~~ may be infrequent, a stock and debt indicator may be viewed as a surrogate for the market approach. The stock and debt method is based on the accounting principle which holds that the market value of assets equal the market value of liabilities plus shareholder's equity.

(d) Reconciliation. When reconciling value indicators into a final estimate of value, the appraiser shall take into consideration the availability, quantity, and quality of data, as well as the strength and weaknesses of each value indicator. Weighting percentages used to correlate the value approaches will generally vary by industry, and may vary by company if evidence exists to support a different weighting. The Division must disclose in writing the weighting percentages used in the reconciliation for the final assessment. Any departure from the prior year's weighting must be explained in writing.

(6) Property Specific Considerations. Because of unique characteristics of properties and industries, modifications or alternatives to the general value indicators may be required for specific industries.

(a) Cost Regulated Utilities.

(i) Rate regulation is one form of regulation that may impact the market value of a company; however, it does not determine the market value of such a company. HCLD is the preferred cost indicator of value for cost regulated utilities because it represents an approximation of the basis upon which the investor can earn a return. -HCLD is calculated by taking the ~~[historic]~~ historical cost less depreciation as reflected in the utility's net plant accounts, and then:

(A) subtracting intangible property as provided in Subsection (3);

(B) subtracting any items not included in the utility's rate base (e.g., deferred income taxes and, if appropriate, acquisition adjustments); and

(C) adding any taxable items not included in the utility's net plant account or rate base.

(ii) Deferred Income Taxes, also referred to as DFIT, is an accounting entry that reflects the difference between the use of accelerated depreciation for income tax purposes and the use of straight-line depreciation for financial statements. For traditional rate base regulated companies, regulators generally exclude deferred income taxes from rate base, recognizing it as ratepayer contributed capital. Where rate base is reduced by deferred income taxes for rate base regulated companies, ~~[they]~~ deferred income taxes shall be removed from HCLD.

(iii) Items excluded from rate base under Subsections (6)(a)(i)(A) or (B) should not be subtracted from HCLD to the extent it can be shown that regulators would likely permit the rate base of a potential purchaser to include a premium over existing rate base.

269 (iv) The allowed or authorized rate of return for rate setting purposes shall be distinguished
270 from is not synonymous with the cost of equity as used in long-term perpetuity cash flow valuations.

271 (b)(i) Railroads.

272 (ii) The cost indicator should generally be given little or no weight because there is no
273 observable relationship between cost and fair market value.

274 (c) Airlines, air charter services, and air contract services.

275 (i) For purposes of this Subsection (6)(c):

276 (A) "aircraft pricing guide" means a nationally recognized publication that assigns value
277 estimates for individual commercial aircraft that are in average condition typical for their type and
278 vintage, and identified by year, make and model;

279 (B) "airline" means an:

280 (I) airline under Section 59-2-102;

281 (II) air charter service under Section 59-2-102; and

282 (III) air contract service under Section 59-2-102;

283 (C) "airline market indicator" means an estimate of value based on an aircraft pricing guide;
284 and

285 (D) "non-mobile flight equipment" means all operating property of an airline, air charter
286 service, or air contract service that is not within the definition of mobile flight equipment under
287 Section 59-2-102.

288 (ii) In situations where the use of preferred methods for determining fair market value under
289 Subsection (5) does not produce a reasonable estimate of the fair market value of the property of an
290 airline operating as a unit, an airline market indicator published in an aircraft pricing guide, and
291 adjusted as provided in Subsections (6)(c)(ii)(A) and (6)(c)(ii)(B), may be used to estimate the fair
292 market value of the airline property.

293 (A)(I) In order to reflect the value of a fleet of aircraft as part of an operating unit, an aircraft
294 market indicator shall include a fleet adjustment or equivalent valuation for a fleet.

295 (II) If a fleet adjustment is provided in an aircraft pricing guide, the adjustment under
296 Subsection (6)(c)(ii)(A)(I) shall follow the directions in that guide. If no fleet adjustment is provided
297 in an aircraft pricing guide, the standard adjustment under Subsection (6)(c)(ii)(A)(I) shall be 20
298 percent from a wholesale value or equivalent level of value as published in the guide.

299 (B) Non-mobile flight equipment shall be valued using the cost approach under Subsection
300 (5)(a) or the market or sales comparison approach under Subsection (5)(c), and added to the value of
301 the fleet.

302 (iii) An income capitalization approach under Subsection (5)(b) shall incorporate the
303 information available to make an estimate of future cash flows.

304 (iv)(A) When an aircraft market indicator under Subsection (6)(c)(ii) is used to estimate the
305 fair market value of an airline, the Division shall:

306 (I) calculate the fair market value of the airline using the preferred methods under Subsection
307 (5);

Commented [LH23]: The Division believes it needs to be clear in the Rule that the authorized returns are not synonymous with the market costs of capital. Using the allowed rate of return authorized by regulators as a surrogate for the cost of capital is not appropriate and can lead to gross valuation errors. The Division proposes the following clarifying language to avoid future confusion on this issue.

"The allowed or authorized rates of return established by regulators for rate setting purposes are neither correlated to nor determinative of the market cost of capital for valuation purposes. The authorized or allowed rates of return calculated in rate cases serve the regulatory purpose of setting rates, but are not an appropriate substitute for the market cost of capital for valuation purposes."

308 (II) retain the calculations under Subsection (6)(c)(iv)(A)(I) in the work files maintained by
309 the Division; and

310 (III) include the amounts calculated under Subsection (6)(c)(iv)(A)(I) in any appraisal report
311 that is produced in association with an assessment issued by the Division.

312 (B) When an aircraft market indicator under Subsection (6)(c)(ii) is used, the Division shall
313 justify in any appraisal report issued with an assessment why the preferred methods under Subsection
314 (5) were not used.

315 (v)(A) When the preferred methods under Subsection (5) are used to estimate the fair market
316 value of an airline, the Division shall:

317 (I) calculate an aircraft market indicator under Subsection (6)(c)(ii);

318 (II) retain the calculations under Subsection (6)(c)(v)(A)(I) in the work files maintained by
319 the Division; and

320 (III) include the amounts calculated under Subsection (6)(c)(v)(A)(I) in any appraisal report
321 that is produced in association with an assessment issued by the Division.

322 (B) Value estimates from an aircraft pricing guide under Subsection (6)(c)(i)(A) along with
323 the valuation of non-mobile flight equipment under Subsection (6)(c)(ii)(B) shall, when possible, also
324 be included in an assessment or appraisal report for purposes of comparison.

325 (C) Reasons for not including a value estimate required under Subsection (6)(c)(v)(B)
326 include:

327 (I) failure to file a return; or

328 (II) failure to identify specific aircraft.

329 (7) The provisions of this rule shall be implemented and become binding on taxpayers
330 beginning January 1, 2022.

The Division believes that the types of properties assessed on a unitary basis are "special use" properties, which are unique. It would be inappropriate to use a normalized rate of return to value unique properties. The Division is concerned that this normal rate of return method would result in setting a ceiling on value that is no greater than the "average" unit of property in the industry. This is inconsistent with accepted appraisal methodologies and with how locally assessed properties are value for property tax purposes.

Further, the Division believes that the statute requires that any above normal return be specifically tied to the 59-2-102(16)(b) factors in order to be considered "goodwill". In practice, attributing an above normal return to specific items listed in either 59-2-102(16)(b) or 59-2-102(16)(c) is impractical if not impossible.

Again, the Division believes 59-2-102(16)(a)(ii)(A) requires that the above normal rate of return be attributable to an item included in 59-2-102(16)(b) in order for it to be considered exempt goodwill. This current language that requires the Division to show that the above normal return is not a result of items included in 59-2-102(16)(c) is inconsistent with the statute's requirements. In practice, attributing an above normal return to specific items listed in either 59-2-102(16)(b) or 59-2-102(16)(c) is impractical if not impossible.

It appears that this method still allows a company to be 100% intangible if its rate of return on assets is greater than 2x the normal rate of return.

The Division believes that the types of properties assessed on a unitary basis are "special use" properties, which are unique. It would be inappropriate to use a normalized rate of return to value unique properties.

This could lead to making a deduction for intangible property in situations where intangibles property has not be captured in the unit value (for example, in situations where weight was placed on a cost approach which already excludes intangible property).

The Division believes the appropriate way to remove intangibles from the unit value is through a market to book ratio, similar to how motor vehicles are removed from the unit in Rule 60. The market to book ratio method ensures that intangibles are removed at the same level they were captured in the unit.

Lines 67-70 require that the largest intangible adjustment should be made to the unit value rather than each unit value indicator. Requiring that the largest intangible adjustment be deducted from the unit value is inconsistent with line 52, which requires the adjustment to be deducted consistent with methods used to derive that indicator.

While the Division opposes this type of "normal rate of return" as a reliable method for removing intangibles in general, it is doubly concerned that this method will result in a mismatch where values will be deducted inconsistently from the unit compared to how they were captured in the unit.

For example, if the cost approach is used, no intangibles will have been captured, yet the "normal rate of return" method would still potentially require intangible value to be deducted when none was captured in the unit value to begin with.

Page 2: [6] Commented [LH12]

Lucas Hendrickson

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The Division is concerned the current language has the following flaw: (ii) could include items already included in (i) and would double count value. Additionally, because (i) and (ii) are to be applied to the unit value indicators and (iii) is to be applied to the unit value, it results in an apples to oranges comparison.

DRAFT

Draft: February 23, 2021

R884. Tax Commission, Property Tax.

R884-24P. Property Tax.

R884-24P-62. Valuation of State Assessed Unitary Properties Pursuant to Utah Code Ann. Section 59-2-201.

(1) Purpose. The purpose of this rule is to:

(a) specify consistent ~~[mass]~~ unitary appraisal methodologies to be used by the Property Tax Division (Division) in the valuation of tangible property assessable by the Commission; and

(b) identify preferred valuation methodologies to be ~~[considered]~~ considered by any party making an appraisal of ~~[an individual]~~ unitary property.

(2) Definitions:

(a) "Asset impairment" means the balance sheet adjustment amount necessary to adjust a company's tangible asset values as reported in a company's books and records kept in the regular course of business to reflect the current fair market value of those assets.

~~[(a)]~~(b) "Cost regulated utility" means any public utility assessable by the Commission whose allowed revenues are determined by a rate of return applied to a rate base set by a state or federal regulatory commission.

~~[(b)]~~(c) "Fair market value" means the amount at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. Fair market value reflects the value of property at its highest and best use, subject to regulatory constraints.

(d) "Historical cost less depreciation" or "HCLD" is the net book value of operating assets as recorded on a company's books and records kept in the regular course of business, including any adjustments for asset impairment reported by the taxpayer.

(e) "Normal rate of return on assets" means the average ratio of net operating income to HCLD, excluding construction work in progress, for comparable firms within an industry.

(f) "Operating cash tax rate" means the sum of cash taxes paid and the change in deferred income tax liability attributable to operating assets, divided by cash flow.

~~[(e)]~~(g) "Rate base" means the aggregate account balances reported as ~~[such by the]~~ aggregate account balances by a cost regulated utility to [the] an applicable state or federal regulatory commission.

~~[(d)]~~(h)(i) "Unitary property" means operating property that is assessed by the Commission ~~[pursuant to Section]~~ in accordance with Subsections 59-2-201(1)(a)(i) through (iii).

~~[(i)]~~(ii) ~~[Unitary properties include:]~~ "Unitary property" includes:

(A) all property that operates as a unit across county lines, if the values must be apportioned among more than one county or state; and

(B) all property of public utilities as defined in Section 59-2-102.

~~[(ii) These properties, some of which may be cost regulated utilities, are defined under one of the following categories:]~~

(iii) "Unitary property" includes the following categories of property:

(A) "Telecommunication ~~[properties]~~ property" ~~[include]~~ includes the operating property of local exchange carriers, local access providers, long distance carriers, cellular telephone or personal communication service (PCS) providers and pagers, and other similar properties.

(B) "Energy ~~[properties]~~ property" ~~[include]~~ includes the operating property of natural gas pipelines, natural gas distribution companies, liquid petroleum products pipelines, and electric corporations, including electric generation, transmission, and distribution companies, and other similar entities.

(C) "Transportation ~~[properties]~~ property" ~~[include]~~ includes the operating property of all airlines, air charter services, and air contract services, including major and small passenger carriers and major and small air freighters, long haul and short line railroads, and other similar properties.

(3)(a) All tangible operating property owned, leased, or used by unitary companies is subject to assessment and taxation according to its fair market value as of January 1, and as provided in Utah Constitution Article XIII, Section 2. Intangible property as defined under Section 59-2-102 is not subject to assessment and taxation.

(b) The value of intangible property exempt under Section 59-2-1101 shall be deducted from the unit value indicator, consistent with the methods used to derive that indicator.

(i) Booked goodwill and other capitalized intangible value determined using accepted accounting standards and practices shall be identified and deducted from the unit value based on their proportional contribution to the unit.

(ii) Documentation shall be obtained to allow for the valuation of intangible property described in Subsection 59-2-102(19)(a), and the value of the intangible property deducted from the unit value based on its proportional contribution to the unit.

(iii) The normal rate of return on assets for guideline companies shall be calculated and then compared to the actual return on assets for the subject company for the most current three to five year period. If this comparison indicates that the subject company's property earns a rate of return on assets that exceeds the normal rate of return on assets, the higher than normal rate of return on assets is not attributable to real property location characteristics or the identification of an improvement to real property, the proportional deduction from unit value for intangible property shall be the subject company's rate of return on assets minus the normal rate of return on assets, divided by the normal rate of return on assets.

(iv) If a subject company has more than one type of intangible property, the proportional adjustment to the unit value is equal to the larger of:

(A) sum of Subsections (3)(b)(i) and (ii); or

(B) Subsection (3)(b)(iii).

70 (v) Intangible property shall be removed in the original assessment if such removal is
71 supported by information provided by the taxpayer with its return or is otherwise known to the
72 Division.

73 (4) General Valuation Principles. Unitary properties shall be assessed at fair market value
74 based on generally accepted appraisal theory as provided under this rule.

75 (a) The assemblage or enhanced value attributable to the tangible property should be included
76 in the assessed value. See *Beaver County v. WilTel, Inc.*, 995 P.2d 602 (Utah 2000). The value
77 attributable to exempt intangible property must, when possible, be identified and removed ~~[from value~~
78 ~~when using any valuation method and before that value is used in the reconciliation process]~~.

79 (b) The preferred methods to determine fair market value are the cost approach and a yield
80 capitalization income indicator as set forth in Subsection (5).


81 (i) Other generally accepted appraisal methods may also be used when it can be demonstrated
82 that such methods are necessary to more accurately estimate fair market value.

83 (ii) Direct capitalization and the stock and debt method typically capture the value of
84 intangible property at higher levels than other methods. To the extent intangible property cannot be
85 identified and removed, relatively less weight shall be given to such methods in the reconciliation
86 process, as set forth in Subsection (5)(d).

87 (iii) Preferred valuation methods as set forth in this rule are, unless otherwise stated,
88 rebuttable presumptions, established for purposes of consistency in ~~[mass appraisal]~~ the valuation of
89 unitary properties. Any party challenging a preferred valuation method must demonstrate, by a
90 preponderance of the evidence, that the proposed alternative establishes a more accurate estimate of
91 fair market value.

92 (c) Non-operating Property. Property that is not necessary to the operation of unitary
93 properties and is assessed by a local county assessor, and property separately assessed by the Division,
94 such as registered motor vehicles, shall be removed from the reconciled ~~[correlated]~~ unit value or
95 from the state allocated value.

96 (5) Appraisal Methodologies.

97 (a) Cost Approach. Cost is relevant to value under the principle of substitution, which states
98 that no prudent investor would pay more for a property than the cost to construct a substitute property
99 of equal desirability and utility without undue delay. A cost indicator may be developed under one
100 or more of the following methods: replacement cost new less depreciation (RCNLD), reproduction
101 cost less depreciation (reproduction cost), and ~~[historic]~~ historical cost less depreciation (HCLD).
102  Obsolescence shall be considered in any cost indicator, and adjusted for, if it exists. Obsolescence
103 shall be adjusted for in the original assessment if the obsolescence adjustment is supported by
104 information provided by the taxpayer with its return or is otherwise known to the Division.

105 (i) "Depreciation" is the loss in value from any cause. Different professions recognize two
106 distinct definitions or types of depreciation.

107 (A) Accounting. Accounting depreciation ~~[Depreciation]~~, often called "book" or
108 "accumulated" depreciation, is calculated according to generally accepted accounting principles or
109 regulatory guidelines. It is the amount of capital investment written off on a firm's accounting records

in order to allocate the original or ~~[historic]~~ historical cost of an asset over its life. Book depreciation shall be ~~[is typically]~~ applied to ~~[historic]~~ historical cost to derive HCLD.

(B) Appraisal. Appraisal depreciation ~~[Depreciation]~~, sometimes referred to as "accrued" depreciation, is the difference between the market value of an improvement and its cost new. Appraisal depreciation ~~[Depreciation]~~ is typically applied to replacement or reproduction cost, ~~[cost]~~ should be applied to ~~[historic cost]~~ HCLD if market conditions so indicate. There are three types of appraisal depreciation:

(I) Physical deterioration results from regular use and normal aging, which includes wear and tear, decay, and the impact of the elements. Measuring physical deterioration generally requires an economic life analysis or similar analysis. In the context of unitary appraisal, properties are typically valued based on the assumption that assets are replaced as they age and physical deterioration is reflected in normal depreciation schedules.

(II) Functional obsolescence is a reduction in market value or usefulness in a property due to inefficiencies or inadequacies of the property itself when compared to more efficient or less costly replacement alternatives. The preferred method for measuring functional obsolescence is the difference between net book value and RCNLD, in conjunction with a "cost to cure" analysis of any remaining functional obsolescence. [caused by internal property characteristics or flaws in the structure, design, or materials that diminish the utility of an improvement.]

(III) External, or economic, obsolescence is an impairment of an improvement due to negative influences from outside the boundaries of the property, and is generally incurable. These influences usually cannot be controlled by the property owner or user. The preferred method for measuring economic obsolescence is a relative performance assessment among comparable firms or future cash flow analysis. The relative performance assessment shall incorporate multiple measures of both operating and financial performance in relation to comparable firms and may include historical trends. Future cash flow analysis shall be based on a firm's estimated future cash flows if available.

(ii) Replacement cost is the estimated cost to construct, at current prices, a property with utility equivalent to that being appraised, using modern materials, current technology and current standards, design, and layout. The use of replacement cost instead of reproduction cost eliminates the need to estimate some forms of functional obsolescence.

(iii) Reproduction cost is the estimated cost to construct, at current prices, an exact duplicate or replica of the property being assessed, using the same materials, construction standards, design, layout and quality of workmanship, and embodying any functional obsolescence.

(iv) ~~[Historic]~~ Historical cost is the original construction or acquisition cost as recorded on a firm's accounting records. Depending upon the industry, it may be appropriate to trend ~~[HCLD]~~ historical cost to estimate current reproduction or replacement cost. [costs.] Only trending indexes commonly recognized by the specific industry may be used to adjust historical cost. [HCLD.] Historical cost differs from HCLD in that HCLD has been adjusted for physical depreciation and asset impairment determined using accepted accounting standards.

(v) Replacement cost new less depreciation (RCNLD) may be impractical to implement for unitary property; therefore the preferred cost indicator of value ~~[in a mass appraisal environment]~~ for

unitary property is HCLD. A party may challenge the use of HCLD by proposing a different cost indicator that establishes a more accurate cost estimate of value.

(b) Income Capitalization Approach. Under the principle of anticipation, benefits from income in the future may be capitalized into an estimate of present value.

(i) Yield Capitalization. The yield capitalization formula is $CF/(k-g)$, where "CF" is a single year's normalized cash flow, "k" is the nominal, risk adjusted discount or yield rate, and "g" is the expected long-term growth rate of the cash flow.

(A) ~~[Cash flow is restricted to the operating property in existence on the lien date, together with any replacements intended to maintain, but not expand or modify, existing capacity or function.]~~ Cash flow is calculated as net operating income (NOI) plus non-cash charges (e.g., depreciation and the change in deferred income tax liability reported on the statement of cash flows), less capital expenditures and additions to working capital necessary to achieve the expected growth "g". Information necessary for the Division to calculate the cash flow shall be summarized and submitted to the Division by March 1 on a form provided by the Division.

(I) "Net operating income" or "NOI" means one of the following as determined by the appraiser: [is defined as]

(a) net income plus interest; or

(b) operating income less operating income tax expense.

(II) Capital expenditures should include only those expenditures necessary to replace or maintain existing plant and should not include any expenditure intended primarily for expansion or productivity and capacity enhancements.

(III) Cash flow is to be projected for the year immediately following the lien date, and may be estimated by reviewing [~~historie~~] historical cash flows, forecasting future cash flows, or a combination of both.

(Aa) If cash flows for a subsidiary company are not available or are not allocated on the parent company's cash flow statements, a method of allocating total cash flows must be developed based on sales, fixed assets, or other reasonable criteria. The subsidiary's total is divided by the parent's total to derive the allocation percentage to estimate the subsidiary's cash flow.

(Bb) If the subject company does not provide the Commission with its most recent cash flow statements by March 1 of the assessment year, the Division may estimate cash flow using the best information available.

(B) The discount rate (k) shall be based upon a weighted average cost of capital (WACC) considering current market debt rates and equity yields. WACC should reflect a typical capital structure for comparable companies within the industry and shall be adjusted for the operating cash tax rate.

(I) The cost of debt should reflect the current market rate (yield to maturity) of debt with the same credit rating as comparable companies within the industry ~~the subject company~~.

(Aa) The cost of debt shall be multiplied by one minus the operating cash tax rate, unless the cash flow is adjusted for cash taxes paid.

189 (II) The cost of equity is estimated using standard methods such as the capital asset pricing
190 model (CAPM), the Risk Premium and Dividend Growth models, or other recognized models.

191 (Aa) The CAPM is the preferred method to estimate the cost of equity. More than one method
192 may be used to correlate a cost of equity.

193 (Bb) The CAPM formula is $k(e) = R(f) + (\text{Beta} \times \text{Risk Premium})$, where $k(e)$ is the cost of
194 equity and $R(f)$ is the risk free rate.

195 (Cc) The risk free rate shall be the current market rate on 20-year Treasury bonds.

196 (Dd) The beta should reflect an average or value-weighted average of comparable companies
197 and should be drawn consistently from Value Line or an equivalent source if Value Line is
198 unavailable. The beta of the specific assessed property should also be considered.

199 (Ee) The risk premium shall be the arithmetic average of the spread between the return on
200 stocks and the income return on long-term bonds for the entire historical period beginning in 1926.
201 [contained in the Ibbotson Yearbook published immediately following the lien date.]

202 (C) The growth rate "g" is the expected future growth of the cash flow attributable to assets
203 in place on the lien date, and any future replacement assets. [attributable to assets in place on the lien
204 date, and any future replacement assets.]

205 (I) If insufficient information is available to the Division, either from public sources or from
206 the taxpayer, to determine a rate, "g" will be the difference in the yield on a 20-year Treasury bond
207 and the yield on a 20-year Treasury Inflation Protected Security (TIPS) bond as of the lien date.
208 [expected inflationary rate in the Gross Domestic Product Price Deflator obtained in Value Line.]
209 The growth rate and the methodology used to produce it shall be disclosed in a capitalization rate
210 study published by the Commission by February 15 April 1 of the assessment year.

211 (ii) A discounted cash flow (DCF) method may be [impractical to implement in a mass
212 appraisal environment, but may be] used when reliable cash flow estimates can be established.

213 (A) A DCF model should incorporate for the terminal year, and to the extent possible for the
214 holding period, growth and discount rate assumptions that would be used in the yield capitalization
215 method defined under Subsection (5)(b)(i).

216 (B) Forecasted growth may be used where unusual income patterns are attributed to

217 (I) unused capacity;

218 (II) economic conditions; or

219 (III) similar circumstances.

220 [G] Growth may not be attributed to assets not in place as of the lien date.]

221 (iii) Direct Capitalization is an income technique that converts an estimate of a single year's
222 income expectancy into an indication of value in one direct step, either by dividing the normalized
223 income estimate by a capitalization rate or by multiplying the normalized income estimate by an
224 income [factor] multiplier.

225 (c) Market or Sales Comparison Approach. The market value of property is directly related
226 to the prices of comparable, competitive properties. The market approach is estimated by comparing
227 the subject property to similar properties that have recently sold.

(I) Sales of comparable property must, to the extent possible, be adjusted for elements of comparison, including market conditions, financing, location, physical characteristics, and economic characteristics. When considering the sales of stock, business enterprises, or other properties that include intangible assets, adjustments must be made for those intangibles.

(II) Because sales of unitary properties ~~[are]~~ may be infrequent, a stock and debt indicator may be viewed as a surrogate for the market approach. The stock and debt method is based on the accounting principle which holds that the market value of assets equal the market value of liabilities plus shareholder's equity.

(d) Reconciliation. When reconciling value indicators into a final estimate of value, the appraiser shall take into consideration the availability, quantity, and quality of data, as well as the strength and weaknesses of each value indicator. Weighting percentages used to correlate the value approaches will generally vary by industry, and may vary by company if evidence exists to support a different weighting. The Division must disclose in writing the weighting percentages used in the reconciliation for the final assessment. Any departure from the prior year's weighting must be explained in writing.

(6) Property Specific Considerations. Because of unique characteristics of properties and industries, modifications or alternatives to the general value indicators may be required for specific industries.

(a) Cost Regulated Utilities.

(i) Rate regulation is one form of regulation that may impact the market value of a company; however, it does not determine the market value of such a company. HCLD is the preferred cost indicator of value for cost regulated utilities because it represents an approximation of the basis upon which the investor can earn a return. HCLD is calculated by taking the ~~[historie]~~ historical cost less depreciation as reflected in the utility's net plant accounts, and then:

(A) subtracting intangible property as provided in Subsection (3);

(B) subtracting any items not included in the utility's rate base (e.g., deferred income taxes and, if appropriate, acquisition adjustments); and

(C) adding any taxable items not included in the utility's net plant account or rate base.

(ii) Deferred Income Taxes, also referred to as DFIT, is an accounting entry that reflects the difference between the use of accelerated depreciation for income tax purposes and the use of straight-line depreciation for financial statements. For traditional rate base regulated companies, regulators generally exclude deferred income taxes from rate base, recognizing it as ratepayer contributed capital. Where rate base is reduced by deferred income taxes for rate base regulated companies, ~~[they]~~ deferred income taxes shall be removed from HCLD.

(iii) Items excluded from rate base under Subsections (6)(a)(i)(A) or (B) should not be subtracted from HCLD to the extent it can be shown that regulators would likely permit the rate base of a potential purchaser to include a premium over existing rate base.

The allowed or authorized rate of return for rate setting purposes shall be distinguished from the cost of equity as used in long-term perpetuity cash flow valuations.

(b)(i) Railroads.

(ii) The cost indicator should generally be given little or no weight because there is no observable relationship between cost and fair market value.

(c) Airlines, air charter services, and air contract services.

(i) For purposes of this Subsection (6)(c):

(A) "aircraft pricing guide" means a nationally recognized publication that assigns value estimates for individual commercial aircraft that are in average condition typical for their type and vintage, and identified by year, make and model;

(B) "airline" means an:

(I) airline under Section 59-2-102;

(II) air charter service under Section 59-2-102; and

(III) air contract service under Section 59-2-102;

(C) "airline market indicator" means an estimate of value based on an aircraft pricing guide; and

(D) "non-mobile flight equipment" means all operating property of an airline, air charter service, or air contract service that is not within the definition of mobile flight equipment under Section 59-2-102.

(ii) In situations where the use of preferred methods for determining fair market value under Subsection (5) does not produce a reasonable estimate of the fair market value of the property of an airline operating as a unit, an airline market indicator published in an aircraft pricing guide, and adjusted as provided in Subsections (6)(c)(ii)(A) and (6)(c)(ii)(B), may be used to estimate the fair market value of the airline property.

(A)(I) In order to reflect the value of a fleet of aircraft as part of an operating unit, an aircraft market indicator shall include a fleet adjustment or equivalent valuation for a fleet.

(II) If a fleet adjustment is provided in an aircraft pricing guide, the adjustment under Subsection (6)(c)(ii)(A)(I) shall follow the directions in that guide. If no fleet adjustment is provided in an aircraft pricing guide, the standard adjustment under Subsection (6)(c)(ii)(A)(I) shall be 20 percent from a wholesale value or equivalent level of value as published in the guide.

(B) Non-mobile flight equipment shall be valued using the cost approach under Subsection (5)(a) or the market or sales comparison approach under Subsection (5)(c), and added to the value of the fleet.

(iii) An income capitalization approach under Subsection (5)(b) shall incorporate the information available to make an estimate of future cash flows.

(iv)(A) When an aircraft market indicator under Subsection (6)(c)(ii) is used to estimate the fair market value of an airline, the Division shall:

(I) calculate the fair market value of the airline using the preferred methods under Subsection (5);

(II) retain the calculations under Subsection (6)(c)(iv)(A)(I) in the work files maintained by the Division; and

(III) include the amounts calculated under Subsection (6)(c)(iv)(A)(I) in any appraisal report that is produced in association with an assessment issued by the Division.

308 (B) When an aircraft market indicator under Subsection (6)(c)(ii) is used, the Division shall
309 justify in any appraisal report issued with an assessment why the preferred methods under Subsection
310 (5) were not used.

311 (v)(A) When the preferred methods under Subsection (5) are used to estimate the fair market
312 value of an airline, the Division shall:

313 (I) calculate an aircraft market indicator under Subsection (6)(c)(ii);

314 (II) retain the calculations under Subsection (6)(c)(v)(A)(I) in the work files maintained by
315 the Division; and

316 (III) include the amounts calculated under Subsection (6)(c)(v)(A)(I) in any appraisal report
317 that is produced in association with an assessment issued by the Division.

318 (B) Value estimates from an aircraft pricing guide under Subsection (6)(c)(i)(A) along with
319 the valuation of non-mobile flight equipment under Subsection (6)(c)(ii)(B) shall, when possible, also
320 be included in an assessment or appraisal report for purposes of comparison.

321 (C) Reasons for not including a value estimate required under Subsection (6)(c)(v)(B)
322 include:

323 (I) failure to file a return; or

324 (II) failure to identify specific aircraft.

325 (7) The provisions of this rule shall be implemented beginning January 1, 2022.



State of Utah

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Lieutenant Governor

Utah State Tax Commission

JOHN L. VALENTINE
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January 29, 2021

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Re: Comments to January 6, 2021 Draft of Proposed Changes to R884-24P-62

Dear Commissioners:

On behalf of the Property Tax Division, I would like to thank you for allowing the Property Tax Division to participate in the discussion regarding potential changes to Rule 62. The Division recognizes the tremendous amount of work put in by the Commission in trying to address complex appraisal issues related to the valuation of unitary properties and appreciates the Commissions efforts.

The Division respectfully submits its comments related to the January 6, 2021 draft of proposed changes to Rule 62 that was circulated to interested parties. While the Division agrees with many of the proposed changes, it believes that some of the proposed changes need additional explanation or clarification, may lead to increased ambiguity and increased potential litigation, and/or may not result in accurate estimates of fair market value. Specifically, the Division believes that many of the proposed changes related to intangibles and obsolescence rely on ad-hoc adjustments that are not supported by market evidence and/or will make the Rule more difficult to administer.

Comments in Support of Proposed Changes

The Division supports a number of the proposed changes outlined in the draft. The following list includes some changes the Division supports:

- The Division believes that removing references to mass appraisal in the Rule is appropriate, since each unitary property is assessed individually considering specific attributes and characteristics of the subject and not using mass appraisal statistical methods.
 - The Division believes that current language in the Rule referring to mass appraisal conveys an inaccurate message that the provisions contained in the Rule are sufficient for an original assessment, but that they are not in line with best practices for unit value generally.
 - Removing references to mass appraisal is appropriate and correctly emphasizes that:
 - The Division's assessments performed pursuant to the preferred methods of the Rule already include careful consideration of unique aspects of the subject properties.
 - The centrally assessed valuations are not performed using actual mass appraisal methods such as employing blanket statistical models.
- The Division supports changes that emphasize that the methods contained in Rule 62 are the preferred methods for all parties for assessments and appeals, and not just by the Division for its original assessments.
 - The Division believes that the provisions of Rule 62 should promote best practices for unitary valuation not only for the Division to use in its assessments, but for all parties to adopt as preferred methods for the valuation of unitary properties for property tax purposes.
 - Of course, any party is still welcome to present or use alternative methods if it can prove by a preponderance of the evidence that those methods result in a more accurate measure of market value (see lines 81-85), but the provisions contained in the Rule would be the preferred methods for all parties.
- The Division supports the change in the date for publication of the capitalization rates from February 15 to April 1. This will allow more time for key resources and inputs to become available and for interested parties to discuss and comment on the study prior to its publication.
- The Division believes that the proposed changes for estimating inflationary growth "g" in cash flows on lines 191-195 is a reasonable way to estimate long-term inflation.
 - A long-term expected growth rate is the appropriate rate to use in a long-run perpetuity model. For a going concern unit, the Division believes an appropriate long-

term growth rate between inflation and the overall growth rate of the economy is generally appropriate.

- The yields on 20-year TIPS and 20-year Treasury Bonds should be readily available at or around the lien date and reflect the market's expectation for long-term inflation as of the lien date.
- The Commission may also want to consider provisions for estimating real growth or total growth in cash flows (and an allowance for total capital expenditures instead of only replacement capital expenditures) if it wants to remove exempt intangibles from the reconciled unit value instead of from each approach before reconciliation. This would help ensure that all tangible and intangible value was captured initially in each indicator so that exempt intangible value could be removed later from the reconciled unit value (more on this below).
- The Division supports the removal of references to “assets not in place as of the lien date”. This phrase can be confusing and misleading in an appraisal context.
 - While the Division does not support taxing assets that don't exist at the lien date, it believes that this phrase is often misinterpreted to mean that you can't consider the additional market value for the property that does exist today, based on what can be done with that property in the future.
 - Market value is largely based on the principle of anticipated future benefits. In other words, what would a willing buyer pay (or a willing seller accept) for existing property today based on what can be done with this existing property in the future (including expanding and adding new assets).
 - For example, two pieces of land that are identical in physical attributes (acreage, grade, locational attributes, etc.), but that are zoned differently may have vastly different values because the zoning impacts what you can do to or with the property in the future. A vacant commercial or industrial property is likely to be more valuable than a vacant agricultural property because you can build income producing assets on the former (such as a hotel, restaurant, plant, etc.), but not on the latter.
 - The increased present fair market value to the commercial property or industrial property compared to the value of the agricultural property does not mean that the value of a future hotel, restaurant, or plant that does not yet exist has been captured, it

simply means that the market recognizes increased current value for the assets that exist presently (vacant land in this case) based on what you can do with it.

- Likewise, centrally assessed units that are located in high growth areas or are otherwise situated or located to take advantage of future investments to capture growth or efficiency opportunities are more valuable today than those that are not situated to do so.
- The Division supports the changes on lines 175-176 related to the cost of debt. It believes using a typical industry credit rating to estimate the cost of debt is appropriate.
- The Division also supports the current Rule's language that identifies the CAPM as the preferred cost of equity model.

Comments Related to Methods to Remove Exempt Intangibles

Some of the Division's main concerns are related to the changes proposed for removing exempt intangible assets.

Removing Intangibles from the Reconciled Value vs. Each Indicator

- The proposed changes include the requirement that intangible property be removed from the reconciled unit value (lines 50-51) instead of the current requirement to remove them from each indicator before reconciliation (lines 71-72).
 - While the Division does not object to this change specifically, it believes if exempt intangible property is to be removed from the reconciled value, that the Rule should ensure the reconciled value actually includes the value of all intangibles to begin with.
 - Several of the methods outlined and recommended in the Rule are already designed to limit the amount of exempt intangibles that are captured in each indicator. For example, the yield capitalization method restricts growth to inflationary growth, the stock and debt method and direct capitalization methods are not preferred due to their capturing the value of intangible property at "higher levels", capex is restricted to replacement capex, and intangible property is either not included in the HCLD indicator to begin with or specifically deducted in the case of rate-regulated utilities (see line 239).
 - It would be inappropriate to exclude or remove some or all intangible property from each indicator and then exclude or remove it again from the reconciled unit value as outlined in proposed subsection (3).

- The best way to avoid double counting the deductions for exempt intangibles (if removing intangibles from a reconciled unit value) is to ensure that all indicators include all intangible value to begin with and to remove exempt intangibles at their contributory value through a market-to-book ratio (more on that below).

Intangible and Other Non-Unit Property Should Be Removed at Contributory Value

- The methods described on lines 52-56 do not remove exempt intangible property at its contributory value to the unit. This mismatch can lead to double counting of intangible value and/or an over or under valuation of the intangible property's value contribution to the unit.
 - Unit valuation is based on the premise that a value is estimated for the entire unit as "one thing" and not estimated for its individual component parts. This is why a parcel of land that is assigned an allocated assessed market value based on its contribution to a larger unit, such as an integrated utility or transportation company, will likely have a different value than if that parcel of land were valued separately from the unit. WSATA and the Tax Commission's own administrative Rules 60 and 61¹ all recognize the importance of removing property from the unit value at its contributory value and not at values that are determined separate and apart from the unit.
 - Removing non-taxable property from the unit value (including exempt intangibles and property that is taxed elsewhere such as licensed motor vehicles) at contributory values ensures that the property is removed in the same manner and at the same value premise as it was captured (apples to apples comparison).
 - For example, if the unit was valued using 50% weight on an income approach and 50% weight on a cost approach, using a market-to-book ratio ensures that the property is removed consistent with how it was valued as part of the unit.
 - Removing booked intangibles from the reconciled unit value at their book values (lines 52-53) or at estimated market values separate from the unit, instead of at their contributory values could lead to removing too much or too little value based on its actual contribution to the unit.
 - While the Division recognizes that no model will likely result in a perfect or precise estimate of the amount of intangible property to remove from the unit, it believes that its current method for removing intangibles is preferred over the

¹ See R884-24P-60-G and R884-24P-61-E where properties (e.g. licensed motor vehicles or recreational motor vehicles) are removed from the unit at contributory value via a market-to-book ratio.

proposed methods outline in the draft. The Division's current method properly removes intangibles at contributory values, is based on the taxpayer's official books and records that are generally audited and available to the public, is consistent with other Commission Rules for removing property from the unit, can be consistently administered to all taxpayers, and has been accepted numerous times in previous Commission decisions.

Issues Related to the Normal Rate of Return Method

- The Division believes there are several issues related to removing intangible value using the normal rate of return method described on lines 57-62.
 - 59-2-102(16)(a)(ii)(A) requires that the above normal rate of return on assets be attributable to an item identified in 59-2-102(16)(b) and not items listed in 59-2-102(16)(c)(ii) in order to be classified as goodwill that would be exempt. The proposed method has no requirement that the source of the above normal rate of return be identified. An above normal rate of return resulting from 59-2-102(16)(c)(ii) or other items not specifically identified in 59-2-102(16)(b) would not give rise to exempt intangible property and are more likely attributes of the taxable tangible property itself (location, proximity to markets, etc.)
 - In practice, attributing an above normal return to specific items listed in the statute is impractical if not impossible.
 - Even if the above normal return could be attributed to items listed in 59-2-102(16)(c)(ii), the formula could result in a zero or negative taxable value in certain circumstances (i.e. the subject's rate of return was more than twice the industry typical return). While these scenarios may be infrequent, the Division does not support a method that presents an opportunity for it to happen.
 - The Division is concerned that the proposed changes that require a normal return analysis shift too much emphasis to the performance and attributes of guideline companies, instead of focusing on the attributes and cash flows of the subject property to estimate the value of the subject. The Division believes that these methods could result in setting a ceiling on value that is no greater than the "average" unit of property in the industry. This is inconsistent with accepted appraisal methodologies and is not consistent with how locally assessed properties are valued for property tax purposes.

- The Division is also concerned that implementing the above normal return methods will lead to more contention and litigation. The selection of guideline companies for capitalization rates has regularly been an area of contention. Having more of the companies' tangible value based on these guideline companies would introduce a greater level of subjectivity and would more than likely result in more appeals. This process of identifying reasonably similar companies, let alone more perfectly comparable companies, is often difficult due to the limited number of publicly traded companies in a given industry such as for short-line railroads. While "reasonably similar" companies and not "perfectly comparable" companies are sufficient for guideline companies for capitalization rates, they may not be appropriate in determining how much property to exempt for the subject.

Comments on the Cost Approach and Obsolescence

The Property Tax Division also has some concerns and comments related to the cost approach and obsolescence.

- The definition for "asset impairment" provided on lines 7-9 could be confusing. Asset impairment typically refers to the accounting process used to write down an asset's value on a company's balance sheet to arrive at net book value, not an adjustment to the subject's official net book value reported on its books and records.
 - The differences between the proposed definition and the accounting definition could cause confusion, particularly on line 19, as it is unclear if an appraiser must perform their own asset impairment analysis to reported net book value or simply rely on HCLD or net book value which already may include accounting asset impairments.
 - The Division agrees that book depreciation is the appropriate depreciation to apply to HCLD (lines 101-102). The Division believes that appraisal depreciation should not be applied to HCLD. Deducting appraisal depreciation as outlined in lines 105-106, would create an HCLD indicator that is not meaningful. Appraisal depreciation is best captured in other market-based indicators such as a properly crafted income approach.
- For income-producing, special-purpose unitary properties, functional obsolescence is generally not relevant in the context of HCLD. To the extent functional obsolescence exists, it should be captured in a properly crafted income approach.

- In regards to changes made on lines 113-117 and 121-125, the Property Tax Division believes functional and economic obsolescence are only relevant to a unitary property if it negatively impacts its ability to generate positive cash flows.
 - The Property Tax Division asserts that if reliable cash flows are available for the unit of assets then those cash flows should be used in the context of an income approach. The cash flows should not be used to convert HCLD to an income approach (e.g. income shortfall methods which have been consistently rejected by the Commission).

Other Comments and Areas for Possible Clarification

In addition to the proposed changes, the Division seeks clarification or changes in the following areas:

- Although the decision has been made to not pursue statutory changes in regards to the telecoms, the Division believes that additional clarity is needed on the criteria to analyze in determining what “other similar properties” (see line 38) qualify for central assessment.
- It is the opinion of the Property Tax Division that the statement at the beginning of line 151 should be changed to either “the change in the deferred income tax liability reported on the statement of cash flows” or the “actual deferred income tax expense for the prior period.”
- The Division believes the methods for adjusting the WACC for inflation and the operating cash tax rate, as written on lines 173 and 174, should be explicitly spelled out in the rule in order to clarify and avoid contention regarding the proper method.
- The Property Tax Division believes that the language in line 242 clearly demonstrates that rate base does not equal value and believes that language stating this plainly would avoid confusion on this issue.
 - The Division recommends that language similar to the following be added to clarify the impact of regulation in valuation.

Regulation: Government regulation may impact the market value of a company.

1. Rate regulation is one form of regulation that may impact the market value of a company; however, it does not determine the value of such a company.

2. Ultimately, while rate-regulators set the prices (rates) that rate-regulated companies may charge, they do not set the value nor dictate the methods that should be used to determine market value for rate-regulated companies.

3. Government regulation does not invalidate any of the three basic approaches to determining value because the market value of any company is determined by market participants (investors), not by regulators.²

- The reality that rate base does not equal value underscores that making a deduction for DIT in HCLD on lines 247 and 248 is not appropriate since the costs associated with DIT are associated with tangible valuable property that is owned, leased or used by the utility to carry out its operations even if it is not included in rate base.
- The Division believes that language is needed to clarify that the allowed return on equity for rate making purposes is not synonymous with the market cost of equity and should not be used interchangeably.³
- Lines 253 and 254 should be rewritten to not be exclusive to railroads. Appraisal theory suggests that the cost approach should be relied upon primarily for new properties.

I have also included for your reference a copy of the National Conference of Unit Valuation States 2018 Unit Valuation Standards and a copy of the District Court Case Decision referred to in footnote 3.

Once again, the Property Tax Division would like to thank the Commissioners for their work on updating Rule 62. We understand that the assessment of unitary properties is not an easy task. Thank you for your time and consideration. If you have any questions concerning these comments please feel free to contact me.

Sincerely,

A handwritten signature in black ink, appearing to read "Lucas Hendrickson", with a stylized flourish at the end.

Lucas Hendrickson
Assistant Director
Property Tax Division
Utah State Tax Commission

² See "Unit Valuation Standards", National Conference of Unit Valuation States, October 2018, Section II-I.

³ See PacifiCorp, Inc., et al., vs. Utah State Tax Commission Memorandum Decision and Order, Second Judicial District Court, Weber County, State of Utah, Tax Division. Case No. 180903986 TX, paragraph 18; See also "Unit Valuation Standards", National Conference of Unit Valuation States, October 2018, Section IV-C-10.



Lucas Hendrickson <lhendrickson@utah.gov>

Rule 62 revisions: intangible property

Lucas Hendrickson <lhendrickson@utah.gov>

Tue, Dec 15, 2020 at 4:41 PM

To: Larry Walters <lcwalters@utah.gov>

Cc: Denny Lytle <dlytle@utah.gov>, Devin Hales <dhales@utah.gov>

Bcc: Kevin Miles <kevinmiles@utah.gov>, Joseph Kasal <jkasal@utah.gov>, Cody Kemp <ckemp@utah.gov>

Commissioner Walters,

The Property Tax Division appreciates the opportunity to participate in the process of analyzing possible changes to Rule 62. We believe your memo on the intangible property clearly identifies some key issues that should be discussed as changes to Rule 62 are considered.

The Property Tax Division has reviewed your memo on intangibles and provided comments. I have attached both a Word and .pdf version of your memo which has been annotated with the Division's comments and suggestions. In the Word version, you may need to select the "show comments" button under the review tab to view the comments. The .pdf version has been reformatted to display all of the comments in the right margin.

Once you have had a chance to review these comments, the Division would welcome the opportunity to discuss any of these issues with you in greater detail or to answer any questions you may have via phone call or Google Meet. We recognize that the issues you raised in your memo are challenging and complex and that talking through the issues can be beneficial for all parties involved.

Once again, we appreciate the opportunity to be involved in this process and are hopeful you will find our comments and suggestions helpful.

Sincerely,

Lucas

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2 attachments

**Intangible value PTD Comments.docx**

52K

**Intangible value Memo PTD Comments.pdf**

352K

Intangible Property and the Utah Property Tax

Lawrence Walters
November 13, 2020 DRAFT

Article XIII, section 2 [of the Utah Constitution] provides that the Legislature is free to choose whether to tax intangibles as property or the income from intangible property. The Legislature has made its choice and decided to tax the income from intangible property. It is therefore prohibited from taxing the intangible property itself. (*T-Mobile USA, Inc. v. Utah State Tax Commission*, 2011 UT 28, ¶ 35)

Introduction and context

Tax Commission Rule R884-24P-62 (Rule 62) is intended to specify consistent appraisal methodologies to be used by the Property Tax Division (Division) in the valuation of tangible property assessable by the Commission; and identify preferred valuation methodologies to be considered by any party making an appraisal of an individual unitary property. The current language of Rule 62 includes the following:

- (3) ... Intangible property as defined under Section 59-2-102 is not subject to assessment and taxation.
- (4)(a) ... The value attributable to intangible property must, when possible, be identified and removed from value when using any valuation method and before that value is used in the reconciliation process.
- (5)(c)(i) ... When considering the sales of stock, business enterprises, or other properties that include intangible assets, adjustments must be made for those intangibles.

As the Commission considers potential updates for Rule 62, the question of how to treat intangible property in a manner that is consistent with the Utah Constitution and current statutes is critical.

In 1997, my co-authors and I wrote a report for the Utah Tax Review Commission in which we reviewed the methods then used by the Utah State Tax Commission in assessing natural resource, utility and other centrally assessed properties.¹ In that analysis, we found that, in the corporate finance world, there is no generally agreed upon method for identifying and isolating intangible value from the enterprise unit value. Further, methods that attempt to adjust the unit value for intangibles have a substantial *ad hoc* component, and little or no foundation in finance theory.

At least since 1897, the courts have acknowledged that assets operating as an integrated unit can have a value in excess of the cost of the component parts.

In the complex civilization of today, a large portion of the wealth of a community consists in intangible property, and there is nothing in the nature of things or in the limitations of

¹ Walters, L.C., Pinegar, J.M. and Schallheim, J.S., 1997, *A Review of Centrally Assessed Property Tax Issues in Utah*, Salt Lake City: Office of Legislative Research and General Counsel.

the Federal Constitution which restrains a State from taxing at its real value such intangible property

To ignore this intangible property, or to hold that it is not subject to taxation at its accepted value, is to eliminate from the reach of the taxing power a large portion of the wealth of the country. Now, whenever separate articles of tangible property are joined together, not simply by a unity of ownership, but in a unity of use, there is not infrequently developed a property, intangible though it may be, which in value exceeds the aggregate of the value of the separate pieces of tangible property. Upon what theory of substantial right can it be adjudged that the value of this intangible property must be excluded from the tax lists, and the only property placed thereon be the separate pieces of tangible property?

To say that there can be no such intangible property, that it is something of no value, is to insult the common intelligence of every man. (*Adams Express Co. v. Ohio State Auditor*, 166 U.S. 185, 218–220, (1897)).

It is worth noting that the Ohio statutes at issue in *Adams Express* allowed for the taxation of intangible property, whereas Utah has elected to exempt intangible property in favor of taxing the income from that property. It is also worth noting that the Utah Legislature did not intend to exempt property value resulting from “tangible property ... joined together ... in a unity of use”. As the Utah Supreme Court found in the 2000 *Wiltel* decision:

... fair market value reflects the benefit stream created by unitary operation of tangible property. If the legislature had desired to limit assessed value to the materials and installation costs of tangible assets, it could have done so. Since it did not do so, we conclude that the statutory and constitutional fair market value requirements recognize some element of value that is not attributable to either intangibles or simple cost and this enhanced value is taxable. (*Beaver County v. Wiltel, Inc.*, 2000 UT 29, ¶139)

Subsequent Utah statutory changes maintain the explicit legislative intent to include the incremental value of tangible assets working together as a unit in the property tax base. See, e.g., Utah Code Ann. §59-2-102(16)(c)(iv) (2020).

Ten years after the *Walters, et al.*, review referenced previously, the Western States Association of Tax Administrators (WSATA) published their *Appraisal Handbook: Valuation of Utility and Railroad Property*. Regarding the valuation and exemption of intangible property, the *Handbook* states:

Separating out the contributions of any asset from a unit market value is likely to be a daunting task. And if “intangible assets”, such as goodwill or going concern value or work force contracts or licenses and franchises to operate, are removed, what is left of the unit value? The market place simply buys and sells assuming all those “intangible” things exist. (WSATA *Handbook*, page VI-3)

After later quoting from the *Walters, et al.*, review, the *Handbook* concludes with “suggestions” to consider in developing rules for exempting intangible property:

- Exempt intangible property should be valued based on its contribution to the unit and deducted from the unit value and not from individual indicators.
- Exempt intangibles should have the characteristics of property so that they can be separated and valued apart from the unit. The removal of an exempt intangible should not destroy the unit.
- With regard to any tax exemption, the burden of proof is on the taxpayer to report and prove the existence of the exempt property.
- Exemptions should not be granted for “intangibles” that merely represent a right and interest in taxable property.
- Limiting the valuation of intangibles to one approach, or to a set formula, or by establishing that one approach is the upper limit of value, is contrary to standard appraisal theory and violates the principles of market valuation.²

Similarly, the 21 member states of the National Conference of Unit Valuation States (of which Utah is an active member) have published their *Unit Valuation Standards (Rev. Oct. 2018)*. With regard to exemptions for intangibles, these standards state:

1. Unitary appraisals should include the value of all operating property both tangible and intangible.
2. Under the unit value concept intangibles have no separate, distinguishable, market value apart from the tangible assets that they adhere to.
3. If intangible assets must be removed from the unit value to comply with local laws or statutes, they should be removed at their contributory value to the unit and not at values that have been derived separately from the unit.
4. Exempt intangibles and other exempt property should be removed at their contributory values. One example of this would be using a market-to-book ratio to determine the contributory value of the intangible property to remove from the unit.³

The challenge of dealing appropriately with intangible property value has led some to question whether the unit approach to value is still viable. In 2013, Richard G. Smith (of Hawley Troxell Ennis & Hawley LLP) published an article titled *Is the Unit Approach Still Viable?: A Legal Perspective*.⁴ Smith makes the argument that:

... the unit approach has relevance only when it can be determined through reliable methods and then only in two situations: (1) where the intangible property, which is exempt in almost all states, can be valued and removed from the unit value; or (2) where the unit value serves as an upper limit on taxable value. (Page 45)

The challenge of finding reliable methods to determine the market value of tangible property without also capturing exempt intangible value should not be underestimated. Utah and a number of other states have

Commented [PTD1]: The Property Tax Division agrees that the issue of valuing just the tangible property, or accurately removing all intangible property, is incredibly complex.

² WSATA, Handbook, page VI-6.

³ <https://www.ncuvs.org/unit-valuation-standards>, page 3.

⁴ *Journal of Property Tax Assessment & Administration*, 10(2):45-56.

largely abandoned the stock and debt approach for this very reason.⁵ But the continued use of the income approach is also likely to capture intangible value if it is present. The courts in both Iowa and Florida have rejected the use of both the income and sales approaches in valuing many centrally assessed properties. Relying on a prior Florida Supreme Court decision, the Florida appellate court found in *GTE Florida, Inc. v. Todora*:

From the single value arrived at by the income approach, it is virtually impossible to segregate specific items and identify their values. Thus, it is unlikely that the value of intangible assets and other nontaxable items can be subtracted in a nonarbitrary fashion to reveal the just valuation of the tangible personal property.⁶

In the 2013 *Union Pacific* case, the Utah Second Judicial District Court opined that a valuation method derived from the full cash flow of an enterprise captures the full value of both tangible and intangible assets.⁷

The Problem

While the courts in Utah, California, and elsewhere have ruled that exempt intangible value must be removed from the unit value, they have not been particularly helpful in providing guidance on how this should be done. In the *WilTel* decision, the court agreed with the taxpayer that goodwill was not taxable. The court also rejected the notion that replacement cost sets an upper limit on value. However, the court never resolved the conflict between the need to remove all intangible property from the unit while still allowing the enhancement component of value to be taxed through the property tax.

In the more recent *T-Mobile* case, the Utah Supreme Court asserted that intangible value can be separated into tax exempt and taxable components using standard unitary valuation methods.

Intangible assets such as “synergy value” and “customer base” are associated with the business being conducted on the property; they are not directly attributable to tangible property. ... And while assets associated with the business being conducted on the property, such as customer base and “going concern value,” can enhance tangible property, it does not follow that these assets constitute enhancement value. ... Rather, to the extent that accounting goodwill includes enhancement value attributable to T-Mobile’s tangible property, that value is reflected in the value of the physical property itself and can be captured by a unitary method of appraisal. (¶ 39)

In this case, the tax court noted that the value in T-Mobile’s goodwill account may have contained enhancement value, but it refused to tax T-Mobile’s goodwill account directly. Rather, the tax court concluded, to the extent T-Mobile’s goodwill account included enhancement value, that value would be captured through the valuation of the tangible property itself. The tax court correctly so concluded. (¶ 40)

⁵ The stock and debt approach measures the value of a company as the sum of the value of equity (stock price times shares outstanding) and the market value of debt as of the lien date. Since stock prices embody investor expectations about future opportunities and earnings for all assets, tangible and intangible, those prices frequently capture intangible value.

⁶ *GTE Florida, Inc. v. Todora*, 854 So. 2d 731, 734 (Fla. App. 2003).

⁷ *Union Pacific R.R. Co. v. Utah State Tax Comm’n*, Utah Tax Court, Case No. 090700830 (April 13, 2013).

In *T-Mobile*, the court turned to FASB FAS 141 for a description of what constitutes good will. FASB FAS 141 sets out the nature of goodwill in a business acquisition. Component #3 is of particular interest in the current discussion. Goodwill includes:

The fair value of the “going-concern” element of the acquired entity’s existing business. The going-concern element represents the **ability of the established business to earn a higher rate of return on an assembled collection of net assets** than would be expected if those net assets had to be acquired separately. That **value stems from the synergies of the net assets of the business**, as well as from other benefits (such as factors related to market imperfections, including the ability to earn monopoly profits and barriers to market entry—either legal or because of transaction costs—by potential competitors).⁸

Thus, the “goodwill” described in FASB FAS 141 includes, at least in part, the enhancement value the *WilTel* decision states is taxable, and the *T-Mobile* decision asserts is readily valued as part of the tangible assets using unitary valuation methods.

The challenge therefore is to develop a practical method for identifying and valuing intangible property using methods that are known to either exclude enhancement and assemblage value (the cost approach), or to capture exempt intangible value (income and market approaches).

The Utah Constitution and Statutes

Utah Constitution Article XIII, Section 2 provides:

- (1) *So that each person and corporation pays a tax in proportion to the fair market value of his, her, or its tangible property, all tangible property in the State that is not exempt under the laws of the United States or under this Constitution shall be:*
- (a) *assessed at a uniform and equal rate in proportion to its fair market value, to be ascertained as provided by law; and*
 - (b) *taxed at a uniform and equal rate.*

A key phrase in this passage is “tangible property in the State that is not exempt”.

Intangible property

Section 2 further provides:

- (5) *The Legislature may by statute determine the manner and extent of taxing or exempting intangible property, except that any property tax on intangible property may not exceed .005 of its fair market value. If any intangible property is taxed under the property tax, the income from that property may not also be taxed.*

This exemption for income producing intangible property applies to commercial properties that are locally assessed, and to all properties that are centrally assessed by the Tax Commission. As of 2019, the statewide effective property tax rates for each of these property classes was:

Commercial properties:	1.23% of assessed value
------------------------	-------------------------

⁸ Financial Accounting Standards Board, 2001, *Statement of Financial Accounting Standards No. 141*, B102. Emphasis added.

Natural resource properties:	1.27%	“
Utility properties:	1.19%	“

Observation #1: If the valuation methodologies used by the Property Tax Division and by local assessors fail to remove all exempt intangible value from their valuations, any remaining intangible value beyond assemblage and enhancement value is being taxed in violation of the constitution. Such is the case because (1) Utah has a corporate income tax (and an individual income tax on pass-through income), and (2) the effective tax rate exceeds the constitutionally mandated limit.

Observation #2: If the state did away with the corporate income tax, intangible income producing property could then be taxed under the property tax. However, the constitutional rate limit in combination with the uniformity requirement may still require a constitutional or statutory change, or both, to remove the rate cap or extend to intangible property an exemption similar to that granted to primary residential property (only larger).

Observation #3: Eliminating the corporate income tax would not eliminate the need to identify and differentiate tangible and intangible property and value both.

Thus, under the constitution, it is essential that the state be able to identify, value and isolate intangible property value. Two statutory definitions are therefore relevant: the definition of intangible property and, as a subcategory, the definition of goodwill.

In 2006, the Legislature expanded the definition of intangible property to include goodwill. Intangible property is currently defined in Utah Code Ann. §59-2-102(19) (2020):

- (19) "Intangible property" means:
 - (a) property that is capable of private ownership separate from tangible property, including:
 - (i) money; (ii) credits; (iii) bonds; (iv) stocks; (v) representative property; (vi) franchises; (vii) licenses; (viii) trade names; (ix) copyrights; and (x) patents;
 - (b) a low-income housing tax credit;
 - (c) goodwill; or
 - (d) a renewable energy tax credit or incentive, including:
 - (i) a federal renewable energy production tax credit under Section 45, Internal Revenue Code;
 - (ii) a federal energy credit for qualified renewable electricity production facilities under Section 48, Internal Revenue Code;
 - (iii) a federal grant for a renewable energy property under American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, Section 1603; and
 - (iv) a tax credit under Subsection 59-7-614(5).

In the same 2006 legislative session, goodwill was defined. The following year, the legislature modified the definition slightly. Currently, goodwill is defined in Utah Code Ann. §59-2-102(16) (2020):

- (16) (a) "Goodwill" means:
 - (i) acquired goodwill that is reported as goodwill on the books and records that a taxpayer maintains for financial reporting purposes; or

- (ii) the ability of a business to:
 - (A) generate income that exceeds a normal rate of return on assets and that results from a factor described in Subsection (16)(b); or
 - (B) obtain an economic or competitive advantage resulting from a factor described in Subsection (16)(b).
- (b) The following factors apply to Subsection (16)(a)(ii):
 - (i) superior management skills;
 - (ii) reputation;
 - (iii) customer relationships;
 - (iv) patronage; or
 - (v) a factor similar to Subsections (16)(b)(i) through (iv).
- (c) "Goodwill" does not include:
 - (i) the intangible property described in Subsection (19)(a) or (b);
 - (ii) locational attributes of real property, including:
 - (A) zoning;
 - (B) location;
 - (C) view;
 - (D) a geographic feature;
 - (E) an easement;
 - (F) a covenant;
 - (G) proximity to raw materials;
 - (H) the condition of surrounding property; or
 - (I) proximity to markets;
 - (iii) value attributable to the identification of an improvement to real property, including:
 - (A) reputation of the designer, builder, or architect of the improvement;
 - (B) a name given to, or associated with, the improvement; or
 - (C) the historic significance of an improvement; or
 - (iv) the enhancement or assemblage value specifically attributable to the interrelation of the existing tangible property in place working together as a unit.

Three approaches for valuing exempt intangible property

This discussion will focus on the valuation of three types of intangible property listed in the statutory definitions: separable intangible property and two types of goodwill.

- 1) Intangible property "capable of private ownership separate from tangible property" can be independently valued.
- 2) Property "reported as goodwill on the books and records that a taxpayer maintains for financial reporting purposes" is valued using accepted financial accounting standards.
- 3) Intangible property that enables a firm to "generate income that exceeds a normal rate of return on assets" or gives the firm some type of competitive advantage can be valued by comparing the rate of return on assets with the normal rate of return on assets of comparable guideline companies.

Each of these approaches are discussed below.

Property capable of private ownership separate from tangible property

In 2016, the IAAO⁹ Special Committee on Intangibles released its special report *Understanding Intangible Assets and Real Estate: A Guide for Real Property Valuation Professionals*.¹⁰ The report is largely focused on locally assessed properties such as hotels, motels and other properties that may include intangible value. The report cites multiple sources and attempts to identify the attributes of intangible property for property tax purposes. The report concludes that the Rushmore or management fee approach is the best available method for valuing the type of exempt intangible property value considered in the report. The authors develop a four-part test for intangible property, which is only summarized here.

Identifying these attributes can assist the assessor in determining whether something intangible rises to the level of an asset. Based on these sources, a four-part test can be used to help determine the existence of an intangible asset, as follows:

1. An intangible asset should be identifiable.
2. An intangible asset should have evidence of legal ownership, that is, documents that substantiate rights.
3. An intangible asset should be capable of being separate and divisible from the real estate.
4. An intangible asset should be legally transferrable. (page 42)

This listing of attributes agrees reasonably well with Utah Code Ann. §59-2-102(19)(a) as interpreted by Utah courts for intangible property capable of separate private ownership. As an example, in the 2013 *Union Pacific* case, the court found that the firm's custom computer software was exempt intangible property because it was capable of private ownership separate from the tangible property and it could be sold separately from the tangible assets. The court explicitly rejected the notion that intangible assets such as custom computer software had to be capitalized on the company's books.¹¹

The IAAO Guide has been strongly criticized, at least within a California context, and some of the criticisms are worth noting. O'Neill and Davis¹² challenge the notion that intangible property must be separable. It is noteworthy that under Utah law, "separable" is only one type of exempt property. The authors also question whether accounting allocations are useful, stating:

Reliance on valuations performed for accounting or tax reporting purposes are nearly always irrelevant and inappropriate for use in property tax assessment appraisals.¹³

However, booked goodwill is expressly exempted under Utah law. (See discussion below.)

The strongest criticisms levied by O'Neill and Davis are reserved for the Rushmore or management fee approach to valuing intangibles. Again with particular reference to lodging properties, the Rushmore

Commented [PTD2]: The Property Tax Division acknowledges that Judge Morris did rule for that specific case based on the facts presented that an additional deduction for computer software was warranted even though it was not on the books.

However, the Division believes that removing intangibles from a unit value at anything other than its contributory value violates unit valuation principles. The Division would also point out that the Commission and Division provided no witnesses in the Union Pacific District Court case. The Division also believes that this issue has not been fully litigated.

⁹ International Association of Assessing Officers.

¹⁰ *Journal of Property Tax Assessment & Administration*, 2016, 14(1):41-91.

¹¹ *Union Pacific R.R. Co. v. Utah State Tax Comm'n*, Utah Tax Court, Case No. 090700830 (April, 13, 2013).

¹² O'Neill, C.K. and Davis, C.S., 2018, *Understanding Intangible Assets and Real Estate: A Response to the IAAO Committee's Guide, California Tax Lawyer*, 27(1):3-14. O'Neill and Davis are practicing attorneys with the firm of Greenberg Traurig, LLP.

¹³ *Ibid*, page 5.

approach presumes that the expenses associated with a property's management by a separate entity captures all of the exempt intangible value. Under the Rushmore approach, by deducting the management fee, exempt intangible value has been removed. This approach has been advocated and used across the country, with varying receptions in the courts.

The criticism that O'Neill and Davis raise is that the approach does not capture the full value of exempt intangibles. The argument they make is that investors require both a *return of* and a *return on* their investment. Property earnings sufficient to reimburse the property owner for the management fee represent only a *return of* the management fee investment. Unless the management company is able to also generate a *return on* that investment in the form of higher income than would otherwise be obtained, the property owner would not enter into the management agreement. The value of this additional income stream over and above the management fee also represents tax exempt intangible property. (In Utah, this additional income should be valued as income that exceeds the normal rate of return on assets.)

A numerical example may serve to illustrate their point. Consider a lodging property owner who currently earns a profit of \$1 million per year. The owner is considering entering into a management contract that will cost \$50,000 per year at current occupancy levels. If the management company is able to generate sufficient income to cover the contract cost of \$50,000, that return to the owner would represent a *return of* the investment. If that is the best the management company can do, there is little reason for the owner to enter into the contract. Only if the management agreement results in a return in excess of the contract cost (a *return on* the investment) is the owner likely to enter into the agreement.

Utah law expressly exempts "property that is capable of private ownership separate from tangible property." The four-part test proposed in the IAAO guide may be useful. However, the approach to the "management fee" valuation of such property provided in the IAAO guide is probably of limited use as it applies only to a subset of intangible property that is exempt in Utah and may capture only a portion of the relevant intangible value. Taxpayers may be required to provide additional documentation regarding the value of intangible property in this category.

As a final note, this conclusion should not be taken to imply that the value of intangible property in this category must be capitalized. The court has affirmed that separable intangible assets may or may not be capitalized and listed on the balance sheet. See *Union Pacific R.R. Co. v. Utah State Tax Comm'n*, Utah Tax Court, Case No. 090700830 (April 13, 2013).

Booked goodwill

While booked goodwill has both supporters and critics as a measure of intangible value in a property tax setting,¹⁴ Utah specifically exempts goodwill that conforms to accepted accounting standards.¹⁵

Utah Code Ann. §59-2-102(16)(a)(i) (2020) defines exempt goodwill as "acquired goodwill that is reported as goodwill on the books and records that a taxpayer maintains for financial reporting purposes." The accounting profession has adopted a standard for the measurement and reporting of such goodwill in

¹⁴ See, e.g., Smith, R., The Continuing Conundrum of How to Exclude Goodwill in Unitary Property Taxation — and a Proposed Solution, *Property Tax Valuation Insights*, www.willamette.com, Summer, 2017. It should be noted this is not a peer-reviewed outlet and may not be considered authoritative.

¹⁵ A firm's ability to earn an above average rate of return on assets is also listed in Utah Code Ann. §59-2-102(16)(a), as discussed in the next section.

Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 141R (revised 2007) (FAS 141R).¹⁶

FAS 141R became effective for most organizations with fiscal years beginning during 2009. The objective of FAS 141R, per Paragraph 1, “is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial reports about a business combination and its effects.” To accomplish this objective, FAS 141R establishes guidance for how an acquirer recognizes and measures identifiable assets (including intangible assets), assumed liabilities, and any non-controlling interest in an acquiree and also how an acquirer recognizes and measures goodwill related to a business combination.

FAS 141R applies to all business combinations in which an acquirer obtains control of one or more businesses. However, it does not apply to the formation of a joint venture, the acquisition of an asset or a group of assets that does not constitute a business, a combination between entities or businesses under common control, or a combination of not-for-profit organizations or the acquisition of a for-profit business by a not-for-profit organization.

Under FAS 141R, goodwill is defined as a residual.

This Statement requires the acquirer to recognize goodwill as of the acquisition date, measured as a residual, which in most types of business combinations will result in measuring goodwill as the excess of the consideration transferred plus the fair value of any noncontrolling interest in the acquiree at the acquisition date over the fair values of the identifiable net assets acquired.¹⁷

Goodwill that has been calculated following the guidance of FAS 141R (and FAS 142 to the extent applicable) under most circumstances should be considered exempt intangible property under current Utah law.

Generating income that exceeds a normal rate of return on assets

Utah Code Ann. §59-2-102(16) specifically excludes from the definition of exempt goodwill “the enhancement or assemblage value specifically attributable to the interrelation of the existing tangible property in place working together as a unit”. Neither is assemblage value listed under the broader definition of intangible property. Value resulting from the ability to generate a return in excess of a “normal rate of return on assets” is exempt. This immediately raises at least two questions:

- 1) Is there a well-defined and practical method for identifying and valuing the enhancement or assemblage value of assets operating as an integrated unit?
- 2) How should the normal rate of return on tangible assets be determined, as distinguished from the overall or total return on all tangible and intangible assets?

As noted in the introductory section, the answer to the first question is no. Practitioners and the courts have acknowledged the existence of assemblage value for over 100 years. Neither practitioners nor the courts have yet developed a method to value the incremental intangible value resulting from tangible

¹⁶ FASB FAS 142, *Goodwill and other intangible assets*, is also relevant. It is somewhat older than FAS 141R and has been amended by FAS 141R in important ways.

¹⁷ <https://www.fasb.org/pdf/fas141r.pdf>, page iv

assets working as an integrated unit that does not also capture exempt intangible value. Replacement cost avoids all intangible value, including assemblage value. As noted in both Iowa and Florida, and in Utah's recent *Union Pacific* case, the income and market approaches capture the value of all assets working together, including exempt intangibles.

For example, it might be argued that the WACC¹⁸ could be used to calculate the income required from the tangible assets, and any income in excess of this amount should be attributed to intangible value. However, WACC calculations taken from publicly available data inevitably incorporate market expectations about the return on all assets, tangible and intangible. To adjust an income indicator developed using such rates involves either making the strong assumption that tangible and intangible assets earn the same rate of return (which has been found to be an inappropriate assumption¹⁹), or disaggregating the cost of capital using the Weighted Average Return on Assets (WARA) approach or something similar. If the former is inappropriate, the latter assumes that the value of intangible assets is known which is precisely what the appraiser is attempting to determine.²⁰

To comply with the statute, the analysis of relative return on assets must focus on the tangible assets, not the entire enterprise. This can be accomplished by first determining the normal or average rate of return on assets for appropriate guideline companies. The appropriate measure for this analysis is a firm's Net Operating Income (NOI) divided by the Historical Cost (less depreciation) (HCLD) of the firm's tangible assets. This averaged ratio of NOI to HCLD for guideline companies complies precisely with the statutory concept of "normal rate of return on assets."²¹

Once the normal rate of return on assets is determined, a given firm's actual return on assets can be calculated and compared using the same metrics. If a firm has a return on assets (NOI/HCLD) higher than the average for guideline companies, the difference may indicate exempt intangible property value.

It is worth noting that this calculation of NOI/HCLD does not require the specific identification of the source of the higher return on assets. Utah Code Ann. §59-2-102(16)(b) (2020) lists specific operating characteristics that may lead to a higher than normal rate of return, but the statute does not require that they be valued separately. In fact, any separate valuation of factors listed in §59-2-102(16)(b) is irrelevant. The determining factor is that the firm exhibits a rate of return on assets that exceeds the normal (average) return.

To improve the stability of these calculations for both taxpayers and local governments in the face of economic and industry fluctuations, the calculation of both the normal rate of return (NOI/HCLD) for

Commented [PTD3]: The Property Tax Division believes that there are other methods to remove intangible property such as its current method of using a ratio based on book value. This method has been upheld in several Commission decisions because it removes intangibles at their contributory value.

Commented [PTD4]: The Property Tax Division believes that the use of NOI/HCLD does not identify whether the higher rate of return is due to factors listed in §59-2-102(16)(b) or if they are factors listed in §59-2-102(16)(c)(ii).

Commented [PTD5]: The Property Tax Division believes that if adjustments were made after reconciliation, the HCLD used in the cost approach should include intangible property. The Property Tax Division believes that this could lead to confusion.

Commented [PTD6]: The Property Tax Division agrees that (16)(b) does not require each characteristic to be valued separately, but believes that (16)(b) does require the identification of which characteristic(s) led to the higher than normal rate of return.

This is what makes applying this portion of the statute difficult if not impossible. Even if everyone can agree what constitutes a "normal" rate of return (no small task), the challenge remains in showing that the above normal rate of return is a result of superior management skills, reputation, customer relationships, patronage, or a similar factor.

The above normal return is not intangible if it results from zoning, location, view, a geographic feature, an easement, a covenant, proximity to raw materials, the condition of surrounding property, or proximity to markets.

¹⁸ Weighted Average Cost of Capital.

¹⁹ Schauten, M., Stegink, R., and de Graaff, G., (2010, The discount rate for discounted cash flow valuations of intangible assets, *Managerial Finance*, 36(9):799-811) find that the appropriate discount rate for intangible assets is higher than the WACC. Another study (Crane, M., 2019, The Legend of Weighted Average Return on Assets and Benchmarking Purchase Price Allocation Data, BVRResearch Pro) finds that the appropriate rate is lower than the WACC. The point here is simply that empirical research finds that the return on intangible assets is not equal to a firm's WACC.

²⁰ Alternatively, if the return on tangible assets and the return on intangible assets are both known, it would be possible to determine the value of intangible assets through an iterative process. Here again, this assumes that most of the pieces of the puzzle are known.

²¹ Replacement cost new less depreciation might be theoretically preferred to historical cost, however, obtaining replacement cost data for all guideline companies is unworkable. Historical cost should be readily available from public sources.

guideline companies and the specific NOI/HCLD for a given firm should be averaged over several years (most likely the most recent 3 to 5 years).

In an effort to understand and consider the implications of this approach, I made a number of estimates of the ratios involved. This is not presented as a definitive analysis, merely as an illustration. I used a popular website²² to obtain two financial statistics for the guideline companies used by the Property Tax Division in their most recent cap rate study. The statistics selected may or may not reflect the values that the Division or taxpayers might use after all appropriate adjustments. Nonetheless, the analysis provides a rough illustration of the method.

The following table illustrates how the “normal rate of return on assets” can be measured for railroads. Again, the firms selected are taken from the Division’s cap rate study, and the specific statistics from the financial website referenced earlier. The average values presented here are the net operating income (NOI) from continuing operations divided by net property, plant and equipment (net PPE) for all of the relevant guideline companies used in the Division’s latest cap rate study.

Net operating income over net property, plant and equipment for guideline railroads

Year	Canadian National Railway	Canadian Pacific Railway	CSX	Norfolk Southern	Union Pacific	Average
2019	10.49%	12.50%	10.19%	8.61%	10.62%	10.48%
2018	11.46%	10.59%	10.34%	8.57%	11.33%	10.46%
2017	16.04%	14.13%	17.22%	17.82%	20.76%	17.19%
2016	10.78%	9.58%	5.50%	5.61%	8.40%	7.97%
Average	12.19%	11.70%	10.81%	10.15%	12.78%	11.53%

Average NOI over Net PPE by Industry and Year

Year	Telecom.	Railroad	Electric	Gas Dist.
2019	11.85%	10.48%	3.86%	3.41%
2018	14.83%	10.46%	3.82%	3.46%
2017	25.98%	17.19%	3.99%	2.69%
2016	10.95%	7.97%	3.70%	3.29%
Average	15.90%	11.53%	3.84%	3.19%

What this brief and preliminary analysis illustrates is that the normal rate of return on assets varies substantially by industry.²³ It is possible, however, to establish a “normal rate of return on assets” for an industry comparison group. Clearly the appropriate selection of comparable firms is critical and will undoubtedly be a point of future contention.

Commented [PTD7]: The Property Tax Division agrees that, if the ROA method were used, there would be a lot of contention about the selection of comparable companies.

²² Finance.yahoo.com.

²³ Purely for interest’s sake, a similar calculation was made for a few other companies. The 4-year average ratio for Alphabet (Google) was 44.7%, for Amazon the average was 10.6%, for Apple it was 145.0% and for a large big-box retailer it was 9.6%.

The question of comparability has come up in other contexts and it is important to be clear that it is an issue of vital importance. For example, it would not be appropriate to compare the operations of a single power plant to the industry average for electric firms. The guideline entities must be comparable in scale, scope and organization. This requirement likely means that it will be difficult to assert intangible value for some entities simply because it is difficult to establish the normal rate of return on assets for truly comparable entities. Again, valuing factors that may contribute to a higher rate of return is of no relevance unless it can be shown that there is a higher than normal rate of return on assets.

The above railroad table also illustrates that the ratio of NOI/HCLD varies by firm and year. How much above the average rate of return on assets must a firm be in order to be found to have exempt goodwill under this metric? The plain language of the statute states simply “income that exceeds a normal rate of return on assets”. To impose a specific minimum requirement would go beyond the statute.

Another observation relates to rate-regulated companies. On first consideration, it may seem that such companies cannot have earnings higher than normal because their rates are set to yield a typical return. From the table it can be seen that capital-intensive, regulated entities are likely to have lower normal rates of return on assets than other industries. However, this does not rule out the possibility that a given firm may earn a rate of return on assets higher than its industry average.

The use of the NOI/HCLD ratio allows the analyst to both test whether or not exempt intangible value is present and determine the value of the exemption if necessary. If the analyst determines that the firm is earning a return on assets that is higher than the industry norm (i.e., the return is above the industry average), the adjustment required to remove this exempt intangible value is:

Company return on assets, divided by the normal return on assets, minus 1.

The reconciled unit value should be reduced by this adjustment factor.

The differences in the normal return on assets (NROA) across industries may suggest to some that industries with relatively high levels of NROA have more intangible value than industries with lower NROA. This may or may not be the case, however the standard set out in the statute is simply the normal rate of return on assets. Comparisons in the real property valuation domain are based on comparisons to comparable properties. Therefore, determination of a normal rate of return must be based on comparable properties.

Utah Code Ann. §59-2-102(16)(a)(ii)(B) provides that the concept of goodwill also includes “an economic or competitive advantage.” The existence of any such advantage will be difficult to demonstrate unless the advantage derives from an intangible asset that can be identified and separately valued or booked goodwill, or the advantage results in a higher than normal rate of return on assets.

The Path Forward

Based on this analysis of Utah’s Constitution, statutes and case law, Rule R884-24P-62 (Valuation of State Assessed Unitary Properties Pursuant to Utah Code Ann. Section 59-2-201) should be amended to clearly provide guidance on the identification and valuation of exempt intangible property. The rule should direct that in valuing centrally assessed properties, all exempt intangible property value should be deducted from the reconciled unit value. The following steps outline the process to be followed:

- A. Any booked goodwill and other capitalized intangible value should be identified.

- B. Documentation should be obtained to allow for the valuation of exempt intangible property that is capable of separate ownership.
- C. The normal rate of return on assets for guideline companies should be calculated using NOI/HCLD and then compared to the actual return on assets for the subject company. If this comparison indicates that the subject property earns a rate of return on assets above the norm, the adjustment factor will be the company's return on assets divided by the normal return on assets (minus 1).

It is conceivable that a firm may have more than one type of exempt intangible property. In such a case, the plain language of the statute suggests that not all three types of intangible value should be allowed. Doing so would almost certainly result in double counting of some asset value. Considering the language used in §59-2-102(19) with §59-2-102(16), the separators selected by the legislature are all "or". Should there be a case in which a firm has more than one type of exempt intangible property, the magnitude of the adjustment to the reconciled unit value should be based on the larger of either the sum of A and B above, or the result of C.

A numerical example may help to clarify this point. Suppose that a centrally assessed company reports the following data:

- Historical cost less depreciation for property, plant and equipment equal to \$10,000,000.²⁴
- Custom computer software valued at \$100,000.
- Booked goodwill from a recent acquisition of \$500,000.
- Average NOI for the past three years of \$1,000,000 per year, and therefore NOI/HCLD = 10%
- A reconciled unit value of \$11,000,000.

If the average NOI/HCLD for the guideline companies is 11% (i.e., higher than the firm's rate of return on assets), the value of the firm would be

$$\$11,000,000 - \$100,000 - \$500,000 = \$10,400,000.$$

However, if the average NOI/HCLD for the guideline companies is 9%, the firm is earning a higher than normal rate of return on assets. Consequently, the deduction for intangible value should be the larger of either the sum of (in this example) custom computer software and booked goodwill (\$600,000) or the increment in earnings above the normal rate of return. In this example, the earnings above the normal rate is larger than the value of the specific intangibles. The final value of the firm should be:

$$\begin{aligned} \$11,000,000 - (\$11,000,000 * ((0.10/0.09) - 1)) &= \\ \$11,000,000 - \$1,222,222 &= \$9,777,778. \end{aligned}$$

Concluding observations

In the introduction, I cited the 1997 report's finding that in the corporate finance world, there is no generally agreed upon method for identifying and isolating intangible value from the enterprise unit value. Methods that attempt to adjust the unit value for intangibles have a substantial *ad hoc* component, and little or no foundation in finance theory. That conclusion still holds. Markets determine value based on the projected future return on all assets, tangible and intangible, working in a "unity of use".

²⁴ Ignoring any adjustments needed for CWIP and other factors.

Commented [PTD8]: The Property Tax Division believes that removing goodwill at its book value and valuing other intangibles separate from the unit violates unitary valuation principles that all assets contribute to unit in proportion to its invested cost. Consistent with this principle, WSATA advises that "exempt intangible property should be valued based on its contribution to the unit."
WSATA Handbook pg VI-6

The Division's ratio method for removing intangibles, while not perfect, adheres to these principles.

Commented [PTD9]: One potential issue with this methodology is that the formula can actually lead to a 100% exemption or more of the total property. For example, if a company were to have an ROA of double the industry norm, the company's assets would be considered completely intangible.

Commented [PTD10]: The Property Tax Division agrees that making adjustments to the reconciled value is possible, but if it were to be done this way, the rule should specify that the HCLD and income approaches to value include all intangible property.

Utah along with many other states has determined as a matter of policy to attempt to exclude intangible property value from the property tax and instead tax the income from that property. Inevitably, the efforts made by policymakers to define and value exempt intangible property will contain *ad hoc* components, especially when some intangible property is considered taxable (assemblage value) and the remainder is exempt.

The Legislature has identified a number of specific categories of intangible property that it seeks to exempt from the property tax. Of particular interest in this discussion are intangible properties capable of separate private ownership (e.g., custom computer software), goodwill reported on a company's books in adherence to standard accounting practices, and a firm's ability to earn a rate of return on assets that exceeds the norm.

This discussion attempts to analyze the challenges in valuing intangible property and lay out a practical approach for carrying out the wishes of the Legislature. As with other communications related to potential revisions to Rule 62, this piece is intended to solicit comments and suggestions in response to the initial and tentative articulation of potential rule revisions. All such comments will be carefully reviewed.

Commented [PTD11]: The Property Tax Division agrees that there is no one method that will perfectly remove exempt intangibles while still valuing the assemblage or enhanced value. We believe that the ratio method currently employed by the Property Tax Division is the most correct method for reducing intangible value while still adhering to unitary principles.



Lucas Hendrickson <lhendrickson@utah.gov>

Property Tax Division Comments to Rule 62 Obsolescence Memo

Lucas Hendrickson <lhendrickson@utah.gov>

Thu, Jun 25, 2020 at 3:50 PM

To: Larry Walters <lcwalters@utah.gov>

Cc: Denny Lytle <dlytle@utah.gov>, Devin Hales <dhailes@utah.gov>

Commissioner Walters,

The Property Tax Division appreciates the opportunity to participate in the process of analyzing possible changes to Rule 62. We believe your memo on obsolescence clearly identifies some key issues that should be discussed as changes to Rule 62 are considered.

The Property Tax Division has reviewed your obsolescence memo and provided comments. I have attached both a Word and .pdf version of your memo which has been annotated with the Division's comments and suggestions. In the Word version, you may need to select the "show comments" button under the review tab to view the comments. The .pdf version has been reformatted to display all of the comments in the right margin.

Once you have had a chance to review these comments, the Division would welcome the opportunity to discuss any of these issues with you in greater detail or to answer any questions you may have via phone call or Google Meet.

Once again, we appreciate the opportunity to be involved in this process and are hopeful you will find our comments and suggestions helpful.

Sincerely,

Lucas

--

Lucas Hendrickson

Assistant Director
Centrally Assessed
Property Tax Division
Utah State Tax Commission
801.297.3609

2 attachments

**Property Tax Division Comments on Obsolescence Memo - 6-25-2020.docx**
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Obsolescence and Rule 62

10 June 2020

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One of the challenges which must be confronted in revising Administrative Rule **R884-24P-62** (Rule 62) is the treatment of obsolescence. Some of the current language in the rule (e.g., the treatment of deferred taxes) appears to be an attempt to work around the lack of agreement on the existence and measurement of obsolescence. This discussion is an attempt to summarize how obsolescence is defined and measured in the literature and in practice. It draws on a variety of sources and attempts to develop a logic that will guide the revisions of the relevant Rule 62 sections. It is intended to provide the foundation for a robust discussion of the issues among all stakeholders, and comments, criticisms and suggestions for improvement are most welcome.

This brief analysis first identifies some of the challenges that exist with the current rule language, and briefly lists alternative definitions of obsolescence concepts taken from a variety of sources. Section II reviews common applied approaches for measuring functional obsolescence. Similarly, Section III reviews approaches to measuring external/economic obsolescence. Given that unitary appraisal is not the only discipline that grapples with these issues, Section IV reviews the treatment of similar concepts in the financial accounting field. Section V discusses the most common methods proposed for quantifying the level of economic obsolescence. Finally, Section VI offers concluding observations that may be used to guide future revisions to Rule 62.

I. Challenges with the current rule language

The current relevant language from Rule 62 is included at the end of this discussion for ease of reference. The current rule identifies both accounting and appraisal depreciation, and subdivides appraisal depreciation into three categories:

- Physical
- Functional
- Economic or external

While the distinctions in the Rule are fairly common in the literature, there are at least five problems with the current language.

- 1) The rule does not acknowledge accounting approaches to obsolescence identification and measurement.
- 2) Functional obsolescence is not defined, only its causes are listed.
- 3) No mention is made of when external/economic obsolescence is relevant.
- 4) No guidance is provided on how any of the three forms of appraisal depreciation should be quantified.
- 5) While HCLD is identified as the preferred cost indicator, no guidance is provided on how appraisal depreciation or accounting approaches to obsolescence should be used, if at all, to adjust the HCLD indicator.

Commented [PTD1]: The Division agrees that whether or not an asset has been impaired from its historical booked cost should be taken into consideration in an HCLD cost approach. While the rule doesn't explicitly state to take asset impairment into account, the Division has always recognized asset impairments as part of its HCLD approaches to value.

Commented [PTD2]: The Division agrees that more guidance is needed to clarify if and when any additional obsolescence should be applied to its HCLD indicator. The Division's position is that once HCLD is derived from the company's books and records that it should not be further adjusted upward or downward for additional market appreciation or depreciation. The Division does believe that adjustments to historical cost for impairments or purchase price accounting already are and should be considered in an HCLD indicator.

The issues are further complicated by the fact that obsolescence is a concept found in the real estate appraisal and accounting literatures. However, many of the methods used in unitary appraisals are drawn from the fields of corporate finance and corporate valuation, where the topic of obsolescence is rarely mentioned.

Accounting depreciation is discussed in corporate finance texts because it reduces taxable income.¹ But financial accounting professionals also grapple with obsolescence concepts when they deal with asset impairment. Asset impairment also receives limited attention in corporate finance and valuation texts.

At the same time, the real estate appraisal literature and appraisal practice are generally focused on specific real property assets, not combinations or groups of assets working in concert. In this context, changing construction standards, market demands and shifting locational needs affect the market attractiveness of the specific assets being valued. However, the role those assets play in the larger enterprise is not considered outside of unitary valuation.

Definitions

Depreciation (from Rule 62): *"Depreciation" is the loss in value from any cause. Different professions recognize two distinct definitions or types of depreciation."*

Accounting depreciation (from Rule 62): (A) *Accounting. Depreciation, often called 'book' or 'accumulated' depreciation,*

Commented [PTD3]: The Division agrees that when considering ways to measure value, obsolescence, or additional enhanced or appreciated value for a unit of operating assets, should all be measured at the unit level and not at the individual asset or component level.

The Division also believes that obsolescence only exists in as much as the market recognizes a loss in market value. The 13th edition of the Appraisal of Real Estate states, "Depreciation is a penalty only insofar as the market recognizes it as causing a loss of value...an appraiser should exercise caution not to penalize a property unduly in the cost approach." (The Appraisal of Real Estate, Thirteenth Edition pg. 393, emphasis added).

¹ One prominent text minimizes the relevance of depreciation with this comment: "Depreciation is a noncash expense; it is important only because it reduces taxable income." (Brealey, et al., 2017, *Principles of Corporate Finance*, 12th ed.)

... Book depreciation is typically applied to historic cost to derive HCLD.

Appraisal Depreciation (from Rule 62): *(B) Appraisal. Depreciation, sometimes referred to as 'accrued' depreciation, is the difference between the market value of an improvement and its cost new. Depreciation is typically applied to replacement or reproduction cost, but should be applied to historic cost if market conditions so indicate.*

Functional obsolescence

- A flaw in the structure, materials, or design that diminishes the function, utility and value of the improvement when compared with the highest and best use and most cost-effective functional design requirements at the time of appraisal. (*Appraisal of Real Estate*, 12th ed., pg 403)
- A flaw in the structure, materials, or design that diminishes the function, utility, and value of the improvement. This may be a loss in value due to technological advances, internal property characteristics, inadequacies, superadequacies, or social requirements. (WASATA manual, pg XVI-11)
- Functional obsolescence is the reduction of an object's usefulness or desirability because of an outdated design feature that cannot be easily changed. (www.investopedia.com)
- The loss in value of a property due to lack of improvements, outdated amenities, and/or poor architectural design, failing to meet today's living standards desired by consumers. (<https://study.com/academy/lesson/functional-obsolescence-in-real-estate-definition-example.html>)

External/Economic obsolescence

- From Rule 62: *(III) External, or economic, obsolescence is an impairment of an improvement due to negative influences from outside the boundaries of the property, and is generally incurable. These influences usually cannot be controlled by the property owner or user.*

- A temporary or permanent impairment of the utility or salability of an improvement or property due to negative influences outside the property (External obsolescence may result from adverse market conditions. Because of its fixed location, real estate is subject to external influences that usually cannot be controlled by the property owner, landlord, or tenant.) (*Appraisal of Real Estate*, 12th ed., pg 363; WASTA manual, pg XVI-8-9)
- ... a loss in value caused by factors outside a property. It is often incurable. (*Appraisal of Real Estate*, 12th ed., pg 412)

In sum, obsolescence is the reduction in market value due to changing conditions and design limitations.

- If the changing (deteriorating) conditions are the result of use, are inherent in the property, and reflect a shortened expected future life, the obsolescence is physical
- If the changing conditions are a manifestation of changing technologies or design preferences that render a property less desirable in the contemporary marketplace even though the expected future life remains unchanged, the obsolescence is functional
- If the reduced market value is due to changes in market conditions beyond management control and which reduce a firm's ability to earn an adequate return on its investment, the obsolescence is economic or external. For a particular property, the change may be locational (e.g., a new road development that impairs a location's access)

II. Approaches to measuring functional obsolescence

Functional obsolescence is typically measured using the "cost to cure". Functional obsolescence is considered curable if spending the money to correct the deficiency will increase the value of the asset by an amount greater than the cost of the correction. If the "cost to cure" exceeds the value added, the obsolescence is considered incurable. This "cost to cure" value is used to adjust either the reproduction or replacement cost of the asset. (See *The Appraisal of Real Estate* for a much more detailed discussion.)

- The Western States Association of Tax Administrators (WASATA) *Appraisal Handbook: Valuation of Utility & Railroad Property (2007)* suggests that functional obsolescence is not of much interest in the unitary appraisal of utility and railroad properties:

If the history of the property type shows that the items tend to be replaced while still in sound operating (physical) condition, then functional obsolescence has been taken into account in the normal economic life expectancy and depreciation tables. If the history shows the property is replaced only when physically worn out, then functional obsolescence is not a significant part of normal depreciation.

... As a general rule, functional obsolescence need not be considered for individual items unless the items constitute a significant component of the property and the obsolescence is truly abnormal. (WASATA, pgs II-15-16)

- Oregon Rule Rule 150-308-0280 *Measuring Functional Obsolescence in Industrial Property* lays out the Oregon approach for quantifying functional obsolescence:

(1)The procedure for estimating functional obsolescence for industrial property in the reproduction cost approach is as follows:

(a)The total functional obsolescence equals:

(A)The physically depreciated reproduction cost of the property with a deficiency requiring a substitution or modernization, or a superadequacy, less

(B)The physically depreciated cost of the replacement property with a deficiency requiring a substitution or modernization, or a superadequacy, plus

(C)The cost to cure or the value of the loss (if less).

(b) For an industrial property with a deficiency requiring an addition follow the same steps as listed in subsection (1)(a), except step (A) equals zero.

(c) The result of (1)(a) equals the total functional obsolescence deduction in the reproduction cost approach attributable to the property with a deficiency or superadequacy. (See https://oregon.public.law/rules/oar_150-308-0280 for the complete rule)

- One author has suggested that functional obsolescence can be measured in any of three ways:

Typically, functional obsolescence is measured by either

1. capitalizing the property's excess operating costs over the property's expected remaining useful life (RUL),

2. reducing the property's superadequacy cost measurement (however defined) by the amount of capital costs related to the excess capacity, or

3. estimating the amount of capital costs required to cure the functional deficiency or structural/capacity inadequacy.²

III. Approaches to measuring external/economic obsolescence

Approaches to external obsolescence are more varied and controversial.

1. *The Appraisal of Real Estate (12th ed.)* lays out three methods for measuring external obsolescence, two of which are of questionable value in nearly all unitary appraisal settings.
 - If a property with a known reproduction cost would sell for less than that cost, based on comparable sales in the market area, the difference can be allocated between the three types of appraisal depreciation. This assumes

² Reilly, R. F., 2013, Consideration of Functional and Economic Obsolescence in the Assessment of Industrial or Commercial Property, *Journal of Property Tax Assessment & Administration*, 10(1):45-58

there is enough of a market for property of this type to establish a comparable sales price. Such is rarely the case in firms valued using a unitary approach.

- The external obsolescence can be measured using a paired sales approach. Again, this is not helpful when sales are few and many unitary properties are relatively unique.
- The income shortfall associated with the property can be capitalized to estimate the value of the external obsolescence, either in perpetuity or for the expected duration of the shortfall.

Commented [PTD4]: Once again, the Division agrees that measurements of obsolescence should be measured at the unit level and applied only if the market recognizes a loss in value.

The first approach is an adjustment to the reproduction cost. The second is an adjustment to the comparable sales value estimate, and the third is based on the income approach.

2. WASATA has attempted to bridge any gaps between real estate appraisal literature and corporate valuation in their *Appraisal Handbook: Valuation of Utility & Railroad Property (2007)*. The following are representative quotations on the topic of external/economic obsolescence.

- Frequently appraisers attempt to deduct obsolescence present in utility property from HCLD. Such a deduction is improper because of the nature of the HCLD indicator—it is merely the net book value of the taxable property. (page II-12)
- “Best of the Best”³ method: “This method involves comparing a mixture of various economic, quality, and efficiency factors among a representative group of railroads. ... The [best of the best] method may have some validity if used in conjunction with current cost concepts. ... Therefore, the obsolescence should be deducted from reproduction or replacement cost rather than HCLD. Others believe it [best of the best approach] is too much a mixture of philosophies and factors to be used at all.” (pg II-13)
- Although it is not appropriate to deduct obsolescence from the HCLD indicator of value, consideration of obsolescence is often the most difficult and important part of developing a valid RCLD indicator. (pg II-15)

Commented [PTD5]: The Division believes that defining HCLD clearly in the rule would reduce misunderstandings and/or misinterpretations regarding HCLD. For example, in practice, HCLD is most commonly the net book value of the taxable property. If HCLD is simply the net book value of the taxable property, then its true historical cost has already been adjusted for accounting depreciation including additional adjustments related to any subsequent acquisitions or impairments. In other words, if HCLD is net book value, then the accountants upward or downward adjustments would have already been made to the historical costs.

However, some may understand an HCLD indicator to only represent the original first cost to the first owner who placed it into service less any accounting depreciation. When WSATA and the Division state that additional obsolescence adjustments to HCLD are inappropriate, it is not because impairments or new acquisitions should not be considered, but because those items have already been considered and are reflected in the net book value of the assets.

Perhaps a definition of HCLD such as, “Historical Cost Less Depreciation (HCLD) is the net book value of the operating assets as recorded on a company’s official books and records”, could help clear up any confusion of what the indicator represents.

³ The Best of the Best method, also referred to as the “Wisconsin method,” was first proposed in the 1960’s and applied to railroads. (Thatcher, L. W. and R. Dubielzig, 1967. *Obsolescence in railroad ad valorem tax assessments*. Milwaukee: Graduate School of Business, University of Wisconsin.)

- Obsolescence may exist when a property is outmoded, poorly designed (functional obsolescence) or some outside event or negative influence has substantially diminished the future earning power of the property (external obsolescence). (Pg. II-15)
- If an appraiser can obtain access to a company's strategic plans that contain estimates of the future earnings of the subject property, an analysis can be performed that indicates whether obsolescence exists in the subject property. The appraiser can use his/her estimate of RCLD as a hypothetical sales price (cash outflow) on the appraisal date and then use the forecasted future earnings as cash inflows. The appraiser can then calculate an internal rate of return on these cash outflows and inflows. If the internal rate of return is greater than the company's weighted average cost of capital, the appraiser can safely assume that no additional adjustment for obsolescence is warranted. (pg II-17)

Commented [PTD6]: The Division agrees that using a company's estimates of future earnings is an appropriate method to determine if obsolescence exists for the subject property. However, the Division also believes that if reliable estimates of future earnings are available, that a properly crafted income approach should receive the bulk of the weight in most cases.

3. The California Board of Equalization has prepared *Guidelines for substantiating additional obsolescence for state-assessed telecommunication properties.* (<https://www.boe.ca.gov/proptaxes/guideproc.htm>)
 - The California Constitution requires the State Board of Equalization to annually assess certain properties, including telecommunication properties. From their Guideline document: "An integral part of the valuation process is the estimation of the obsolescence suffered by assessable property."
 - California BOE staff calculate a Replacement Cost New Less Depreciation (RCNLD) indicator of value each year using cost indexes and historical trends. These trending factors are updated and published annually.
 - "The purpose of this [Guideline] document is to provide guidance to state assesses on how to substantiate additional or extraordinary obsolescence before the Board."
 - "Obsolescence or depreciation is defined as a decrease in utility resulting in a loss in property value; the difference between estimated replacement or reproduction cost new as of a given date and market value as of the same date."
 - Board staff recognize several methods to quantify obsolescence, including Replacement Cost Studies,

Income shortfall studies, Inutility studies, and economic life studies.

- Studies submitted by taxpayers to support a claim for additional obsolescence are reviewed by staff who then make a recommendation to the BOE.

IV. Related issues in financial accounting

Both USTC Property Tax Division current practice and the *WSATA Handbook* raise concerns about adjusting HCLD cost indicators for obsolescence. However, the financial accounting profession has no such qualms.

In 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long-lived Assets*. SFAS No. 144 applies to long-lived tangible and intangible assets that are carried on a company's balance sheet, including leasehold interests. If a long-lived asset is part of a group that includes other assets (and liabilities) outside the scope of SFAS No. 144, SFAS No. 144 would apply to the group. The level at which a group should be established is the lowest level for which identifiable cash flows are largely independent of cash flows of other groups of assets and liabilities. If the assets are to be disposed of, the group will be those assets to be disposed of in a single transaction (as well as the liabilities directly associated with those assets).

SFAS No. 144 has many other distinctions and exemptions. The key point for this discussion is that SFAS No. 144 specifies how "impairment" for these long-lived assets (groups) should be tested and how adjustments for impairment should be made. The test is to compare the undiscounted future cash flow from the assets to the asset value carried on the company books. If the total undiscounted future cash flow⁴ is less than the current carrying amount, the asset (group) is "impaired".

If impairment is indicated, the appropriate adjustment under SFAS No. 144 is the difference between the current carrying amount and the fair value of the asset (group). Fair value is defined and discussed in detail in SFAS No. 157, and in most cases it is the fair market value as understood by real estate appraisers. Fair value is defined as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction

Commented [PTD7]: The Division would emphasize that it already incorporates the financial accounting guidance into its HCLD indicators. The Division's implementation of HCLD is more or less determined by the net book values of assets as booked on the company's books and records. In other words, the Division's HCLD indicators already reflect the accountants' adjustments to historical costs that have been made on the company's books, including impairments, write downs, or purchase price accounting adjustments.

⁴ Over the company's normal planning horizon for this type of asset or group, plus any salvage value.

between market participants at the measurement date". Importantly, "Valuation techniques consistent with the market approach, income approach, and/or cost approach shall be used to measure fair value."

It should be clear from this brief discussion that the concepts of economic obsolescence and asset impairment are closely related. Both reflect an inability to earn a market rate of return on the assets being valued, and that inability is beyond the control of management. SFAS lays out a method for assessing whether or not asset impairment exists, and if it does, an approach for adjusting the asset value carried on the company books (the book value). It is not clear why unitary appraisals could not adopt a parallel method for determining whether economic obsolescence is present and for adjusting HCLD based on the current market value of the assets in question.

V. Summary of methods proposed to measure external/economic obsolescence

Economic obsolescence exists if the property in question is unable to earn a market rate of return on investment due to conditions beyond the control of owners/managers. The following discussion looks at methods used to quantify economic obsolescence in the context of unitary appraisal. The observations made might well differ in other contexts.

1. Income shortfall

Since economic obsolescence most fundamentally represents a firm's inability to earn a desired rate of return on invested capital, it seems logical to consider the degree to which income falls short. However, some applications make the calculation another income approach rather than an adjustment to the cost approach. If obsolescence is measured simply by the difference between the income indicator and the RCNLD indicator, the effect is to adjust the RCNLD indicator so that it always equals the income indicator.

A more appropriate approach is that employed in financial accounting in determining asset impairment. There, the first step is to determine whether economic obsolescence is present by comparing the book value of the asset group to projected undiscounted future cash flows, as described earlier. If the projected (undiscounted) cash flow is less than current book value, economic obsolescence is judged to be present.

Commented [PTD8]: As previously stated, the Division's HCLD indicators already reflect the accountants' and auditors' determinations of impairment as the Division relies on the net book value of the assets in question.

Additionally, the Division believes that if reliable cash flows are available for the unit of assets being valued, those cash flow estimates should be used in the income approach, and the income approach should receive a majority of the weight. In other words, if reliable cash flows are available, why not just do an income approach and let HCLD stand on its own?

Commented [PTD9]: Numerous court cases have rejected the income shortfall method based on its circularity. (See, 1. Puget Sound Power & Light Co. v. Dept. of Revenue, 232 Mont. 314, 761 P.2d 336 (1988); 2. Delta Airlines, Inc. v. Dept. of Revenue, 328 Ore. 596, 618-619, 984 P.2d 836 (1999); 3. Michigan Bell Telephone Co. v. Dept. of Treasury, 1990 Mich. Tax LEXIS 24 (Michigan Tax Tribunal ruled that using income shortfall produces neither a reliable nor truly independent indication of true cash value); 4. AT&T Communications v. State of Washington Dept. of Revenue, 1988 Wash. Tax LEXIS 499)

Additionally, WSATA and The National Conference of Unit Valuation States (NCUVS) reject this method as a valid way of measuring obsolescence or appreciation. NCUVS states the following in its Unit Valuation Standards:

"2. Market depreciation should not be calculated using a circular formula methodology that compares the difference in value between one approach to value to another approach. Each approach to value should stand on its own merit and an appraiser's judgment as to which approach should be relied upon should be addressed in the reconciliation phase of an appraisal assignment."

Quantifying the level of obsolescence requires an evaluation of the current fair value of the asset group using some combination of market, income and cost analysis. The level of obsolescence is then the difference between the HCLD book value and the estimated fair value.

While this is the approach used in financial accounting, it is counter intuitive for appraisers to use undiscounted cash flows. Nonetheless, the approach is worth considering simply because it is employed in financial accounting.

2. Best of the best (also called the Blue Chip or “Wisconsin” Method)

As noted previously, the “best of the best” method involves comparing a mixture of various economic, quality, and efficiency factors among a representative group of firms or asset groups. The method was originally developed and applied to railroads but has been utilized in other industries as well. The method involves comparing the performance of the subject firm on a particular factor to the best observed performance among the comparison firms. For example, the load factor for the subject railroad is divided by the best observed load factor among the comparison firms. The ratio is interpreted as an indicator of relative efficiency. A similar process is followed for each of the performance factors deemed relevant. The set of ratios are then combined (usually averaged) to arrive at an overall efficiency rating for the firm. This efficiency rating is interpreted as an indication of the degree of economic obsolescence. The rating is then used to adjust the replacement cost new, though in some instances the ratio has been applied to HCLD.

One theoretical problem with the best-of-the-best method is that every firm is likely to have some level of obsolescence. Unless a firm is the absolute best performer on every selected dimension, the approach will attribute some level of obsolescence to the firm. However, it may not be technically possible for a firm to be the best performer on every dimension. There are likely performance tradeoffs, or specific technical or organizational firm attributes that result in a firm emphasizing some performance factors over others. If there is no single firm that is the best on every performance dimension, it is difficult to argue that all firms have obsolescence in relation to this unattainable (in practice) standard.

Commented [PTD10]: The Division agrees that this is a reasonable approach when it comes to the cost approach. In essence, if the asset has been impaired on the books, then it will also be reflected in HCLD.

Commented [PTD11]: The Division agrees with the concerns raised here regarding the best of the best method. Additionally, it has concerns that this method would lead to obsolescence adjustments that are not recognized or measured by market participants. The Division would reemphasize that an obsolescence penalty exists “**only insofar as the market recognizes it as causing a loss of value**...an appraiser should exercise caution not to penalize a property unduly in the cost approach.” (Appraisal of Real Estate 13th Edition pg. 393, emphasis added).

An alternative approach was proposed by a team of academics and valuation professionals.⁵ This alternative approach is based on the development of performance comparison groups and best performance combinations actually found in practice. This “best practice” approach has received little attention from practitioners.

3. Inutility formula

The Inutility Formula is an adjustment to replacement cost new due to unneeded capacity. It compares actual capacity utilization to rated capacity and attributes shortfalls in output to economic obsolescence. In developing an inutility analysis, it is essential to ask whether the same size asset/facility would be built new on the valuation date considering the expected market demand for the product as of that date. If, because of required scale, peak demand needs, seasonality or other factors, a similar size facility would be built on the lien date, no apparent utilization shortfall should be attributed to economic obsolescence.

In addition, capacity utilization looks at only one aspect of economic obsolescence (EO). As one evaluation put it:

*The Inutility Formula may be used to quantify only a form of EO. In those cases, a reduction to replacement cost new is the outcome due to the appraiser's conclusion that the asset/facility is overbuilt in terms of capacity. Analyzing obsolescence merely on a percentage of capacity basis disconnects it from the very essence of what EO is, namely, a constrained ability to earn economic returns, due to factors external to the current use or condition of the asset. Thus, application of an inutility penalty does not preempt the need to assess whether sufficient cash flows will be generated by an asset/facility and further EO adjustments may be warranted.*⁶

4. Replacement Cost Studies

⁵ Walters, L. C., G. C. Cornia, D.W. Shank, C. Gerschevske and K.C. Ulrich, 1994, Measuring obsolescence in regulated firms: Enhancements to the cost approach, *The Assessment Journal* 1(3):47-58.

⁶ Chaplin, M. and P. Prendergast, 2017, Estimating Economic Obsolescence – Why the Inutility Formula is of Limited Utility, *The MTS Journal*, 33(3):11-15, page 14.

Commented [PTD12]: The Division agrees that cash flow analysis is still the best methodology when it comes to measuring obsolescence and that the inutility formula is generally of little utility when trying to determine economic obsolescence.

In the context of unitary appraisal, it appears that the most common approach for estimating RCNLD is to trend the original cost using some sort of construction cost index such as those published by California, the Handy-Whitman index for public utilities, or similar.

Replacement cost estimates can be useful in removing some types of functional obsolescence (*Appraisal of Real Estate, 12th ed.*, page 358). It is less clear how a replacement cost analysis is useful in estimating limitations in future cash flows and earnings (economic obsolescence).

5. Economic life studies

Economic life is defined as “[t]he period over which improvements to real property contribute to property value,” (*Appraisal of Real Estate, 12th ed.*, page 386)

The *Appraisal of Real Estate, 12th ed.*, also states:

All aspects of a property and its market, including quality and condition of construction, the functional utility of the improvements, and market and locational externalities, must be considered in the estimation of a property’s economic life. (page 386)

In addition to the physical and functional considerations that shape the economic life of a property, external considerations including supply and demand factors should be evaluated. (*Appraisal of Real Estate, 12th ed.*, page 386)

Economic life studies are acknowledged to be difficult (*Appraisal of Real Estate, 12th ed.*, pgs 386-7). The essential question in the current context is whether they contribute actionable insights into expected future cash flows and earnings as of the lien date.

VI. Concluding observations

The consensus in both real estate appraisal and financial accounting appears to be that historical cost less book depreciation often bears little resemblance to current market value.

Developing a meaningful cost indicator of value in a unitary appraisal generally requires the development of a replacement

Commented [PTD13]: The Division agrees that a replacement cost analysis may be useful to estimate obsolescence or appreciation in individual assets, but its usefulness may be limited in unitary applications. The National Conference of Unit Valuation States (NCUVS) states the following in its Unit Valuation Standards:

G. A Replacement Cost New approach is usually impractical for large multi-state units.

1. A Replacement Cost approach is only reliable if it influences potential market participants’ investment decisions.

2. Any Replacement Cost approach should adhere to the principle of substitution and include all costs.

3. Under the principle of substitution, the replacement unit must be of equivalent utility and not result in any “costly delays in construction” or “undue cost due to delay.”

a) An appraiser should consider the timeframe needed to replace the entire unit and whether this timeframe will lead to any “undue cost due to delay” as a result of replacing the unit.

b) Costs to replace the unit including lost opportunity costs (foregone profits during construction compared to profits earned by purchasing an assembled existing unit) and financing costs should be considered.

c) A true replacement unit should be physically and economically feasible and be available within a reasonable timeframe.

Commented [PTD14]: The Division believes that one of the difficulties with applying this method to unitary properties is the fact that unitary properties have been created over many years and consist of thousands of different components. Unitary properties are more akin to a living thing which constantly changes as it ages. One of the key fundamentals of unitary valuation is that the unit is valued as a going concern with an indefinite life. While individual components have finite lives and will wear out, the unit valuation premise is that the unit will continue indefinitely.

Commented [PTD15]: The Division generally agrees that HCLD is not as reliable as an income or market approach. However, if the property has been recently built, purchased, or adjusted for impairment, HCLD may be more reliable in those cases. Yet, even in those cases, the Division believes that a properly crafted income or sales comparison approach is generally more reliable.

Furthermore, in cases where reliable market or income information is limited, HCLD gives a general benchmark of value based on a company’s actual investment in the unit.

cost estimate, less age-based depreciation, as the starting point. In many contexts, this RCNLD indicator is simply a trended original cost, using the best available construction cost indexes.

The RCNLD indicator will adjust for many, but not all, types of functional obsolescence. A “cost to cure” approach may be required to further account for functional obsolescence.

Measuring economic obsolescence requires an estimate of future cash flows. Whether these projections are based on undiscounted flows as is done in asset impairment studies, some measure of comparative performance, or an analysis of remaining economic life, the intent is to assess the ability of the assets in question to earn an adequate rate of return going forward. Some common approaches (such as the inutility formula) may capture only a portion of economic obsolescence.

While adjustments for economic obsolescence are generally made to RCNLD indicators, some methods can be applied to HCLD, as is done in asset impairment adjustments.

Any revisions to Rule 62 should continue to acknowledge that obsolescence may exist in state assessed properties. The rule revisions should both define the types of obsolescence and specify the methods that may be used to quantify the level of obsolescence. The Utah State Tax Commission should promulgate guidelines for the methods that taxpayers might use to support claims for additional obsolescence.

More specifically, Rule 62 should be modified as follows:

- 1) Stated problem: The rule does not acknowledge accounting approaches to obsolescence identification and measurement.

****** The rule should acknowledge the conceptual ties between obsolescence and asset impairment as used in financial accounting.

******* The rule should assert that the subject property is the unit. Obsolescence should be measured at the unit level. Obsolescence measured for individual assets shall not be applied to the unit.

- 2) Stated problem: Functional obsolescence is not defined, only its causes are listed.

Commented [PTD16]: While in theory an RCNLD may be preferable, it is usually impractical in a unitary context. The main issues with RCNLDs in a unitary setting include finding the reliable market evidence in order to properly measure appraisal depreciation at the unit level. If reliable market evidence can be obtained at the unit level in the form of comparable sales or reliable cash flows, those estimates can simply be used outside of a cost approach in a comparable sales or income approach indicator. If reliable market evidence is not available in the form of sales or reliable cash flows, then an RCNLD will likely not yield better results than HCLD.

Even a trended Historical cost would not reflect true market value of most properties. For example a company like Union Pacific railroad was granted large amounts of land to complete their railway system that were never placed on the books of the company and would likely be impossible to quantify as some of the permitting to place a railway system through that land today would be difficult if not impossible. Also many trended costs indexes fail to adequately account for the opportunity cost of the time it would take to reconstruct the unit, which leads to a dramatic undervaluation of the subject property. (See Cellco Partnership DBA Verizon Wireless vs Property Tax Division of the Utah State Tax Commission (2013-2014) Appeal Numbers 13-1343 & 147-1241 Findings of Fact, Conclusions of Law, and Final Decision. pages 29-52)

Commented [PTD17]: The Division agrees with WSATA's position that functional obsolescence in unitary settings is generally not of great concern. As unitary properties are income producing properties, a properly crafted income approach should account for all forms of obsolescence and appreciation if applicable.

Commented [PTD18]: The Division sees accounting adjustments, such as impairments, write downs, and adjustments for purchase price accounting, as adjustments to arrive at HCLD, not adjustments applied to HCLD. In other words, net book value should already include all accounting adjustments.

Commented [PTD19]: The Division believes the Rule could explain that because HCLD is based on a company's net book value of its assets, adjustments to the historical costs for impairments and acquisitions should already be reflected, and no additional adjustments are necessary. The Division believes that HCLD should stand on its own as a benchmark to other indicators.

Commented [PTD20]: The Division supports adding this or similar language to the Rule to emphasize that obsolescence needs to be measured at the unit level.

**** Functional obsolescence should be defined as a reduction in market value due to changing technologies or design preferences that render a property less desirable in the contemporary marketplace even though the expected future useful life remains unchanged.**

- 3) Stated problem: No mention is made of when external/economic obsolescence is relevant.

**** The current rule definition should be retained: "External, or economic, obsolescence is an impairment of an improvement due to negative influences from outside the boundaries of the property, and is generally incurable. These influences usually cannot be controlled by the property owner or user."**

**** When it can be shown that economic obsolescence is present either through an impairment of future cash flows directly or through performance comparisons with peer entities, the obsolescence adjustment should be made to RCNLD.**

- 4) Stated problem: No guidance is provided on how any of the three forms of appraisal depreciation should be quantified.

**** Physical obsolescence should be measured using an economic life analysis or similar analysis of physical deterioration beyond that anticipated by book depreciation.**

**** The preferred method for measuring functional obsolescence is the difference between book value and RCNLD, augmented by a "cost to cure" analysis of any remaining functional obsolescence.**

**** The preferred method for measuring economic obsolescence is a comparative performance assessment or future cash flow analysis. The obsolescence adjustment should be made to RCNLD.**

- 5) Stated problem: While HCLD is identified as the preferred cost indicator, no guidance is provided on how appraisal depreciation or accounting approaches to obsolescence should be used, if at all, to adjust the HCLD indicator.

Commented [PTD21]: The Division believes that this definition is reasonable. However, it also believes that the Rule needs to make it clear that functional obsolescence is generally not a driving force in the market value of income producing unitary properties and that the impact of any functional obsolescence on market value should already be reflected in a properly crafted income or market approach.

Also, the rule should clarify that the ideal property in the contemporary marketplace must actually exist and not be a theoretical perfect property.

Commented [PTD22]: The Division once again emphasizes that obsolescence should be quantified by market evidence, not on a comparison of peer entities. The Division believes that a properly crafted income approach or unit sales data are the preferable market data required to measure obsolescence or depreciation with any level of confidence. It would also again stress a RCNLD approach may be impractical to implement for Unitary properties.

Commented [PTD23]: The Division believes that unitary properties are valued as going concerns. A going concern has an indefinite life. Unitary properties are valued based on the assumption that assets will be replaced as they wear out or as technology changes or market preferences demand. Again, the subject property is the unit not the individual components which make up the unit.

Commented [PTD24]: Once again, the challenges with RCNLD are many. An RCNLD is only reliable if it influences potential market participants' investment decisions. Market data at the unit level is required to accurately measure obsolescence or appreciation to be applied to RCNLD. As the Division previously stated, if the market data needed to make these adjustments was available, the Division believes that a properly crafted Income or market approach would provide a better estimate of market value.

**** Consistent with SFAS No. 144, the HCLD indicator can be adjusted for obsolescence following the guidelines provided in SFAS No. 144 and SFAS No. 157 for the identification and measurement of impairment.**

All comments, questions, suggestions, proposed changes, etc., should be directed to Utah State Tax Commission, attention Commissioner Larry Walters (lcwalters@utah.gov), and will be gratefully received.

Commented [PTD25]: The Division believes this is unnecessary. SFAS 144 adjustments have already been made in arriving at HCLD (net book value), they are not adjustments to HCLD. As such, the Division agrees with WSATA and NCUVS that the appropriate depreciation to deduct from Historical cost is accounting or book depreciation. Among other things, NCUVS states the following related to market depreciation:

“6. Market depreciation adjustments for functional or external obsolescence may be appropriate to apply to replacement cost or reproduction cost, but not historical cost (book value). Book depreciation is the appropriate amount to deduct from historical cost. Historical cost less book depreciation (net book value) should stand on its own as an indicator of value without further adjustments for additional market depreciation or appreciation. The relevance of HCLD should be reflected in the appraiser’s reconciliation analysis.”

Current Administrative Rule R884-24P-62 language relating to obsolescence

R884-24P-62(5) Appraisal Methodologies.

(a) Cost Approach. ...

(i) "Depreciation" is the loss in value from any cause. Different professions recognize two distinct definitions or types of depreciation.

(A) Accounting. Depreciation, often called "book" or "accumulated" depreciation, ... Book depreciation is typically applied to historic cost to derive HCLD.

(B) Appraisal. Depreciation, sometimes referred to as "accrued" depreciation, is the difference between the market value of an improvement and its cost new. Depreciation is typically applied to replacement or reproduction cost, but should be applied to historic cost if market conditions so indicate. There are three types of depreciation:

(I) Physical deterioration results from regular use and normal aging, which includes wear and tear, decay, and the impact of the elements.

(II) Functional obsolescence is caused by internal property characteristics or flaws in the structure, design, or materials that diminish the utility of an improvement.

(III) External, or economic, obsolescence is an impairment of an improvement due to negative influences from outside the boundaries of the property, and is generally incurable. These influences

usually cannot be controlled by the property owner or user.

(ii) Replacement cost ... The use of replacement cost instead of reproduction cost eliminates the need to estimate some forms of functional obsolescence.

(iii) Reproduction cost is the estimated cost to construct, at current prices, an exact duplicate or replica of the property being assessed, using the same materials, construction standards, design, layout and quality of workmanship, and embodying any functional obsolescence.

(iv) Historic cost is the original construction or acquisition cost as recorded on a firm's accounting records. ...

(v) RCNLD may be impractical to implement; therefore the preferred cost indicator of value in a mass appraisal environment for unitary property is HCLD. ...



VIA EMAIL

jvalentine@utah.gov

May 12, 2021

Commission Chair John L. Valentine
Utah State Tax Commission
210 North 1950 West
Salt Lake City, Utah 84134

Re: *Recommended Revisions to Proposed Commission Rule 62*

Dear Commissioner Valentine:

One of the purposes of the Utah Taxpayers Association ("Association") is to ensure necessary taxes are applied fairly and consistently to "permit a strong, healthy economy" while maintaining a "sensible balance" for government expenditures. The Association is appreciative of the Utah State Tax Commission's ("Commission's") efforts in revising its Administrative Rule 62 in an effort to improve the fair, equal and consistent application of Utah's property tax in the area of central assessment.

A number of our members have continued to express concern regarding some of the Commission's recommended revisions to Rule 62. Consequently, we believe it is appropriate for our Association to communicate some of these concerns to the Commission. Previously we submitted more general, theoretical comments. Inasmuch as the Commission has now published its proposed revisions to Rule 62, we are now respectfully submitting on behalf of our members several specific comments and recommended revisions in the hope that these comments may be of assistance to the Commission in finalizing its Rule.

We have attached a copy of the April 15, 2021 Utah State Bulletin pages 37-43, which contains a copy of the Commission's proposed revisions to Rule 62, as Exhibit A. In Exhibit A we have identified in redline and highlights the revisions we recommend to the proposed rule.

1. **Intangible Property - Section (3)(b) on Page 40 – the last clause of this sentence should be deleted.** The Commission correctly notes that intangible property is not subject to property tax in Utah and thus the value of intangible property must be removed when included in a unitary assessment. We believe that the last clause in Section (3)(b) should be removed because the requirement of removing intangible property values “consistent with the methods used to derive the unit value” is ambiguous and inconsistent with Utah law. In *Union Pacific Railroad Co. v. Utah State Tax Comm’n*, Case No. 090700830 (Utah 2nd Dist. Ct. 2013), the district court determined the fair market value of the unit using an income approach and the fair market value of the intangible property using a replacement cost approach. The Court concluded that because both of the values were fair market values, the intangible fair market value could appropriately be deducted from the fair market value of the unit. We are concerned that the words “consistent with the methods used to derive the unit value” will be used by the Property Tax Division to require that the same valuation approaches be used to value both the unit and the intangible property (i.e., income or cost approach for both types of properties). This additional restriction would not be consistent with Utah law and might not provide the most accurate estimates of the fair market values of the respective properties. We recommend that the last clause of this section be deleted.
2. **Capitalized Intangible Properties - Section (3)(b)(i) on Page 40 – the last clause of these sentences should be deleted.** We believe that the last clause in subsection (3)(b)(i) should be removed because the requirement of removing intangible property values “based on their proportional contribution to the unit” is ambiguous and inconsistent with Utah law. The standard of value in Utah is fair market value, and the fair market value of such intangible property should be removed from the assessment. We are concerned that the Property Tax Division has often attempted to use a market-to-book ratio technique to try and remove intangible property values from a unitary assessment. This technique can be skewed when not all intangible properties are capitalized. We believe it is best to delete the last clause of this sentence and allow the appraiser to remove the intangible property values by using the most appropriate methods applicable to the particular assignment.
3. **Intangible Properties that are not Capitalized - Section (3)(b)(ii) on Page 40 – the last clause of these sentences should be deleted.** The last clause of this subsection should be removed for the same reasons identified in the preceding paragraph. In addition, this subsection limits the removal of intangible properties to only those that are identified in Utah Code Ann. § 59-2-102(19)(a). This is not consistent with

Utah law. In *T-Mobile USA, Inc. v. Utah State Tax Comm’n*, 2011 UT 28, ¶ 29, the Utah Supreme Court ruled that all intangible property must be removed from the unit value whether it is identified in Utah Code Ann. § 59-2-102(19)(a) or not. Thus, the limitation identified to Utah Code Ann. § 59-2-102(19)(a) should be removed from this subsection. Inasmuch as subsection (3)(b)(i) relates to intangibles that are capitalized on the books of the taxpayers, we believe it is appropriate to expressly clarify that this subsection (ii) relates to intangible properties that are not on the taxpayer’s books.

4. **Intangible Properties - Normal Rate of Return Method - Section (3)(b)(iii) on Page 40 – additional language should be added.** This subsection identifies a unique alternative method for estimating the value of intangible properties that is based on a comparison of the normal rate of return of the subject company to “guideline companies.” Subsection (iv) identifies that this is an alternative valuation method to those identified in subsections (i) and (ii). We believe it would be appropriate to include additional language at the first of this subsection (iii) that expressly identifies this method as being an alternative to the other methods.
5. **Trended Historical Cost - Section (5)(a)(iv) on Page 41 – the words “or replacement” should be deleted.** This subsection contains an error. It states that it may be appropriate to “trend historical cost” to estimate the current “reproduction or replacement cost.” This is a true statement for estimating a “reproduction cost,” i.e., exact replica of the property, but it is not true for estimating a “replacement cost.” New technologies might not even include the costs of older technologies, and thus their costs would be irrelevant whether trended or not.
6. **Assets in Existence - Section (5)(b)(i)(A) and (II) on Page 41 – the deleted language in the first sentence should not be deleted.** Utah’s property tax law clearly states that property should be valued as of the January 1st lien date. However, in Section (5)(b)(i)(A) the Commission is recommending language that restricts cash flow estimates in the income approach to “operating property in existence on the lien date” be removed. We believe that this removal will lead to the improper inclusion of cash flows from property that does not exist on the lien date and will cause the property of centrally assessed taxpayers valued under the income approach to be treated in a disparate and unequal manner in relation to locally assessed properties. Furthermore, the removal of this language is inconsistent with Section (5)(b)(i)(A)(II) that “Capital expenditures should include only those expenditures necessary to replace or maintain existing plant.” It would be a mismatch to allow

income generated by assets that do not exist on the lien date to be included in the cash flow estimate but to only deduct capital expenditures that are restricted to replace assets in existence. We recommend that Commission leave the language in Section (A) in the Rule.

7. **CAPM Model - Section (5)(b)(i)(B)(II)(Aa) on Page 41 – the first sentence of this section should be deleted.** While the CAPM Model is a generally accepted model for estimating the cost of equity, it is not the preferred model for all industries and in all situations. We are concerned that designating the CAPM as the preferred model will not lead to fair market value in all situations and will lead to unequal treatment of taxpayers. We recommend that Section (Aa) be revised to remove the language in the first sentence of that section. In addition, in subsection (Bb), the CAPM model should be the cost of equity that the would-be purchaser/seller would expect. Thus, the risk-free rate should be the expected market rate rather than the current rate.
8. **Growth Rate - Section (5)(b)(i)(C)(I) on Page 41 – should be deleted.** The statement in Section (5)(b)(i)(C) that the “growth rate “g” is the expected future growth of the cash flow attributable to assets in place on the lien date and any future replacement assets” is a correct statement. However, the statement in the next subsection that in the absence of sufficient information to establish what the growth rate is for the cash flows, the Property Tax Division should use an inflation rate in its place, is arbitrary and not applicable in many situations. The use of this inflationary estimate as the growth factor in the income approach may cause assessments to exceed the fair market value of such properties and cause centrally assessed taxpayers to be treated in a disparate and unequal manner in relation to locally assessed properties. We recommend that this subsection be deleted and that the Property Tax Division only use a “g” that is supported by the facts and circumstance of the particular property being valued.
9. **Rate Regulation Impacts on Value – Section (6)(a)(i) on page 42 – the first sentence should be revised.** The first sentence of this subsection states that regulation may impact the value of a company. Utah law does not charge the Property Tax Division to determine the value of companies, but rather the taxable, tangible property that may be owned by a taxpaying company. This language should be changed to state that rate regulation may impact the value of property.

The Association respectfully requests that the Commission make the above identified changes to its proposed revisions of Rule 62.

Sincerely,

Rusty Cannon

President

Utah Taxpayers Association

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UTAH STATE BULLETIN

OFFICIAL NOTICES OF UTAH STATE GOVERNMENT
Filed March 16, 2021, 12:00 a.m. through April 01, 2021, 11:59 p.m.

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Nancy L. Lancaster, Managing Editor

The *Utah State Bulletin* (*Bulletin*) is an official noticing publication of the executive branch of Utah state government. The Office of Administrative Rules, part of the Department of Administrative Services, produces the *Bulletin* under authority of Section 63G-3-402.

The Portable Document Format (PDF) version of the *Bulletin* is the official version. The PDF version of this issue is available at <https://rules.utah.gov/>. Any discrepancy between the PDF version and other versions will be resolved in favor of the PDF version.

Inquiries concerning the substance or applicability of an administrative rule that appears in the *Bulletin* should be addressed to the contact person for the rule. Questions about the *Bulletin* or the rulemaking process may be addressed to: Office of Administrative Rules, PO Box 141007, Salt Lake City, Utah 84114-1007, telephone 801-957-7110. Additional rulemaking information and electronic versions of all administrative rule publications are available at <https://rules.utah.gov/>.

The information in this *Bulletin* is summarized in the *Utah State Digest* (*Digest*) of the same volume and issue number. The *Digest* is available by e-mail subscription or online. Visit <https://rules.utah.gov/> for additional information.

Public Notice Information

9. The public may submit written or oral comments to the agency identified in box 1. (The public may also request a hearing by submitting a written request to the agency. The agency is required to hold a hearing if it receives requests from ten interested persons or from an association having not fewer than ten members. Additionally, the request must be received by the agency not more than 15 days after the publication of this rule in the Utah State Bulletin. See Section 63G-3-302 and Rule R15-1 for more information.)

A) Comments will be accepted until:	05/17/2021
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10. This rule change MAY become effective on:	05/24/2021
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NOTE: The date above is the date on which this rule MAY become effective. It is NOT the effective date. After the date designated in Box 10, the agency must submit a Notice of Effective Date to the Office of Administrative Rules to make this rule effective. Failure to submit a Notice of Effective Date will result in this rule lapsing and will require the agency to start the rulemaking process over.

Agency Authorization Information

Agency head or designee, and title:	Chris Caras, Division Director	Date:	03/30/2021
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R708. Public Safety, Driver License.

~~[R708-18. Regulatory and Administrative Fees.~~

R708-18-1. Authority.

~~This rule is authorized by Section 53-3-104(2), 53-3-105, 53-3-808, 53-3-905 and Subsection 63J-1-301(2).~~

R708-18-2. Definitions as Used in this Chapter.

~~(1) "Accident Report" means an officer's report of an accident as described under Subsection 41-6a-402.~~

~~(2) "Accompanying data" means supplemental accident reports or addenda there to.~~

~~(3) "Driving Record", more commonly known as a Driver License Record (DLR) means a computer-generated compilation of particular elements contained in the Driver License Division electronic database, consisting of:~~

~~(a) Driver's name;~~

~~(b) License certificate number;~~

~~(c) Driver's date of birth;~~

~~(d) Driver's zip code;~~

~~(e) Member of military;~~

~~(f) Reportable arrests and convictions;~~

~~(g) Reportable notices from courts indicating failure to comply with terms of a citation or failure to comply with terms set by the court, pursuant to UCA 53-3-221(2) and 53-3-221(3);~~

~~(h) Reportable department actions;~~

~~(i) Driving Privilege Status;~~

~~(j) License certificate issue/expiration dates; and~~

~~(k) License certificate class/type/endorsement.~~

~~(4) "Driving Record" "Certified Copy" means an authenticated Driving Record and/or accident report and/or accompanying data prepared under the seal of the division. (Other records or information may be included only under order or rule of the court.)~~

~~(5) "Photocopies" means the mechanical reproduction of an original digitized or filmed document.~~

~~(6) "Recording" means a verbatim magnetic tape or digitized recording of sworn, or unsworn testimony, or information.~~

R708-18-3. Fees.

~~The Driver License Division charges user fees for some services. A schedule of these fees is available for public examination at any Driver License office location. These fees are set by the legislature in Section 53-3-105, 808, and 905, and in the annual appropriations act as recorded in "The Laws of Utah" as passed at the General Session of the Legislature".~~

R708-18-4. Exemptions.

~~The fees established may not be charged to any municipal, county, state or federal agency as defined in Subsection 53-3-105(33)(b).~~

R708-18-5. Records.

~~All fees charged shall be receipted and recorded under normal accounting principles established by the Driver License Division.~~

KEY: driver education, licensing, fees

~~Date of Enactment or Last Substantive Amendment: October 27, 2005~~

~~Notice of Continuation: January 14, 2021~~

~~Authorizing, and Implemented or Interpreted Law: 63J-1-301(2); 41-6a-402; 53-3-104(2); 53-3-105; 53-3-808; 53-3-905; 53-3-221(2); 53-3-221(3)]~~

NOTICE OF PROPOSED RULE

TYPE OF RULE: Amendment

Utah Admin. Code Ref (R no.):	R884-24P-62	Filing No. 53377
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Agency Information

1. Department:	Tax Commission	
Agency:	Property Tax	
Building:	Utah State Tax Commission	
Street address:	210 N 1950 W	
City, state:	Salt Lake City, UT 84134	
Contact person(s):		
Name:	Phone:	Email:
Chantay Asper	801-297-3901	casper@utah.gov

Please address questions regarding information on this notice to the agency.

General Information**2. Rule or section catchline:**

R884-24P-62. Valuation of State Assessed Unitary Properties Pursuant to Utah Code Ann. Section 59-2-201

3. Purpose of the new rule or reason for the change:

The purpose of this amendment is to clarify definitional and calculation issues related to the valuation of centrally assessed property.

4. Summary of the new rule or change:

This amendment addresses the treatment of obsolescence and intangible property for the purpose of determining the value of centrally assessed property for property taxation.

Fiscal Information**5. Aggregate anticipated cost or savings to:****A) State budget:**

This amendment is not expected to impact the state budget because property tax revenue does not impact the state general fund.

B) Local governments:

This amendment is not expected to increase or decrease costs or revenues to local governments because any increase or decrease in property tax for a particular taxpayer as a result of this amendment will cause the certified tax rate to be recalculated to maintain funding for the local government at budgeted levels. However, it should be noted that this amendment could result in a minor shift in the source of property tax revenue from centrally assessed taxpayers to locally assessed taxpayers.

C) Small businesses ("small business" means a business employing 1-49 persons):

This amendment could result in a minor increase in property tax liability for small locally assessed business property. This amendment may result in a shift of property tax liability from centrally assessed businesses to locally assessed businesses and residences. The extent of this increase cannot be estimated but will be dependent on the mix of centrally assessed property and locally assessed property in each county and the extent to which the centrally assessed property in the county experiences a tax decrease.

D) Non-small businesses ("non-small business" means a business employing 50 or more persons):

This amendment could result in a minor increase in property tax liability for non-small locally assessed business property. The extent of this increase cannot be estimated but will be dependent on the mix of centrally assessed property and locally assessed property in each

county and the extent to which centrally assessed property in the county experiences a tax decrease. Alternatively, for any non-small business that is centrally assessed, there could be a minor reduction in property tax revenue subject to the type of business property that is subject to tax.

E) Persons other than small businesses, non-small businesses, state, or local government entities ("person" means any individual, partnership, corporation, association, governmental entity, or public or private organization of any character other than an **agency**):

This amendment could result in a minor increase in property tax liability for persons other than small businesses, non-small businesses, state, or local government entities. This amendment may result in a shift of property tax liability from centrally assessed businesses to locally assessed businesses and residences. The extent of this increase cannot be estimated but will be dependent on the mix of centrally assessed property and locally assessed property in each county and the extent to which the centrally assessed property in the county experience a tax decrease.

F) Compliance costs for affected persons:

This change is expected to reduce compliance costs on centrally assessed business taxpayers by clarifying issues related to the valuation of certain business property.

G) Regulatory Impact Summary Table (This table only includes fiscal impacts that could be measured. If there are inestimable fiscal impacts, they will not be included in this table. Inestimable impacts will be included in narratives above.)

Regulatory Impact Table

Fiscal Cost	FY2021	FY2022	FY2023
State Government	\$0	\$0	\$0
Local Governments	\$0	\$0	\$0
Small Businesses	\$0	\$0	\$0
Non-Small Businesses	\$0	\$0	\$0
Other Persons	\$0	\$0	\$0
Total Fiscal Cost	\$0	\$0	\$0
Fiscal Benefits			
State Government	\$0	\$0	\$0
Local Governments	\$0	\$0	\$0

Small Businesses	\$0	\$0	\$0
Non-Small Businesses	\$0	\$0	\$0
Other Persons	\$0	\$0	\$0
Total Fiscal Benefits	\$0	\$0	\$0
Net Fiscal Benefits	\$0	\$0	\$0

H) Department head approval of regulatory impact analysis:

The Commissioner of the Tax Commission, Rebecca L. Rockwell, has reviewed and approved this fiscal analysis.

6. A) Comments by the department head on the fiscal impact this rule may have on businesses:

The exact fiscal impact of this amendment cannot be estimated but depending on the type of property owned by a taxpayer and whether the taxpayer is subject to central or local assessment, this amendment could result in either a minor increase or decrease in property tax liability.

B) Name and title of department head commenting on the fiscal impacts:

Rebecca Rockwell, Commissioner

Citation Information**7. This rule change is authorized or mandated by state law, and implements or interprets the following state and federal laws. State code or constitution citations (required):**

Section 59-2-201

Public Notice Information

9. The public may submit written or oral comments to the agency identified in box 1. (The public may also request a hearing by submitting a written request to the agency. The agency is required to hold a hearing if it receives requests from ten interested persons or from an association having not fewer than ten members. Additionally, the request must be received by the agency not more than 15 days after the publication of this rule in the Utah State Bulletin. See Section 63G-3-302 and Rule R15-1 for more information.)

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Agency Authorization Information

Agency head or designee, and title:	Rebecca L. Rockwell, Commissioner	Date:	03/24/2021
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R884. Tax Commission, Property Tax.**R884-24P. Property Tax.****R884-24P-62. Valuation of State Assessed Unitary Properties Pursuant to Utah Code Ann. Section 59-2-201.**

(1) Purpose. The purpose of this rule is to:

(a) specify consistent ~~mass~~ unitary appraisal methodologies to be used by the Property Tax Division (Division) in the valuation of tangible property assessable by the Commission; and

(b) identify preferred valuation methodologies to be considered by any party making an appraisal of ~~an individual~~ unitary property.

(2) Definitions:

(a) "Asset impairment" means the balance sheet adjustment amount necessary to adjust a company's tangible asset values as reported in a company's books and records kept in the regular course of business to reflect the current fair value of those assets.

~~(a)~~ (b) "Cost regulated utility" means any public utility assessable by the Commission whose allowed revenues are determined by a rate of return applied to a rate base set by a state or federal regulatory commission.

~~(b)~~ (c) "Fair market value" means the amount at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. Fair market value reflects the value of property at its highest and best use, subject to regulatory constraints.

(d) "Historical cost less depreciation" or "HCLD" is the net book value of operating assets as recorded on a company's books and records kept in the regular course of business, including any adjustments for asset impairment reported by the taxpayer.

(e) "Normal rate of return on assets" means the average ratio of net operating income to HCLD, excluding construction work in progress, for comparable firms within an industry.

~~(e)~~ (f) "Rate base" means the aggregate account balances reported as ~~such by the~~ aggregate account balances by a cost regulated utility to ~~the~~ an applicable state or federal regulatory commission.

~~(f)~~ (g) (i) "Unitary property" means operating property that is assessed by the Commission ~~pursuant to Section~~ in accordance with Subsections 59-2-201(1)(a)(i) through (iii).

~~(g)~~ (i) ~~[Unitary properties include:]~~ "Unitary property" includes:

(A) all property that operates as a unit across county lines, if the values must be apportioned among more than one county or state; and

(B) all property of public utilities as defined in Section 59-2-102.

~~These properties, some of which may be cost regulated utilities, are defined under one of the following categories.]~~

(iii) "Unitary property" includes the following categories of property:

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(A) "Telecommunication ~~[properties]~~property" ~~[include]~~includes the operating property of local exchange carriers, local access providers, long distance carriers, cellular telephone or personal communication service (PCS) providers and pagers, and other similar properties.

(B) "Energy ~~[properties]~~property" ~~[include]~~includes the operating property of natural gas pipelines, natural gas distribution companies, liquid petroleum products pipelines, and electric corporations, including electric generation, transmission, and distribution companies, and other similar entities.

(C) "Transportation ~~[properties]~~property" ~~[include]~~includes the operating property of all airlines, air charter services, and air contract services, including major and small passenger carriers and major and small air freighters, long haul and short line railroads, and other similar properties.

(3)(a) All tangible operating property owned, leased, or used by unitary companies is subject to assessment and taxation according to its fair market value as of January 1, and as provided in Utah Constitution Article XIII, Section 2. Intangible property as defined under Section 59-2-102 is not subject to assessment and taxation.

(b) The value of intangible property exempt under Section 59-2-1101 shall be deducted from unit value, ~~consistent with the methods used to derive the unit value.~~

(i) Booked goodwill and other capitalized intangible ~~properties whose values are~~ determined using accepted accounting standards and practices shall be identified and deducted from the unit value ~~based on their proportional contribution to the unit.~~

(ii) Documentation shall be obtained to allow for the valuation of intangible property ~~that is not capitalized on the books of the taxpayer, described in Subsection 59-2-102(19)(a), and the value of such the intangible property shall be deducted from the unit value based on its proportional contribution to the unit.~~

(iii) ~~As an alternative to identifying and valuing intangible properties under subsection (i) and (ii), the Division may consider the following method for estimating the value of intangible property: t~~The normal rate of return on assets for guideline companies shall be calculated and then compared to the actual return on assets for the subject company for the most current three to five year period. If this comparison indicates that the subject company's property earns a rate of return on assets that exceeds the normal rate of return on assets, and the higher than normal rate of return on assets is not attributable to real property location characteristics or the identification of an improvement to real property, the proportional deduction from unit value for intangible property shall be the subject company's rate of return on assets minus the normal rate of return on assets, divided by the normal rate of return on assets.

(iv) If a subject company has more than one type of intangible property, the ~~proportional~~ adjustment to the unit value is equal to the larger of:

(A) the sum of Subsections (3)(b)(i) and (ii); or

(B) Subsection (3)(b)(iii).

(v) Intangible property shall be removed in the original assessment if such removal is supported by information provided by the taxpayer with its return or is otherwise obtainable by the Division.

(4) General Valuation Principles. Unitary properties shall be assessed at fair market value based on generally accepted appraisal theory as provided under this rule.

(a) The assemblage or enhanced value attributable to the tangible property should be included in the assessed value. See *Beaver County v. WilTel, Inc.*, 995 P.2d 602 (Utah 2000). The value attributable to ~~exempt~~ intangible property must, when possible, be identified and removed ~~from value when using any valuation method and before that value is used in the reconciliation process~~.

(i) The preferred methods to determine fair market value are the cost approach and a yield capitalization income indicator as set forth in Subsection (5). Other generally accepted appraisal methods may also be used when it can be demonstrated that such methods are necessary to more accurately estimate fair market value.

(ii) Direct capitalization and the stock and debt method typically capture the value of intangible property at higher levels than other methods. To the extent intangible property cannot be identified and removed, relatively less weight shall be given to such methods in the reconciliation process, as set forth in Subsection (5)(d).

(iii) Preferred valuation methods as set forth in this rule are, unless otherwise stated, rebuttable presumptions, established for purposes of consistency in ~~[mass appraisal]~~the valuation of unitary ~~properties~~. Any party challenging a preferred valuation method must demonstrate, by a preponderance of the evidence, that the proposed alternative establishes a more accurate estimate of fair market value.

(b) Non-operating Property. Property that is not necessary to the operation of unitary properties and is assessed by a local county assessor, and property separately assessed by the Division, such as registered motor vehicles, shall be removed from the ~~reconciled~~~~[correlated]~~ unit value or from the state allocated value.

(5) Appraisal Methodologies.

(a) Cost Approach. Cost is relevant to value under the principle of substitution, which states that no prudent investor would pay more for a property than the cost to construct a substitute property of equal desirability and utility without undue delay. A cost indicator may be developed under one or more of the following methods: replacement cost new less depreciation (RCNLD), reproduction cost less depreciation (reproduction cost), and ~~[historic]~~historical cost less depreciation (HCLD). Obsolescence shall be considered in any cost indicator, and adjusted for, if it exists. Obsolescence shall be adjusted for in the original assessment if the obsolescence adjustment is supported by information provided by the taxpayer with its return or is otherwise obtainable by the Division.

(i) "Depreciation" is the loss in value from any cause. Different professions recognize two distinct definitions or types of depreciation.

(A) Accounting. Accounting depreciation~~[Depreciation]~~, often called "book" or "accumulated" depreciation, is calculated according to generally accepted accounting principles or regulatory guidelines. It is the amount of capital investment written off on a firm's accounting records in order to allocate the original or ~~[historic]~~historical cost of an asset over its life. Book depreciation ~~shall be~~~~[is typically]~~ applied to ~~[historic]~~historical cost to derive HCLD.

(B) Appraisal. Appraisal depreciation~~[Depreciation]~~, sometimes referred to as "accrued" depreciation, is the difference between the market value of an improvement and its cost new. Appraisal depreciation~~[Depreciation]~~ is typically applied to replacement or reproduction cost, but should be applied to ~~[historic cost]~~HCLD if market conditions so indicate. There are three types of appraisal depreciation:

(I) Physical deterioration results from regular use and normal aging, which includes wear and tear, decay, and the impact of the elements. Measuring physical deterioration generally requires an economic life analysis or similar analysis. In the context of unitary appraisal, properties are typically valued based on the assumption that assets are replaced as they age and physical deterioration is reflected in normal depreciation schedules.

(II) Functional obsolescence is a reduction in market value or usefulness in a property due to inefficiencies or inadequacies of the property itself when compared to more efficient or less costly replacement alternatives. The preferred method for measuring functional obsolescence is the difference between net book value and RCNLD, in conjunction with a "cost to cure" analysis of any remaining

~~functional obsolescence, caused by internal property characteristics or flaws in the structure, design, or materials that diminish the utility of an improvement.]~~

(III) External, or economic, obsolescence is an impairment of an improvement due to negative influences from outside the boundaries of the property, and is generally incurable. These influences usually cannot be controlled by the property owner or user. The preferred method for measuring economic obsolescence is a relative performance assessment among comparable firms or future cash flow analysis. The relative performance assessment shall incorporate multiple measures of both operating and financial performance in relation to comparable firms and may include historical trends. Future cash flow analysis shall be based on a firm's estimated future cash flows if available.

(ii) Replacement cost is the estimated cost to construct, at current prices, a property with utility equivalent to that being appraised, using modern materials, current technology and current standards, design, and layout. The use of replacement cost instead of reproduction cost eliminates the need to estimate some forms of functional obsolescence.

(iii) Reproduction cost is the estimated cost to construct, at current prices, an exact duplicate or replica of the property being assessed, using the same materials, construction standards, design, layout and quality of workmanship, and embodying any functional obsolescence.

(iv) ~~Historic~~ Historical cost is the original construction or acquisition cost as recorded on a firm's accounting records. Depending upon the industry, it may be appropriate to trend ~~HCLD~~ historical cost to estimate current reproduction or replacement cost. ~~costs.~~ Only trending indexes commonly recognized by the specific industry may be used to adjust historical cost. ~~HCLD.~~ Historical cost differs from HCLD in that HCLD has been adjusted for physical depreciation and asset impairment determined using accepted accounting standards.

(v) Replacement cost new less depreciation (RCNLD) may be impractical to implement for unitary property; therefore the preferred cost indicator of value ~~[in a mass appraisal environment]~~ for unitary property is HCLD. A party may challenge the use of HCLD by proposing a different cost indicator that establishes a more accurate cost estimate of value.

(b) Income Capitalization Approach. Under the principle of anticipation, benefits from income in the future may be capitalized into an estimate of present value.

(i) Yield Capitalization. The yield capitalization formula is $CF/(k-g)$, where "CF" is a single year's normalized cash flow, "k" is the nominal, risk adjusted discount or yield rate, and "g" is the expected long-term growth rate of the cash flow.

(A) Cash flow is restricted to the operating property in existence on the lien date, together with any replacements intended to maintain, but not expand or modify, existing capacity or function. [Cash flow is restricted to the operating property in existence on the lien date, together with any replacements intended to maintain, but not expand or modify, existing capacity or function.] Cash flow is calculated as net operating income (NOI) plus non-cash charges (e.g., depreciation and the change in deferred income taxes), less capital expenditures and additions to working capital necessary to achieve the expected growth "g". Information necessary for the Division to calculate the cash flow shall be summarized and submitted to the Division by March 1 on a form provided by the Division.

(I) "Net operating income" or "NOI" means one of the following as determined by the appraiser: [is defined as]

(Aa) net income plus interest;

(Bb) operating income less operating income tax expense.

(II) Capital expenditures should include only those expenditures necessary to replace or maintain existing plant and should not include any expenditure intended primarily for UTAH STATE BULLETIN, April 15, 2021, Vol. 2021, No. 08

expansion or productivity and capacity enhancements.

(III) Cash flow is to be projected for the year immediately following the lien date, and may be estimated by reviewing ~~historic~~ historical cash flows, forecasting future cash flows, or a combination of both.

(Aa) If cash flows for a subsidiary company are not available or are not allocated on the parent company's cash flow statements, a method of allocating total cash flows must be developed based on sales, fixed assets, or other reasonable criteria. The subsidiary's total is divided by the parent's total to derive the allocation percentage to estimate the subsidiary's cash flow.

(Bb) If the subject company does not provide the Commission with its most recent cash flow statements by March 1 of the assessment year, the Division may estimate cash flow using the best information available.

(B) The discount rate (k) shall be based upon a weighted average cost of capital (WACC) considering current market debt rates and equity yields. WACC should reflect a typical capital structure for comparable companies within the industry.

(I) The cost of debt should reflect the current market rate (yield to maturity) of debt with the same credit rating as ~~the subject company~~ comparable companies within the subject industry.

(II) The cost of equity is estimated using standard methods such as the capital asset pricing model (CAPM), the Risk Premium and Dividend Growth models, or other recognized models.

(Aa) The CAPM is the preferred method to estimate the cost of equity. More than one method ~~may~~ shall be used to correlate a cost of equity, ~~but only if the CAPM method is weighted at least 50% in the correlation.~~

(Bb) The CAPM formula is $k(e) = R(f) + (\text{Beta} \times \text{Risk Premium})$, where $k(e)$ is the cost of equity and $R(f)$ is the risk free rate.

(Cc) The risk free rate shall be the current expected market-rate on 20 year Treasury bonds.

(Dd) The beta should reflect an average or value-weighted average of comparable companies and should be drawn consistently from Value Line or an equivalent source if Value Line is unavailable. The beta of the specific assessed property should also be considered.

(Ee) The risk premium shall be the arithmetic average of the spread between the return on stocks and the income return on long-~~term~~ bonds for the entire historical period beginning in 1926. Implied equity risk premium models may also be considered, [contained in the Ibbotson Yearbook published immediately following the lien date.]

(C) The growth rate "g" is the expected future growth of the cash flow attributable to assets in place on the lien date, and any future replacement assets.

(I) If insufficient information is available to the Division, either from public sources or from the taxpayer, to determine a rate, "g" will be the difference in the yield on a 20 year Treasury bond and the yield on a 20 year Treasury Inflation Protected Security (TIPS) bond as of the lien date, [expected inflationary rate in the Gross Domestic Product Price Deflator obtained in Value Line.] The growth rate and the methodology used to produce it shall be disclosed in a capitalization rate study published by the Commission by [February 15] April 1 of the assessment year.

(ii) A discounted cash flow (DCF) method may be ~~[impractical to implement in a mass appraisal environment, but may be]~~ used when reliable cash flow estimates can be established.

(A) A DCF model should incorporate for the terminal year, and to the extent possible for the holding period, growth and discount rate assumptions that would be used in the yield capitalization method defined under Subsection (5)(b)(i).

(B) Forecasted growth may be used where unusual income patterns are attributed to:

NOTICES OF PROPOSED RULES

- (I) unused capacity;
- (II) economic conditions; or
- (III) similar circumstances.

(C) Growth may not be attributed to assets not in place as of the lien date.

(iii) Direct Capitalization is an income technique that converts an estimate of a single year's income expectancy into an indication of value in one direct step, either by dividing the normalized income estimate by a capitalization rate or by multiplying the normalized income estimate by an income ~~factor~~ multiplier.

(c) Market or Sales Comparison Approach. The market value of property is directly related to the prices of comparable, competitive properties. The market approach is estimated by comparing the subject property to similar properties that have recently sold.

(I) Sales of comparable property must, to the extent possible, be adjusted for elements of comparison, including market conditions, financing, location, physical characteristics, and economic characteristics. When considering the sales of stock, business enterprises, or other properties that include intangible assets, adjustments must be made for those intangibles.

(II) Because sales of unitary properties ~~are~~ may be infrequent, a stock and debt indicator may be viewed as a surrogate for the market approach. The stock and debt method is based on the accounting principle which holds that the market value of assets equal the market value of liabilities plus shareholder's equity.

(d) Reconciliation. When reconciling value indicators into a final estimate of value, the appraiser shall take into consideration the availability, quantity, and quality of data, as well as the strength and weaknesses of each value indicator. Weighting percentages used to correlate the value approaches will generally vary by industry, and may vary by company if evidence exists to support a different weighting. The Division must disclose in writing the weighting percentages used in the reconciliation for the final assessment. Any departure from the prior year's weighting must be explained in writing.

(6) Property Specific Considerations. Because of unique characteristics of properties and industries, modifications or alternatives to the general value indicators may be required for specific industries.

(a) Cost Regulated Utilities.

(i) Rate regulation is one form of regulation that may impact the market value of a property, company; however, it does not determine the market value of such a company. HCLD is the preferred cost indicator of value for cost regulated utilities because it represents an approximation of the basis upon which the investor can earn a return. HCLD is calculated by taking the ~~historie~~ historical cost less depreciation as reflected in the utility's net plant accounts, and then:

(A) subtracting the value of intangible property as provided in Subsection (3);

(B) subtracting any items not included in the utility's rate base (e.g., deferred income taxes and, if appropriate, acquisition adjustments); and

(C) adding any taxable items not included in the utility's net plant account or rate base.

(ii) Deferred Income Taxes, also referred to as DFIT, is an accounting entry that reflects the difference between the use of accelerated depreciation for income tax purposes and the use of straight-line depreciation for financial statements. For traditional rate base regulated companies, regulators generally exclude deferred income taxes from rate base, recognizing it as ratepayer contributed capital. Where rate base is reduced by deferred income taxes for rate base regulated companies, ~~they~~ deferred income taxes shall be removed from HCLD.

(iii) Items excluded from rate base under Subsections (6)(a)(i)(A) or (B) should not be subtracted from HCLD to the extent it can be shown that regulators would likely permit the rate base of a potential purchaser to include a premium over existing rate base.

(b)(i) Railroads.

(ii) The cost indicator should generally be given little or no weight because there is no observable relationship between cost and fair market value.

(c) Airlines, air charter services, and air contract services.

(i) For purposes of this Subsection (6)(c):

(A) "aircraft pricing guide" means a nationally recognized publication that assigns value estimates for individual commercial aircraft that are in average condition typical for their type and vintage, and identified by year, make and model;

(B) "airline" means an:

(I) airline under Section 59-2-102;

(II) air charter service under Section 59-2-102; and

(III) air contract service under Section 59-2-102;

(C) "airline market indicator" means an estimate of value based on an aircraft pricing guide; and

(D) "non-mobile flight equipment" means all operating property of an airline, air charter service, or air contract service that is not within the definition of mobile flight equipment under Section 59-2-102.

(ii) In situations where the use of preferred methods for determining fair market value under Subsection (5) does not produce a reasonable estimate of the fair market value of the property of an airline operating as a unit, an airline market indicator published in an aircraft pricing guide, and adjusted as provided in Subsections (6)(c)(ii)(A) and (6)(c)(ii)(B), may be used to estimate the fair market value of the airline property.

(A)(I) In order to reflect the value of a fleet of aircraft as part of an operating unit, an aircraft market indicator shall include a fleet adjustment or equivalent valuation for a fleet.

(II) If a fleet adjustment is provided in an aircraft pricing guide, the adjustment under Subsection (6)(c)(ii)(A)(I) shall follow the directions in that guide. If no fleet adjustment is provided in an aircraft pricing guide, the standard adjustment under Subsection (6)(c)(ii)(A)(I) shall be 20 percent from a wholesale value or equivalent level of value as published in the guide.

(B) Non-mobile flight equipment shall be valued using the cost approach under Subsection (5)(a) or the market or sales comparison approach under Subsection (5)(c), and added to the value of the fleet.

(iii) An income capitalization approach under Subsection (5)(b) shall incorporate the information available to make an estimate of future cash flows.

(iv)(A) When an aircraft market indicator under Subsection (6)(c)(ii) is used to estimate the fair market value of an airline, the Division shall:

(I) calculate the fair market value of the airline using the preferred methods under Subsection (5);

(II) retain the calculations under Subsection (6)(c)(iv)(A)(I) in the work files maintained by the Division; and

(III) include the amounts calculated under Subsection (6)(c)(iv)(A)(I) in any appraisal report that is produced in association with an assessment issued by the Division.

(B) When an aircraft market indicator under Subsection (6)(c)(ii) is used, the Division shall justify in any appraisal report issued with an assessment why the preferred methods under Subsection (5) were not used.

(v)(A) When the preferred methods under Subsection (5) are used to estimate the fair market value of an airline, the Division shall:

(I) calculate an aircraft market indicator under Subsection (6)(c)(ii);

(II) retain the calculations under Subsection (6)(c)(v)(A)(I) in the work files maintained by the Division; and

(III) include the amounts calculated under Subsection (6)(c)(v)(A)(I) in any appraisal report that is produced in association with an assessment issued by the Division.

(B) Value estimates from an aircraft pricing guide under Subsection (6)(c)(i)(A) along with the valuation of non-mobile flight equipment under Subsection (6)(c)(ii)(B) shall, when possible, also be included in an assessment or appraisal report for purposes of comparison.

(C) Reasons for not including a value estimate required under Subsection (6)(c)(v)(B) include:

(I) failure to file a return; or

(II) failure to identify specific aircraft.

(7) The provisions of this rule shall be implemented beginning January 1, 2022.

KEY: taxation, personal property, property tax, appraisals

Date of Enactment or Last Substantive Amendment:
2021~~November 30, 2020~~

Notice of Continuation: November 10, 2016

Authorizing, and Implemented or Interpreted Law: Art. XIII, Sec 2; 9-2-201; 11-13-302; 41-1a-202; 41-1a-301; 59-1-210; 59-2-102; 59-2-103; 59-2-103.5; 59-2-104; 59-2-201; 59-2-210; 59-2-211; 59-2-301; 59-2-301.3; 59-2-302; 59-2-303; 59-2-303.1; 59-2-305; 59-2-306; 59-2-401; 59-2-402; 59-2-404; 59-2-405; 59-2-405.1; 59-2-406; 59-2-508; 59-2-514; 59-2-515; 59-2-701; 59-2-702; 59-2-703; 59-2-704; 59-2-704.5; 59-2-705; 59-2-801; 59-2-918 through 59-2-924; 59-2-1002; 59-2-1004; 59-2-1005; 59-2-1006; 59-2-1101; 59-2-1102; 59-2-1104; 59-2-1106; 59-2-1107 through 59-2-1109; 59-2-1113; 59-2-1115; 59-2-1202; 59-2-1202(5); 59-2-1302; 59-2-1303; 59-2-1308.5; 59-2-1317; 59-2-1328; 59-2-1330; 59-2-1347; 59-2-1351; 59-2-1365; 59-2-1703

End of the Notices of Proposed Rules Section



Amy Briley
Senior Manager, Property Tax
Lumen Technologies, Inc.
1025 Eldorado Blvd
Broomfield, CO 80021

March 5, 2021

Mr. Larry Walters
Commissioner, UT State Tax Commission
210 North 1950 West
Salt Lake City, UT 84134

Dear Commissioner Walters:

Thank you for addressing each concern submitted by the many parties invested in this process. The time, thoughtfulness, and respect involved in your effort to improve Rule 62 are appreciated and admired.

Below are our comments on the latest draft of Rule 62.

- Lines 7 – 9. We don't disagree with this definition, but to avoid confusion, a caution that "the lack of an asset impairment by the company does not indicate the assets don't have obsolescence", may be useful.
- Lines 20 – 21. We understand your concern, and withdraw any objection to this definition.
- Lines 58 – 65. We understand this guidance is related to Utah Code 59 -2-102(16)(a)(ii), however we believe it should not be included in the rule. As PacifiCorp and the Division both point out, this method will likely result in contention around guideline companies (Lumen for example has no similar company in terms of size, product offerings, risk, and capital structure); and can result in an erroneous un-booked goodwill amount.
- Line 69. Subsection ii refers to intangible property described in 59-2-102(19)(a). These intangibles are separate from booked goodwill (section i) and un-booked goodwill (section iii) which are both included in 59-2-102(19)(c). As such they should be added to both sections iii and i. The adjustment should be the larger of subsection (3)(b)(i) + (3)(b)(ii) or (3)(b)(iii) + (3)(b)(ii)
- Lines 157 – 158. The Division's argument that a subject property should include value for what can be done with it in the future (its potential) is relevant if it is matched with a reduction to NOI

for the cash needed to install equipment to meet that potential. Without investment in improved technology that allows us to offer the services our customers will demand, our revenues will decline.

- Lines 183 – 184 and 187 – 188. We believe a change to the operating cash tax rate is unnecessary. The Division has properly matched NOI to the cap rate as it relates to the treatment of income taxes and the tax benefit of interest. A change to using the operating cash tax rate will not affect the outcome, and its calculation creates more work. Additionally, the information needed to calculate the operating cash tax rate is not always publicly available.
- Lines 200 – 202. Aswath Damodaran and Bradford Cornell both state that the best valuation practice should consider forward looking risk premiums.
- Line 269 – Lumen believes the cost indicator is an important indicator but is only accurate when all forms of obsolescence are applied.

Thank you for considering these further comments. If you have any questions or please feel free to call me at 913-884-1146 or email me at amy.c.briley@lumen.com

A handwritten signature in blue ink, appearing to read "Amy Briley".

Amy Briley
Senior Manager, Property Tax



Amy Briley
Senior Manager, Property Tax
Lumen Technologies, Inc.
1025 Eldorado Blvd
Broomfield, CO 80021

May 13, 2021

UT State Tax Commission
210 North 1950 West
Salt Lake City, UT 84134

Dear Commissioners:

Thank you for addressing each concern submitted by the many parties invested in this process. The time, thoughtfulness, and respect involved in your effort to improve Rule 62 are appreciated.

Below are our comments on the latest draft of Rule 62.

- Lines 56 – 63. We understand this guidance is related to Utah Code 59 -2-102(16)(a)(ii), however we believe it should not be included in the rule. As PacifiCorp and the Division have also both pointed out, this method will likely result in contention around guideline companies (Lumen for example has no similar company in terms of size, product offerings, risk, and capital structure); and can result in an erroneous un-booked goodwill amount.
- Line 69. Subsection ii refers to intangible property described in 59-2-102(19)(a). These intangibles are separate from booked goodwill (section i) and un-booked goodwill (section iii) which are both included in 59-2-102(19)(c). As such they should be added to both sections iii and i. The adjustment should be the larger of subsection (3)(b)(i) + (3)(b)(ii) or (3)(b)(iii) + (3)(b)(ii)
- Lines 155 – 156. The Division's argument that a subject property should include value for what can be done with it in the future (its potential) is relevant if it is matched with a reduction to NOI for the cash needed to install equipment to meet that potential. Without investment in improved technology that allows us to offer the services our customers demand, our revenues will decline. The "property in existence" language is an important reminder that cash flow projections should not include revenue derived from property that must have a greater capacity for us to retain customers.

- Lines 200 – 202. Aswath Damodaran and Bradford Cornell both state that the best valuation practice should consider forward looking risk premiums.

Thank you for considering these further comments. If you have any questions or please feel free to call me at 913-884-1146 or email me at amy.c.briley@lumen.com

A handwritten signature in cursive script, appearing to read "Amy Briley".

Amy Briley
Senior Manager, Property Tax

CENTURYLINK COMMENTS TO COMMISSIONER WALTERS' RULE 62 OBsolescence REVISION

1.0 SUMMARY

CenturyLink fully supports all efforts to revise the treatment of obsolescence under Administrative Rule **R884-24P-62** (Rule 62) to fit current market conditions for the telecommunications industry. The purpose of these comments is to substantiate additional or extra obsolescence in Historical Cost Less Depreciation ("HCLD") and the Reproduction Cost New Less Depreciation ("Reproduction Cost") methods.¹ While the methods being advocated are neither definitive nor exhaustive in addressing the issue of additional obsolescence, they are among the most widely adopted methods in the industry. We have briefly provided examples of these concepts utilizing CenturyLink to emphasize the need to recognize the possibility of the existence of extra obsolescence in the telecommunications industry and its adjustment, where applicable.

CenturyLink's network is unique in relation to other Utah telecommunications entities with substantial unused conduit, metallic cable, and duplicate fiber routes. Thus, any rule would need to clearly provide for the removal of additional obsolescence for these types of items.

2.0 COMMISSIONER WALTERS' RECOMMENDATIONS

CenturyLink supports in part the five recommendations for modifying Rule 62:

- 2.1 The rule should acknowledge the conceptual ties between obsolescence and asset impairment as used in financial accounting.
- 2.2 Functional obsolescence should be defined as a reduction in market value due to changing technologies or design preferences that render a property less desirable in the contemporary marketplace even though the expected future useful life remains unchanged.
- 2.3 When it can be shown that economic obsolescence is present either through an impairment of future cash flows directly or through performance comparisons with peer entities, the obsolescence adjustment should be made to RCNLD.

¹ Care must be taken to not mix Reproduction Cost New Less Depreciation ("Reproduction Cost") with Replacement Cost New Less Depreciation ("RCNLD"). If a proper RCNLD is performed, many of the items discussed herein regarding additional obsolescence to the Reproduction Cost approach will already be accounted for.

2.4 Quantification of obsolescence:

- Physical obsolescence should be measured using an economic life analysis or similar analysis of physical deterioration beyond that anticipated by book depreciation.
- The preferred method for measuring functional obsolescence is the difference between book value and RCNLD, augmented by a “cost to cure” analysis of any remaining functional obsolescence.
- The preferred method for measuring economic obsolescence is a comparative performance assessment or future cash flow analysis. The obsolescence adjustment should be made to RCNLD

2.5 Consistent with SFAS No. 144, the HCLD indicator can be adjusted for obsolescence following the guidelines provided in SFAS No. 144 and SFAS No. 157 for the identification and measurement of impairment.²

CenturyLink will articulate its position in the recommendations below where there are differences.

3.0 CENTURYLINK RECOMMENDATIONS

3.1 *Responses to Commissioner Walters’ Five Recommendations*

- 3.1.1 We agree that the conceptual ties between obsolescence and asset impairment as used in financial accounting should be acknowledged; however, it must be understood that depreciation for accounting purposes is different than depreciation for valuation purposes.
- 3.1.2 Functional Obsolescence refers to loss of service usefulness due to internal property characteristics, inadequacies, super adequacies, or technological changes³. Additionally, symptoms suggesting the presence of functional obsolescence are excess operating cost, excess construction (excess capital cost), over-capacity, inadequacy, lack of utility, or similar conditions⁴.

² According to the financial accounting standards, impairment is defined as the condition that exists when the carrying amount (net book value) of a long-lived asset (or asset groups) exceeds its fair market value. An impairment loss is recognized only if the full carrying charge is not recoverable. The carrying amount is not recoverable if it exceeds the undiscounted cash flows that are expected to flow from the asset’s use and eventual disposition. The loss will be measured by the difference between the carrying amount and the fair market value. Fair market value then becomes the new cost basis of the asset or asset groups still in use.

³ Glossary of Terms, Utilities and Railroad Property Valuation Workshop, 2019, page 108.

⁴ American Society of Appraisers, Valuing Machinery and Equipment, Fourth Edition, page 48-49.

- 3.1.3 We agree that adjustments should be made to RCNLD when it is shown that economic obsolescence is present. However, following guidelines provided in SFAS No. 144 and SFAS No. 157 for identification and measurement of impairment is difficult in an ad valorem taxation setting for unitary properties. Testing for impairment is a major undertaking in and of itself due to time constraints involved in ad valorem taxation.

In addition, company comparisons are difficult as companies may have unique characteristics.

- 3.1.4 There are various ways of quantifying obsolescence as shown in chapter three of the fourth edition of the 'Valuing Machinery and Equipment: The Fundamentals of Appraising Machinery and Technical Assets' published by the American Society of Appraisers (ASA). Methods of quantifying economic obsolescence are specifically shown from pages 68 through to 72.

Chill and Reilly⁵ describe five common methods that can be used to measure economic obsolescence. These methods can include the following:

- Inutility Analysis
- Gross Margins Analysis
- Industry Return Analysis
- Sales Transactions/Market-Derived Approach
- Income-Derived Approach/Market Earnings Shortfall.

- 3.1.5 We agree that the HCLD a can be adjusted for obsolescence following the inutility formula. Most telecommunication companies have network utilization data that can be provided to substantiate super-adequacy.

3.2 **Proposal No. 1: *Historical Cost Less Depreciation ("HCLD") Method***

- The ***Historical Cost Less Depreciation ("HCLD") method*** must be adjusted further to account for additional functional or economic obsolescence.
- The HCLD method used by the Utah State Tax Commission is suitable for rate-base regulated utilities and is not appropriate for companies that do not fall under the ambit of rate-base regulation. The HCLD method fails to fully consider functional and economic obsolescence affecting non-rate-based companies.⁶ WSATA – CCAP

⁵ Economic Obsolescence: Inutility and Beyond, 2015 Wichita Ad Valorem Conference.

⁶ See the following on the need to adjust the HCLD method for economic obsolescence: Gary C. Cornia, David J. Crapo, and Lawrence C. Walters, *Infrastructure and Land Policies*, Ch. 5, "The Unit Approach to the Taxation of Railroad and Public Utility Property," pp 140-41 (Lincoln Institute of Land Policy, 2013); Arlo Wooley, *Valuation of*

Handbook, page II-5 recommends appraisal adjustments where “[o]bsolescence may exist when a property is outmodeled, poorly designed (functional obsolescence) or some outside event or negative influence has diminished the future earning power of the property (external obsolescence).”

- Whenever the operating level of a plant or an asset is significantly less than its rated or design capability, and the condition is expected to exist for some time, the asset is less valuable than it would otherwise be. Such a penalty for inutility can be a measure of the loss in value from this form of economic obsolescence.⁷

Inutility can be quantified with the following formula:

$$\text{Inutility as a percent formula} = \left[1 - \left(\frac{\text{Capacity B}}{\text{Capacity A}} \right)^x \right] \times 100 =$$

Where Capacity A = Rated or design capacity
 Capacity B = Actual production
 x = Exponent or scale factor

- CenturyLink, for example, suffers from inutility amounting to as much as 72%.
- Old obsolete assets are not retired unless there is a business justification. Assets are not retired if a single customer utilizes the asset. In some cases, state and federal regulations may not permit retirement of assets.
- CenturyLink, for example, has the following assets that warrant extra functional and economic obsolescence adjustments to the HCLD indicator of value:
 - 11 empty conduits.
 - Old Infinera and Huawei equipment, as well as old equipment acquired in acquisitions.
 - Excess dark fiber.
 - Excess Copper cable.
 - Equipment no longer supported by manufacturers.

3.3 Proposal No. 2: Reproduction Cost New Less Depreciation (“Reproduction Cost”) Method

- A **Reproduction Cost New Less Depreciation (“Reproduction Cost”)** must be adjusted further to account for additional functional or economic obsolescence

Railroad and Utility Property, pp. 63-64 (Lincoln Institute of Land Policy and the Wichita Public Utility and railroad Workshop); *Unitary Valuation Methods*, pp 1-2 (State of California Board of Equalization, 2003).

⁷ American Society of Appraisers, *Valuing Machinery and Equipment*, Fourth Edition, page 68.

- An RCNLD is the proper starting point for utilizing the cost approach.
- A Reproduction Cost may be an accurate indicator of value for property only if that property reflects functional utility typical today and is constructed from materials currently used.
- A Reproduction Cost is developed for each individual site to arrive at the overall Reproduction Cost. It should be noted that components in a typical communication network have average economic lives with normal expected renewal and replacements. This economic life does not imply that all components will only last a certain amount of years. Rather, while some may fail early on and some may last longer, the average life we would expect for a large collection of specific types of components is its economic life.
- Additionally, the physical and economic life of a communication plant can be extended with proper maintenance and renewals, including the replacement of key components when they wear out.
- The telecommunications industry is impacted by cost and price compression⁸. A good amount of the equipment becomes technologically obsolete shortly after installation, and prices that customers find acceptable continue to decline. To grow revenues, or merely to maintain its existing revenues, telecommunication companies must acquire new property to increase the data transmission capacity of the network.
- There are three forms of depreciation that need to be considered in the development of the cost approach indicator of value: physical depreciation, functional and economic obsolescence. Often times, additional obsolescence must be accounted for even after a Reproduction Cost is developed with the use of indices.
- Age /life techniques based on straight-line valuation depreciation concepts (not straight-line accounting depreciation) are used to determine physical depreciation. This depreciation is applicable after the economic life of the class of assets is determined.
- Economic obsolescence is a reduction in value due to factors external to an asset. An example of economic obsolescence could be low utilization of manufacturing equipment driven by falling market demand for a product.
- As an example, CenturyLink currently has numerous assets which are route duplicative because of its organic and acquisition growth strategy. Additionally, its

⁸ Cost compression is the result of rapid technological change in which newer equipment continues to be substantially less expensive per unit of capacity than older existing equipment. Price compression refers to the fact that prices that can be charged to customers also decrease rapidly, because of both intense industry competition and technological change.

fiber strands are underutilized and its copper pairs have experienced considerable loss in customer utilization. The costs associated with these duplicative and antiquated assets are the basis of significant additional obsolescence.

4.0 CONCLUSION

Both the Historical Cost Less Depreciation (“HCLD”) and the Reproduction Cost New Less Depreciation (“RCNLD”) can be adjusted for additional or extra obsolescence prevalent in the telecommunication industry.

It is CenturyLink’s hope that the State Tax Commission will adopt one of the recommended approaches to adjusting for additional or extra obsolescence that is prevalent in the telecommunication industry. Data is readily available and can be provided upon request for adjustments to be made.

Centurylink, Inc.
1025 Eldorado Blvd.
Broomfield, CO 80021



November 27, 2019

Mr. Larry Walters, Commissioner
Utah State Tax Commission
210 North 1950 West
Salt Lake City, UT 84116

Dear Commissioner Walters:

Thank you for meeting with the telecommunications industry regarding Rule 62, sharing your thoughts, and listening to ours.

We support the Commission's efforts to establish a rule requiring the Division to use a Cost Approach with RCNLD tables to value the operating properties owned by telecommunication companies. However, CenturyLink's network is unique in relation to other Utah telecommunications entities (i.e. unused conduit, metallic cable, and duplicate fiber routes), and thus any rule would need to clearly provide for the removal of additional obsolescence for these types of items. Additionally, in order to avoid the complication of the counties valuing the real estate owned by telecommunications entities, we would recommend that the Commission's rule include a table for buildings such as the table used in Arizona. I've attached a copy of the Arizona table for your reference. We believe that a rule with the above modifications could be beneficial to all parties as it removes the difficult step of valuing and removing intangible properties from the unit value, and will likely reduce litigation.

Other proposed Rule 62 changes and statutory changes that are of concern to Centurylink are:

- Rule 62 Lines 106-107; 150-151; 167: Assets in Existence: We strongly urge you not to remove any language regarding assets in existence. In an industry strongly influenced by technological changes, it is important to consider that any replacement of current assets should be evaluated with the same capacity as the assets in existence at the lien date. The inclusion of an inflation rate is only appropriate if the cash flows reflect only the revenue produced by the assets in existence at the lien date. An increase in cash flows can only occur with new technology and expanded capacity.
- Rule 62 Line 95: Trending HCLD to estimate current reproduction or replacement costs is inappropriate in the telecommunication industry due to a fast rate of technological substitution. In addition, the excess capital costs of transitioning to new technologies would not be considered.
- Rule 62 Lines 14-15; 130-132: The use of an operating cash tax rate that includes net operating loss (NOL) carryforwards will inflate the value of the unit by including the value of the NOL's.
- Statutory Change - Intangible definition: We believe this change is unnecessary and may cause confusion regarding Goodwill.

Additional Rule 62 items of concern to Centurylink but not included in the proposed rule changes are:

- Line 97: The use of the word "preferred" in reference to the HCLD indicator of value is inappropriate.
- Lines 145 – 146: The words "if Value Line is unavailable" should not be included. If data is also available from another reliable source, appraisers should be allowed to use an such reliable data even if Value Line data is available.
- Lines 139 – 140: the requirement of 50% CAPM weighting constrains an appraiser from making informed judgement calls when appropriate. We would recommend that the 50% weighting requirement be removed.

We look forward to seeing further drafts of Rule 62. Please feel free to call or email me if you have any questions or comments. My phone number is 913-707-6259 and my email address is amy.c.briley@centurylink.com.

Thank you again for your time and consideration.

Amy Briley
Property Tax Manager

Enc.

LUMEN COMMENTS TO COMMISSIONER LARRY WALTERS' RULE 62 DRAFT REVISION OF JANUARY 6, 2021

Lines	Number	Subject	Comment
20-21	2	Normal rate of return on assets.	<ol style="list-style-type: none"> 1. Definition cited may be applicable for rate-base regulated entities and not non-regulated entities like railroads and telecommunications. 2. Standard finance/accounting definition is 'net income divided by total assets.'
57-62	3	The normal rate of return on assets for guideline companies shall be calculated and then compared to the actual return on assets for the subject company.	<ol style="list-style-type: none"> 1. The normal rate of return on assets based on guideline companies may be impractical due their diverse nature of operations and growth drivers.
121-125	5	The preferred method for measuring economic obsolescence is a relative performance assessment among comparable firms or future cash flow analysis. The relative performance assessment shall incorporate multiple measures of both operating and financial performance in relation to comparable firms and may include historical trends. Future cash flow analysis shall be based on a firm's estimated future cash flows if available	<ol style="list-style-type: none"> 1. Other methods of measuring economic obsolescence have not been mentioned. 2. Using a 'future cash flow analysis' may be impractical as it may be prone to company-specific subjectivity. 3. The Inutility method may be more practical for telecommunication assets.
172-174	5	WACC should reflect a typical capital structure for comparable companies within the industry and should be adjusted for inflation and the operating cash tax rate.	<ol style="list-style-type: none"> 1. The WACC is typically calculated using the marginal tax rate. 2. The use of an operating cash tax rate will include net operating loss (NOL) carryforwards, which will inflate the value of the unit by including the value of the NOL's.
179-181	5	The CAPM is the preferred method to estimate the cost of equity.	<ol style="list-style-type: none"> 1. Problems of relying on the CAPM were highlighted during the 2008-2010 financial crisis

			<p>when equity risk premiums went down instead of upwards.</p> <ol style="list-style-type: none"> 2. The unprecedented current environment of ultra-low interest rates gives credence to using multiple cost of equity models. 3. 50% weighting on CAPM removes appraisal judgement/flexibility. 4. Using a modified CAPM is more appropriate.
188-189	5	The risk premium shall be the arithmetic average of the spread between the return on stocks and the income return on long-term bonds for the entire historical period beginning in 1926	<ol style="list-style-type: none"> 1. Best valuation practice should consider both historical and forward-looking risk premiums, with adjustments made where appropriate. 2. There are ways of deriving forward looking equity risk premiums, such as Damodaran's implied equity risk premium, supply-side equity risk premium.
148/191-192/208	5	Property in existence on the lien date/Assets in place on the lien date/Assets not in place on the lien date	<ol style="list-style-type: none"> 1. It is important to distinguish between growth attributable to assets in existence on the lien date and growth derived from future assets with enhanced technical capabilities. 2. The current language should not be removed.
209-212	5	Direct Capitalization is an income technique that converts an estimate of a single year's income expectancy into an indication of value in one direct step, either by dividing the normalized income estimate by a capitalization rate or by multiplying the normalized income estimate by an income [factor] multiplier.	<ol style="list-style-type: none"> 1. The valuation multiples approach is inappropriate for complex properties with varied business operations and growth drivers. 2. A valuation multiple is simply an expression of market value relative to a key statistic that is assumed to relate to that value. To be useful, that statistic – whether earnings, cash flow or some other measure – must bear a logical relationship to the market value observed; to be seen, in fact, as the driver of that market value.

			3. Market Multiples model heavily relies on derivation of an Enterprise Value, which is market capitalization plus seasonally adjusted net debt, pension provisions, the value of minorities and other provisions deemed debt enterprises.
252-254	5	The cost indicator should generally be given little or no weight because there is no observable relationship between cost and fair market value	<ol style="list-style-type: none"> 1. The equal and uniform argument comes in of treating railroads differently without consideration of other deregulated industries. 2. For the telecommunications industry, this indicator only becomes relevant if extra obsolescence is taken into consideration.

849 N 400 E
Springville, UT 84663
17 May 2021

John Valentine, Chair
Michael Cragun, Commissioner
Rebecca Rockwell, Commissioner
Utah State Tax Commission
210 N 1950 W
Salt Lake City, UT 84134

Re: Comments on proposed changes to **Rule R884-24P-62 Valuation of State Assessed Properties**

Greetings,

First, let me thank you for the opportunity to address the Commission at the public hearing on May 13, 2021. To supplement and clarify my oral comments, I would like to submit the following.

Concern has been expressed by both the Division and taxpayers that the language in Section (3)(b)(iii) regarding the normal rate of return on assets has the potential to create conflict over the selection of comparable “guideline companies.” As I have acknowledged before, the concern is valid. However, the relevant statute requires that the Commission determine the “normal rate of return on assets” in order to ascertain whether the subject property realizes a rate of return in excess of the normal rate. [UCA 59-2-102(16)(a)(2)(A)]

It may be possible to reduce the likelihood of conflicts if all parties can agree on the dimensions that will be used to determine comparability. For example, comparable firms are often identified using criteria such as:

- Business operations in the same 4-digit NAICS code, and excluding business operations that do not fall within that code and operations outside the United States
- Firms that offer very similar products and services
- Firms of similar size, as determined by
 - Net (or gross) property, plant and equipment
 - Gross sales
 - Number of employees
 - Number of customers (by type of customer)

There are well known methods available to make multi-dimensional comparisons of this sort to identify the best guideline companies to use for the industries and firms being assessed. This approach will not avoid all contention, but it may minimize it. Hopefully, the procedure for establishing the normal rate of return on assets in each industry can avoid the need for legislative intervention. Methods are likely to evolve over time and it would be unfortunate to specify in statute a remedy that becomes obsolete, unfair or inappropriate for a given industry.

In addition, I offer the following comments in response to the written comments and testimony presented at the hearing.

Comments in response to Utah Taxpayers Association (UTA) letter of May 12, 2021 (Section numbers refer to sections of the proposed Rule 62):

1. Section (3)(b)—The UTA expresses concern that the phrase “consistent with the methods used to derive the unit value” may be used by the Division to require “that the same valuation approaches be used to value both the unit and the intangible property (i.e., income or cost approach for both types of properties).” Several observations in response are appropriate. First, as the Rule goes on to state, three different approaches to valuing intangible property are provided for and they are not consistent in the methods implied for valuing intangible property. Booked goodwill [see (3)(b)(i)] is measured using standard accounting procedures generally arising from a purchase price allocation. Other identifiable intangible property which can be isolated [(3)(b)(ii)] is valued using standard methods which may involve some combination of cost, sales or income. Extraordinary returns [(3)(b)(iii)] are determined using an income approach. Valuing intangible property in Utah will require methods appropriate for the type of property being valued. Given that the courts have been willing to accept mixed valuation approaches in making the adjustment for intangible value (See the *Union Pacific* case cited by the UTA), the Division is unlikely to unilaterally attempt to ignore the rule or overturn judicial precedent.
2. Section (3)(b)(i)—The proposed language is consistent with current Division practice and is based on reasonable logic. In the development of this language, the Division provided good examples of their reasoning and methods. The Commission should review the Division’s comments carefully in this regard.
3. Section (3)(b)(ii)—The UTA argues that this section somehow limits that amount of intangible property that must be deducted from the unit value in violation of the *T-Mobile* ruling. However, Section (3)(b)(ii) is only one of three approaches to the valuation of intangible property value set forth in the Rule. All three types of intangible property are specifically identified in statute [59-2-102(16) and 59-2-102(19)]. For the Commission to reach beyond the Legislature’s definition of exempt intangible property would seem to be overreaching their responsibility.
4. Section (3)(b)(iii)—UTA argues that this subsection identifies an alternative approach for valuing intangible property. In fact, it simply sets forth the third type of exempt intangible property identified in statute [59-2-102(16)(a)(ii)]. While it may be the case that the proposed method is “unique”, it is not an “alternative” method. The statute specifically defines “income that exceeds a normal rate of return on assets” and distinguishes it from acquired and booked goodwill [59-2-102(16)(a)(i)] and “property that is capable of private ownership separate from tangible property” [59-2-102(19)(a)]. The Commission is required therefore to value goodwill reflected by a firm’s ability to generate income in excess of the normal rate of return. To be sure, Section 59-2-102(16)(a)(ii) specifies that goodwill is either acquired and booked goodwill OR the ability of a business to generate income that exceeds a normal rate of return on assets. Hence the need for (3)(b)(iv) in the proposed Rule that avoids double counting in the adjustment for exempt intangible value.
5. Section (5)(a)(iv)—UTA takes issue with trended historical costs in determining replacement costs. UTA raises a valid concern that trended historical costs may not fully reflect changes in technology. However, several states, including California, use exactly this approach to estimate replacement costs.

6. Section (5)(b)(i)(A) and (II)—UTA raises concerns about striking the first sentence of (5)(b)(i)(A). I agree with their objection. I believe this strike-out transferred from an earlier draft and was simply missed in the final editing.
7. Section (5)(b)(i)(B)(II)(Aa)—UTA and several speakers at the public hearing on May 13, 2021 expressed concern that, while the proposed Rule language strikes the requirement that the CAPM model be given at least 50% weight in determining the cost of equity, the proposed language still expresses a preference for CAPM. They recommend that this subsection be revised to remove any expression of preference for CAPM. As I expressed in my oral testimony, there is wide agreement in the corporate finance world that CAPM is not supported by the empirical evidence. At the same time, CAPM is still widely used. As one prominent finance professor put it recently:

The workhorse [cost of capital] model for nearly half a century has been the Capital Asset Pricing Model, or CAPM. It dominates textbooks, teaching, and practice. Over 90 percent of all publicly-traded companies use it. Courts and appraisers also use it. In many contexts, it is even the only accredited model.¹

Based on this overwhelming pattern, there is very good reason for Utah to continue to give CAPM pride of place, simply to be consistent with standard practice. However, Professor Welch goes on in the next paragraph to state:

Unfortunately—and I write this with a heavy heart—the CAPM is not just imperfect; it is so badly wrong that it is best ignored.²

Professor Welch goes on to explain that while CAPM is elegant and simple (for finance types!), the predictions it yields do not match what is actually observed in capital markets. Other references could be provided to support this argument. Equally unfortunate is the fact that there are no elegant and simple alternatives to CAPM. Turns out the real world is much messier than the models.

As a practical matter, I agree that it is time for Utah to acknowledge that CAPM is not necessarily the best model for estimating the cost of equity. However, I also don't think Utah should abandon totally an approach that is still so widely used. If "over 90 percent of all publicly-traded companies use it", it should be prominently included in Utah's estimates.

Whether the first sentence of subsection (5)(b)(i)(B)(II)(Aa) is stricken or not, CAPM should not be the only approach used to estimate the cost of equity.

8. Section (5)(b)(i)(C)(I)—The UTA objects to using an inflation factor for "g" in the standard valuation formula. It should be noted that such an inflation factor is a long-standing practice by the Commission. The proposed language only changes which inflation factor is used, updating the language for changes in available market data since the last Rule revision. I also note that the current language does not include recent developments in the corporate valuation world that suggest the standard formula is mathematically incorrect in a real world context affected by

¹ Welch, Ivo, 2021, "The Cost of Capital: If Not the CAPM, Then What?", *Management and Business Review*, Winter issue, <https://mbrjournal.com/2021/01/26/the-cost-of-capital-if-not-the-capm-then-what/>

² *ibid*

inflation. However the necessary changes were left out of this draft because the proposed modifications in the valuation formulas have not been sufficiently vetted in practice. I recommend the Commission retain the proposed language.

9. Section (6)(a)(i)—UTA and Mr. Norm Ross (Pacifcorp) both request that the word “company” in the first sentence of the subsection be changed to “property.” This would seem to be a reasonable change.

Comments in response to testimony by Mr. Norm Ross from Pacifcorp.

10. Section (5)(a)(i)(B)(III)—Mr. Ross argued that the preferred method for valuing external or economic obsolescence should not be comparative. By its very nature, however, all forms of obsolescence are comparative. Physical “deterioration” is a comparison with prior performance levels. Functional obsolescence is a comparison with other available technologies and designs. Economic obsolescence is a comparison either with other similar firms or with a time trend. In the realm of obsolescence, comparison is unavoidable.

Mr. Ross did raise a valid point that if the obsolescence is so widespread that it affects an entire industry, comparisons across firms may not correctly identify and quantify the obsolescence. In such cases, time trends and multi-year cash flow analysis are needed. But the proposed language allows for this approach.

11. Section (5)(b)(i)(B)(II)(Ee)—Mr. Ross raised concerns about the inclusion of the potential use of implied equity risk premium models. This language was added at the request of other centrally assessed taxpayers. I recommend leaving the language in the Rule, but directing the Division to convene a working group to address the concerns raised by Mr. Ross.

May 17, 2021

VIA EMAIL -jvalentine@utah.gov

Commission Chair John L. Valentine
Utah State Tax Commission
210 N. 1950 W.
Salt Lake City, UT 84134

RE: Proposed Changes to Administrative Rule R884-24P-62

Dear Commissioner Valentine:

PacifiCorp appreciates the Commission's efforts over the past two years to review Rule R884-24P-62 and to solicit input from interested parties concerning possible rule changes. Last week's Zoom call provided an opportunity to focus on items that remain a concern. I have attached a copy of the slides I discussed during our call and I hope that the Commission will find the illustrations on the slides and the following brief comments helpful.

1. R884-24P-62 (5)(a)(i)(B)(III) – Measuring External Obsolescence

The concerns I expressed about the proposal to measure external obsolescence by comparing the “*relative performance*” of “*comparable firms*” were validated when Dr. Walters acknowledged that the procedure will not account for factors that contribute to external obsolescence on a broader or industry wide basis. In other words, the procedure will at best measure only a portion of the external obsolescence affecting property value.

I believe Dr. Walters may have also indicated that the “*relative performance*” procedure is a step in the right direction. That may be true but it is nevertheless an incomplete and unqualified step. Because the rule contains no qualifying language to explain that the “*relative performance*” procedure will not account for obsolescence that broadly affects all industry members, some may wrongly assume that the procedure accounts for 100% of external obsolescence when it does not in fact do so.

With these concerns in mind, PacifiCorp recommends that the procedure either be eliminated or that a qualifying sentence similar to the following be appended to the end of the paragraph

Note that the relative performance procedure described above may not account for the portion of external obsolescence that occurs on an industry wide basis.

2. R884-24P-62 (5)(b)(B)(II)(Aa) –Preferred Status Assigned to the CAPM

I believe it was Mr. Laron Lind who claimed during the call that the Capital Asset Pricing Model (“CAPM”) was the most widely *used* model and thus it should retain the preferred status noted in

the rule. When making that argument, Mr. Lind failed to acknowledge that there is a difference between a model that is *used* or calculated by an analyst and a model whose estimate of the cost of equity is *relied upon* by an analyst. Not all analysts that prepare the CAPM rely on its results.

To illustrate this point, I prepared the following schedule which summarizes information about the use of the CAPM by Mr. Charles Peterson, one of Mr. Lind's witnesses during the appeal of PacifiCorp's 2015 Utah Assessment. Until his recent retirement, Mr. Peterson served as the Utah Division of Public Utilities' ("DPU") primary cost of capital witness and prior to that time he was an appraiser for the Property Tax Division. During his time with the DPU, Mr. Peterson provided cost of capital testimony on behalf of the DPU in six PacifiCorp rate cases.

Utah Public Service Commission Docket	C. Peterson Source Document	C. Peterson's CAPM Result	Weight Assigned by C. Peterson to CAPM Result	C. Peterson's Recommended Cost of Equity
07-035-93	Exhibit 2.5	9.10%	Not Disclosed	10.10%
08-035-23	Exhibit 2.5	7.15%	Not Disclosed	10.75%
09-035-23	Exhibit 1.5	8.30%	0.00%	10.50%
10-035-124	Exhibit 4.3	8.73%	0.00%	10.00%
11-035-200	Exhibit 1.3	8.43%	1.00%	9.30%
13-035-184	Exhibit 1.3	8.65%	5.00%	9.25%

Although Mr. Peterson prepared the CAPM in all six rate cases, he assigned no more than 5.0% weight to the cost of equity estimate derived from the CAPM during any of those cases and in at least two cases, he assigned no weight to the CAPM. Another thing that stands out is the fact that in all six rate cases, Mr. Peterson's final cost of common equity recommendation was substantially higher than the cost of equity estimate produced by use of the CAPM. Clearly, the CAPM did not represent a "*preferred method*" to Mr. Peterson. The "*preferred method*" wording in Rule 62 should be eliminated.

Thank you for your consideration of this information.

Very truly yours,



Norman Ross, CPA, ABV
Tax Director
TEL (503) 813-5938



Items of Concern Related to Proposed Changes to Rule 62

Norman Ross, CPA, ABV

Tax Director at PacifiCorp

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R884-24P-62 (5)(a)(i)(B)(III)

The preferred method for measuring economic obsolescence is a **relative performance assessment among comparable firms** or future cash flow analysis. The relative performance assessment shall incorporate multiple measures of both operating and financial performance in relation to comparable firms and may include historical trends. Future cash flow analysis shall be based on a firm's estimated future cash flows if available.

External obsolescence can be caused by a variety of factors, such as changes in the highest and best use of a property due to market shifts or governmental actions, tariffs, regulated rate of return, restrictions on income, zoning, neighborhood decline, lack of property demand, and national economic conditions (war, oil prices and interest rates).

International Association of Assessing Officers, *Property Assessment Valuation*, Third Edition (Kansas City, MO: 2010), p. 260.

Invalid Comparison Contemplated in Draft Rule

Company A	Company B
Value Impacted by External Factors: Governmental Actions, Tariffs, Regulated Rate of Return, Restrictions on Income, Zoning, Neighborhood Decline, Lack of Demand, National Economic Conditions, etc.	Value Impacted by External Factors: Governmental Actions, Tariffs, Regulated Rate of Return, Restrictions on Income, Zoning, Neighborhood Decline, Lack of Demand, National Economic Conditions, etc.

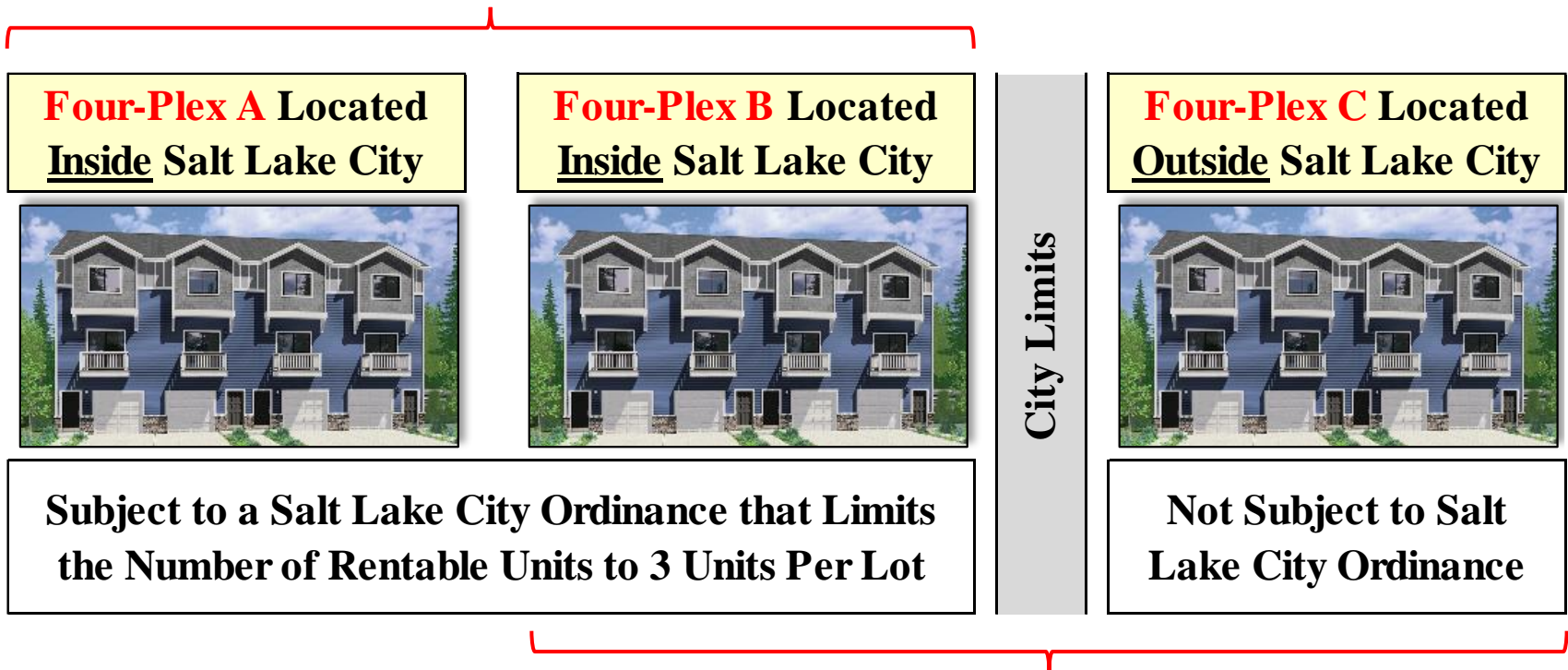
Valid With and Without Comparison

Company A	Company C
Value Impacted by External Factors: Governmental Actions, Tariffs, Regulated Rate of Return, Restrictions on Income, Zoning, Neighborhood Decline, Lack of Demand, National Economic Conditions, etc.	Value Impacted by External Factors: None of the Factors Impacting Company A

R884-24P-62 (5)(a)(i)(B)(III)

The preferred method for measuring economic obsolescence is a relative performance assessment among comparable firms or future cash flow analysis. The relative performance assessment shall incorporate multiple measures of both operating and financial performance in relation to comparable firms and may include historical trends. Future cash flow analysis shall be based on a firm's estimated future cash flows if available.

Comparing **Four-Plex A** to **Four-Plex B** is Not Meaningful



This is a Meaningful Comparison

R884-24P-62 (5)(a)(i)(B)(III)

The preferred method for measuring economic obsolescence is a **relative performance assessment among comparable firms** or future cash flow analysis. The relative performance assessment shall incorporate multiple measures of both operating and financial performance in relation to comparable firms and may include historical trends. Future cash flow analysis shall be based on a firm's estimated future cash flows if available.

Estimating External Obsolescence

Income Approach

Value is Estimated by
Reference to Income

Cost Approach

Cost less
Depreciation

Sales Comparison Approach

Value is Estimated by
Reference to Sales Data

Like incurable functional obsolescence, external obsolescence can be measured either by the sales comparison or capitalization of income method.

International Association of Assessing Officers, *Property Assessment Valuation*, 2nd ed., (Chicago, IL: 1996), p. 186

The “relative performance” procedure:

- Is not found within or supported by generally accepted appraisal literature
- Is not employed by any other state
- May create considerably more problems than it attempts to solve
- May be completely arbitrary from period to period and from taxpayer to taxpayer
- Is likely to lead to more litigation

R884-24P-62 (5)(b)(B)(II)(Ee)

Implied equity risk premium models may also be considered.

CAPM: $R_e = \text{Long-Term Treasury Rate} + (\text{Beta} \times \text{Equity Risk Premium})$

Return on the Market (R_m) - Long-Term Treasury Rate

2021 CAPM Result – Based on Use of the Historical Risk Premium

$R_e = \text{Long-Term Treasury Rate} + (\text{Beta} \times \text{Historical Equity Risk Premium})$

$7.76\% = 1.45\% + (.87 \times 7.25\%)$

2021 CAPM Result – Based on Use of the Implied Risk Premium

$R_e = \text{Long-Term Treasury Rate} + (\text{Beta} \times \text{Implied Risk Premium})$

$5.37\% = 1.45\% + (.87 \times 4.50\%)$

2021 CAPM Result – Based on Use of the Implied Risk Premium

$R_e = \text{Long-Term Treasury Rate} + (\text{Beta} \times \text{Implied Risk Premium})$

$5.37\% = 1.45\% + (.87 \times 4.50\%)$

R884-24P-62 (5)(b)(B)(II)(Ee)

Implied equity risk premium models may also be considered.

Equity Risk Premium (ERP) = Return on the Market (R_m) - L-T Treasury Rate

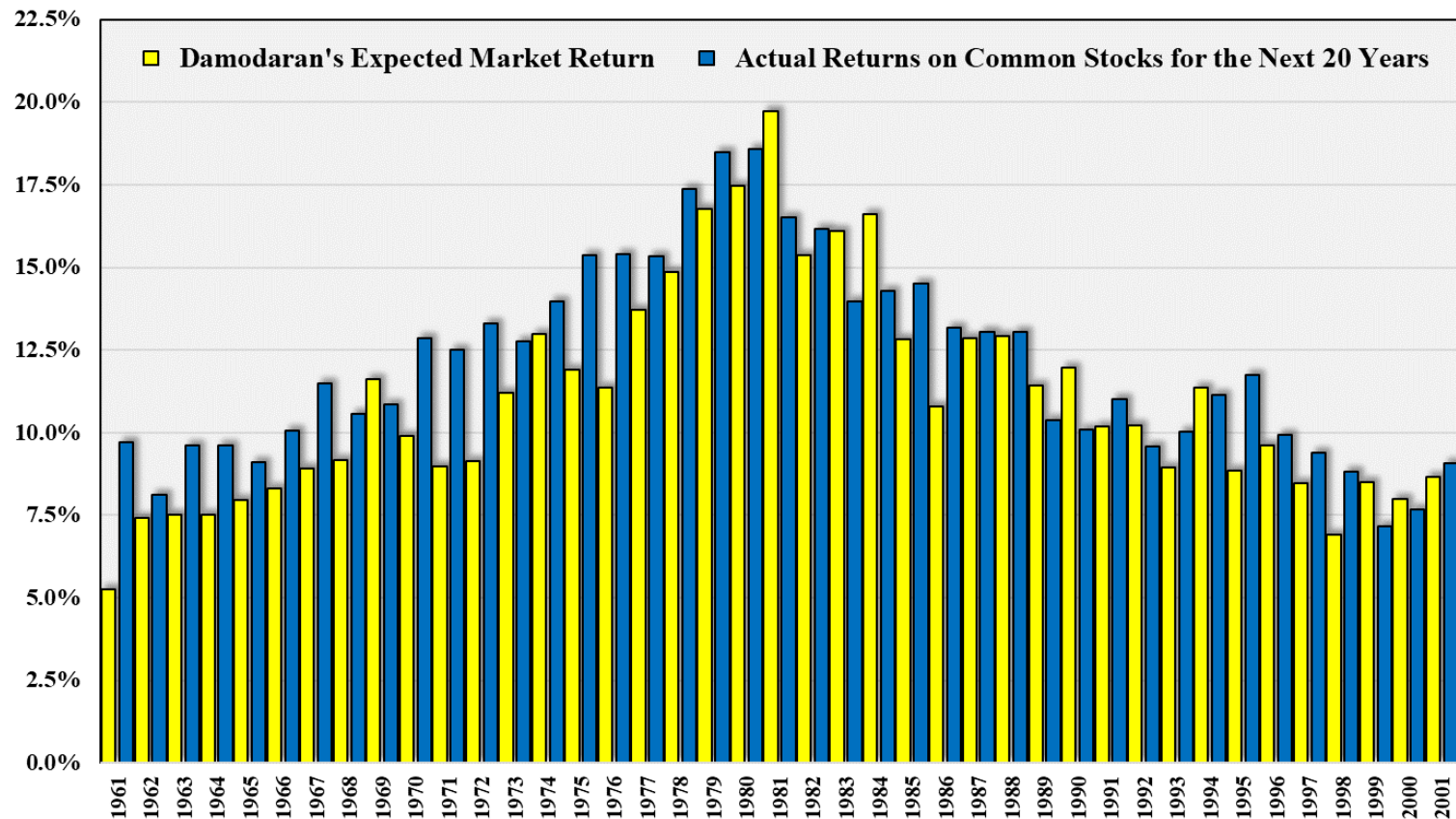
- **If R_m is Underestimated, the ERP Will Be Underestimated**
- **If the ERP is Underestimated, the Cost of Equity Will be Underestimated**
- **If the Cost of Equity is Underestimated, Value Will Be Overstated**

Key Question: Do the Methods Employed by Damodaran Produce Valid Estimates of Future Market Returns (R_m)? **No.**

R884-24P-62 (5)(b)(B)(II)(Ee)

Implied equity risk premium models may also be considered.

Comparison of Damodaran's Expected Market Returns with Actual Market Returns Over Successive 20 Year Periods

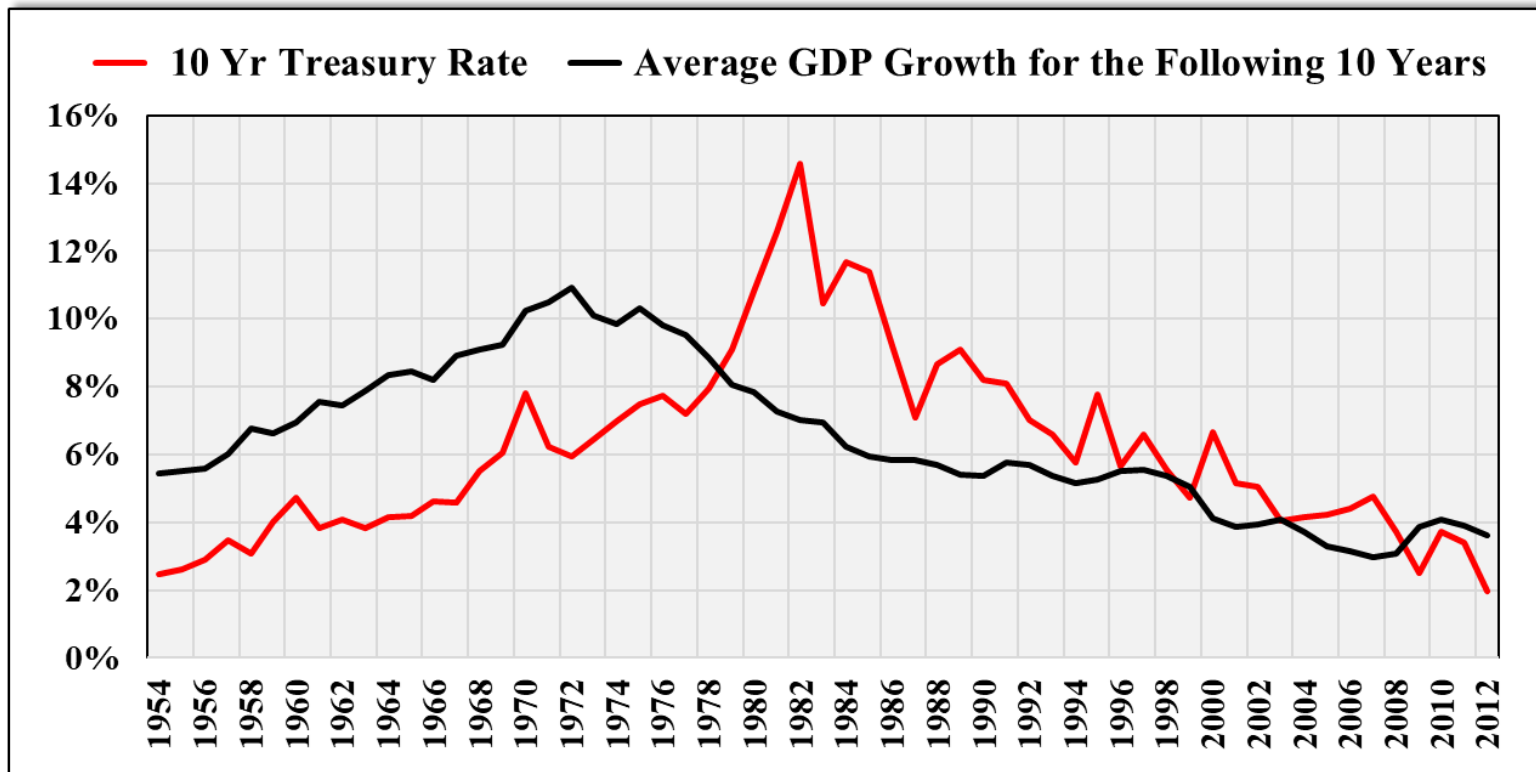


Conclusion: Actual returns on common stocks for successive 20 year periods exceeded Damodaran's expected market returns (" R_m ") for 31 of the 41 years (or 76% of the time) from 1961 through 2001

R884-24P-62 (5)(b)(B)(II)(Ee)

Implied equity risk premium models may also be considered.

Why is Damodaran's Estimate of R_m Consistently Understated?
- He Wrongly Uses a 10 Year Treasury Rate as a L-T Growth Rate



The 10 Year Treasury Rate is Not a Valid Proxy for Future GDP Growth

R884-24P-62 (5)(b)(B)(II)(Ee)

Implied equity risk premium models may also be considered.

Congressional Budget Office 2021 Long-Term Budget Outlook

THE 2021 LONG-TERM BUDGET OUTLOOK

MARCH 2021

Table A-2.

Average Annual Values for Economic Variables That Underlie CBO's Extended Baseline Projections

Percent	1991-2020	2021-2031	2032-2041	2042-2051	2021-2051
Growth of GDP					
Real GDP	2.3	2.2	1.6	1.5	1.8
Real potential GDP*	2.4	1.8	1.6	1.5	1.6
Potential labor force	0.9	0.3	0.3	0.3	0.3
Potential labor force productivity	1.5	1.4	1.3	1.2	1.3
Nominal GDP (Fiscal year)	4.3	4.2	3.6	3.5	3.8

<https://www.cbo.gov/system/files/2021-03/56977-LTBO-2021.pdf>

Tax Commission's 2021 Capitalization Rate Study



UTAH STATE TAX COMMISSION PROPERTY TAX DIVISION KEY RATES AND FIGURES

4/1/2021

2021

Page 5

CORPORATE BONDS		PUBLIC UTILITY BONDS	
Aaa	2.26%	Aaa	N/A
Aa	2.44%	Aa	2.57%
A	2.72%	A	2.77%
Baa	3.16%	Baa	3.05%
Ba1		PREFERRED STOCKS	
Ba2		Aaa	N/A
Ba3		Aa	N/A
B1		A	N/A
B2		Baa	N/A
B3		MISCELLANEOUS RATES	
Caa1		Airline 'TEFRA' Relief Factor	6.76%
Caa2		4-R Act Relief for Railroads	14.28%
Caa3		4-R Act Relief (BNSF only)	6.76%
Ca		Marginal Income Tax Rate	25.00%
C		GDP Price Deflator Forecast	2.20%
		Long Term Growth Rate	3.80%

<https://propertytax.utah.gov/rate-studies/utcapratestudy2021.pdf>

The proposed wording gives legitimacy to a questionable if not plainly invalid method. This may lead to the use of substantially lower cost of equity rates and more litigation.

R884-24P-62 (5)(b)(B)(II)(Aa)

The CAPM is the preferred method to estimate the cost of equity. More than one method ~~[may]~~ shall be used to correlate a cost of equity~~], but only if the CAPM method is weighted at least 50% in the correlation]~~.

When measuring equity costs, which essentially deals with the measurement of investor expectations, no one single methodology provides a foolproof panacea. Each methodology requires the exercise of considerable judgment on the reasonableness of the assumptions underlying the methodology and on the reasonableness of the proxies used to validate the theory.

Morin, Roger A., *New Regulatory Finance, Utilities Cost of Capital*, (Vienna, VA: Public Utilities Reports, Inc., 2006), p. 28.

There is no single, widely accepted, best pricing model-just as there is still no consensus on some fundamental issues, such as the efficient market hypothesis (EMH).

Villadsen, B., Michael J. Vilbert, Dan Harris, and A. Lawrence Kolbe, *Risk and Return for Regulated Industries*, (Cambridge, MA: Academic Press, 2017), p. 38.

We have seen that empirically none of the models of the cost of equity has been accepted as consistently holding in practice or providing a “best answer.”

Ogier, Tim et al., *The Real Cost of Capital*, (Glasgow: Person Education Limited, 2004) p. 93.

R884-24P-62 (5)(b)(B)(II)(Aa)

The CAPM is the preferred method to estimate the cost of equity. More than one method ~~[may]~~ shall be used to correlate a cost of equity~~], but only if the CAPM method is weighted at least 50% in the correlation]~~.

Conscientious appraisers, recognizing the limitations inherent in any single method, can use several different methods. Correlating the results from several different methods can reduce the bias inherent in any single method.

Woolery, Arlo, *Valuation of Railroad and Utility Property*, Published in cooperation with The Lincoln Institute of Land Policy and The Wichita Public Utility and Railroad Workshop, p. 108.

At the outset we should state that most experts in the field of finance believe that all cost of capital models have limitations and that no method produces reasonable results under all circumstances.

Hayward, David L. and Schmidt, Michael R., *Valuing an Electric Utility; Theory and Application*, Public Utility Reports, Inc., 1999, p. 189.

Various models have been proposed and are in active use by practitioners because the single-factor textbook CAPM has generally proven to provide unreliable estimates of the cost of equity capital.

Pratt, Shannon P. and Grabowski, Roger J, *Cost of Capital, Applications and Examples*, (Hoboken, New Jersey, John Wiley & Sons, Inc. 2008) p. 253.

R884-24P-62 (5)(b)(B)(II)(Aa)

The CAPM is the preferred method to estimate the cost of equity. More than one method ~~[may]~~ shall be used to correlate a cost of equity[, but only if the CAPM method is weighted at least 50% in the correlation].

The “preferred method” wording leaves in place the problem that elimination of the 50% weighting scheme was supposed to fix.

The “preferred method” wording presumes that the CAPM model, with the inputs specified in Rule 62, will at all times and in all types of capital markets produce reasonable estimates of the cost of equity capital. That implicit assumption is invalid.

There is no sound appraisal related justification for assigning either a minimum weight or preferred status to a specific cost of equity estimation model.

No state other than Utah has found it necessary to assign preferred status to a specific cost of equity model in order to facilitate the valuation of centrally assessed property.

For these reasons, the “preferred method” language should be deleted.

R884-24P-62 (6)(a)(i)

Rate regulation is one form of regulation that may impact the market value of a company; however, it does not determine the market value of such a company.

Rate regulation is one form of regulation that may impact the market value of a
~~company~~ **property**; however, it does not determine the market value of ~~such a company~~
property.

R884-24P-62 (5)(b)(i)(A)

~~[Cash flow is restricted to the operating property in existence on the lien date, together with any replacements intended to maintain, but not expand or modify, existing capacity or function.]~~

Why eliminate wording that reminds everyone involved that the appraisal assignment given to the Tax Commission by the Legislature is limited to valuing the property that exists today?

The “property in existence” language should be retained.



BUILDING AMERICA®

VIA EMAIL: casper@utah.gov

May 17, 2021

Chairman John L. Valentine
Commissioner Rebecca L. Rockwell
Commissioner Michael Cragun
Utah State Tax Commission
210 North 1950 West
Salt Lake City, UT 84134

Dear Commissioners:

Union Pacific Railroad Company ("Union Pacific") has previously submitted extensive comments to the Utah State Tax Commission ("Commission") on its proposed changes to Utah Rule R884-24P-62 ("Rule 62"). Most recently, Union Pacific provided a written communication on February 15, 2021, which incorporated a number of previously submitted attachments. For your convenience, a copy the February 15, 2021 communication, including all of the aforementioned attachments accompanies this letter.

Union Pacific's comments on Rule 62 during the Commission's May 13, 2021 public hearing summarized the main points found in our prior communications, including comments on the general areas of intangible property, the appropriate measure of cash flow, the measurement and use of a growth rate, and other items.

- **Intangible Property** – Intangible property is not subject to property tax in Utah and, therefore; the value of intangible property must be removed from a unitary assessment. The proposed Rule 62 requirement of removing intangible property values "consistent with the methods used to derive the unit value" [Section (3)(b)] is ambiguous and contradicts Utah law. *Union Pacific Railroad Co. v. Utah State Tax Comm'n*, Case No. 090700830 (Utah 2nd Dist. Ct. 2013). The last clause in Section (3)(b) [page 40] should be removed.

Furthermore, the Utah Supreme Court ruled that all intangible property must be removed from the unit value whether it is identified in Utah Code Ann. § 59-2-102(19)(a) or not. *T-Mobile USA, Inc. v. Utah State Tax Comm'n*, 254 P.3d 752 (Utah Sup Ct. 2011). This same logic would apply whether the intangible property is capitalized on a taxpayer's books and records or not. Inasmuch as subsection (3)(b)(i) and (ii) contemplate whether intangibles are booked or unbooked, both subsections should be removed.

The Commission is also proposing a new method (i.e., a “Normal Rate of Return” method) for estimating the value of intangible property. [Section (3)(b)(iii) Page 40]. The procedures specified for determining a “normal return” are vague (the word “documentation” is not defined), and proposed “method” does not provide the taxpayer with a reasonable understanding of who it would be compared to. Union Pacific asserts it is clearly wrong to state that intangibles only exist when a taxpayer’s return on assets is greater than a “normal return.” All companies in a particular industry may require intangible assets to operate, but it is impossible for all of these companies to have a rate of return greater than “normal” which is the requirement created by the Commission’s proposed rule. Union Pacific recommends removal of Section (3)(b)(iii).

- **Proper Measurement of Cash Flow** - Utah’s property tax law clearly states that property should be valued as of the January 1st lien date. However, in Section (5)(b)(i)(A) the Commission is recommending language that restricts cash flow estimates in the income approach to “operating property in existence on the lien date” be removed. Union Pacific requests Section (5)(b)(i)(A) and (II) [Page 41] not be amended (i.e., the existing sentence should remain).
- **Growth** – Fundamentally, the weighted average cost of capital (WACC) or “k” should never be adjusted for inflation. As part of the yield income approach, it may be appropriate to consider the effect of inflation on the growth rate (i.e., “g”), but it is separate from the WACC or “k”. It should also be noted that inflation does not necessarily equate to the growth rate. While inflation may influence growth, it is fundamentally wrong to assume inflation is the only influence on the net cash flows. Inflation may increase gross cash flows, while net cash flows remain unchanged. In this example, it would be incorrect to measure the growth rate or “g” as inflation. For these reasons, Union Pacific recommends removing Section (5)(b)(i)(C)(I) [Page 42].
- **Alternative Data Sources** - While the *Value Line Investment Survey* may be a reliable source, Rule 62 should not foreclose other data sources regardless of whether *Value Line* is available or not. Union Pacific would recommend deleting Section (5)(b)(i)(B)(II)(Dd).

Union Pacific shares the concerns of a number of other centrally assessed taxpayers related to the proposed changes to Rule 62. We hope the broad participation at the Commissions’ May 13, 2021 public hearing signals to the Commission that there is strong opposition to many of the proposed changes to Rule 62.

Utah State Tax Commission
May 17, 2021
Page 3

Thank you for your time. We would be happy to answer any questions.

Sincerely,

A handwritten signature in black ink, appearing to read "Robert C. Meyer". The signature is fluid and cursive, with a long horizontal stroke at the end.

RAM:dlt
Attachments (Total of 13 pages)



BUILDING AMERICA[®]

VIA EMAIL: lcwalters@utah.gov

February 15, 2021

Commissioner Lawrence Walters
Utah State Tax Commission

Dear Commissioner Walters:

Union Pacific Railroad Company ("Union Pacific") appreciates the invitation from the Utah State Tax Commission ("Commission") to provide comments on the proposed changes to Utah Rule R884-24P-62 ("Rule 62"). We look forward to continued dialogue and thoughtful review before any revisions are made to Rule 62.

We have previously submitted comments in separate communications based on the topic being addressed. We have included copies of such communications as attachments to this letter and would like them incorporated into the record of this matter. A summary of the main points in our prior communications are provided immediately below.

- Union Pacific's letter dated December 12, 2019 addressed a variety of proposed changes to Rule 62, including the following:
 - Removing flexibility associated with whether preferred valuation methodologies must be "considered" or "adopted." Union Pacific does not believe this change is warranted and removes needed discretion of the appraiser to reach fair market value.
 - Introduction of a new definition of "operating cash tax rate" is fraught with potential issues. Union Pacific recommends instead utilizing "effective tax rate."
 - Removal of the language restricting cash flow to operating property in existence on the lien date is a serious concern. Union Pacific strongly recommends keeping the language of Rule 62 which restricts cash flow to operating property as of lien date.
 - Defining the discount rate to include an inflation adjustment would not be proper because other valuation techniques use a discount rate that is not adjusted for growth.
 - Limiting the sources for beta only if Value Line is unavailable is a stringent requirement that is not necessary.
 - While inflation may influence growth, it is fundamentally wrong to assume inflation is the only influence on the net cash flows.

- To consider any growth attributed to assets not in place may lead to a value more akin to an enterprise valuation and, therefore; Union Pacific does not support this change. Enterprise valuation is not appropriate in determining value for property tax purposes.
- Union Pacific's letter dated July 10, 2020 addressing our concerns with additional proposed changes to Rule 62, summarized as follows:
 - "Cost" as an appraisal (value) concept is not the same as "cost" as presented in a taxpayer's financial statements (reporting and expense allocation concept). These are two very different concepts and shouldn't be confused.
 - For entities that are not rate-of-return regulated, HCLD may have little to no relevance as an indicator of value. It should be up to the appraiser to demonstrate its relevance. If the appraiser decides HCLD is relevant, all forms of obsolescence must be measured and recognized.
 - Rule 62 should continue to specify the differences in application of the Rule to different industries.
- Union Pacific's letter dated December 23, 2020 addressed our concerns with the new proposed "path forward" to valuation of intangible properties. In response to your letter requesting comments, we noted our concerns with the "normal rate of return" concept outlined in the steps to valuation of intangible property you proposed. I'm summarizing my comments below.
 - Your proposal relies on book accounting for both the subject company and the comparison class. There are many completely appropriate adjustments made for book accounting purposes that could impact the comparability among companies. Trying to compare companies that have gone through transactions requiring either the write-up or write-down of assets to companies that continue to report original acquisition costs will not be meaningful. How will the proposed changes address these common differences among comparable companies?
 - Developing the appropriate comparison class will be important and may require consideration of a more diverse pool of companies. Will the proposed changes address this necessary expanded view of comparable companies?
 - It will be imperative that the Commission utilize a consistent and representative income measure, despite the variety of companies the Commission values. The income measure should exclude the income attributable to the intangible assets of the comparison class companies.

Commissioner Lawrence Walters
Utah State Tax Commission
February 15, 2021
Page 3

- o Differences in leverage between the subject company and the comparison class need to also be addressed.

As stated above, Union Pacific shares the concerns of a number of other centrally assessed taxpayers related to the proposed changes to Rule 62. We hope the broad participation from a large number of other taxpayers signals to the Commission that there is strong opposition to most of the proposed changes to Rule 62.

When Rule 62 was originally adopted, many envisioned the Rule providing a framework for more uniformity in the assessments of the Property Tax Division. The proposed changes to Rule 62 seem to go far afield from this original purpose. The idea that one can somehow turn this Rule into a "best practices" in centrally assessed valuation for every taxpayer would be a mistake. We urge the Commission to reconsider its proposed changes. Union Pacific, along with many other centrally assessed taxpayers, sincerely wants its concerns to be heard by the Commission and considered in the final determination of the language of the Rule. Working together, we can address these common taxpayer concerns and ensure the final changes to Rule 62 are necessary, clear and fair.

Thank you for your time. We would be happy to answer any questions.

Sincerely,

Robert A. Morgan



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VIA EMAIL: lcwalters@utah.gov

December 12, 2019

Commissioner Lawrence Walters
Utah State Tax Commission

Dear Commissioner Walters:

On behalf of Union Pacific Railroad Company ("Union Pacific"), I wish to express my appreciation to the Utah State Tax Commission ("Commission") for providing Union Pacific with the proposed changes to Utah Rule R884-24P-62 ("Rule 62") as well as associated legislative modifications. Distributing the Commission's proposal in advance of any formal rule-making and soliciting comments from taxpayers provides for an open and inclusive process. I welcome this opportunity to provide feedback on the Commission's proposal.

As you probably know, Union Pacific has a proud history in the State of Utah. Promontory Summit marked the culmination of arguably one of the most important feats in America's history, the completion of the transcontinental railroad. Since May 10, 1869, Union Pacific's operations have grown and developed in Utah. Union Pacific operates over 1,200 miles of track in Utah and has invested more than \$329 million strengthening Utah's transportation infrastructure from 2014 – 2018. Union Pacific pays more than \$124 million in annual payroll in Utah and purchases approximately \$110 million of goods and services from Utah based companies. Utah is a vital crossroads for Union Pacific and we deeply value the relationship we have with the state. Again, we thank you for the opportunity to engage in dialogue with you regarding the Commission's proposal.

As you are aware, Rule 62 was established to provide a framework for the difficult task of valuing centrally assessed taxpayers' property for property tax purposes. While the process predates me, I understand from those involved at the time that it was a deliberate process that permitted all parties the time needed to create a stable framework that remained consistent over the years. Given the substantive changes proposed by the Commission, Union Pacific looks forward to again taking the requisite time to truly improve the existing rule. Listed below are Union Pacific's initial comments provided for consideration by the Commission. Given that the changes currently being proposed by the Commission are extensive and many of which are substantive, Union Pacific provides these initial comments and reserves the right to comment further as this review process continues.

Comments on Commission's Proposed Changes to Rule 62

- *Line 4 (R884-24P-62(1)(b))* – The proposal contemplates replacing the word “considered” with “adopted” when addressing preferred valuation methodologies. Valuing centrally assessed taxpayers is a complex task. Appraisers need to be allowed to use judgment in reaching an appropriate valuation. The proposed change could, however, limit the appraiser’s ability to make necessary changes and/or modifications to the preferred valuation methodologies in order to reach a reasonable value. Union Pacific recommends the continued use of the word “considered” when discussing preferred valuation methodologies.
- *Lines 14 – 15 (R884-24P-62 (2)(b))* – The proposal provides a new definition for “operating cash tax rate.” First, it may be helpful to clarify that “operating cash tax rate” is the sum of the cash taxes paid in a year plus the change in the deferred income tax liability for that same year. Secondly, the term cash flow is vague. For example, does one mean gross cash flows, net cash flows, or cash flows from operations, etc. Context is warranted regarding this definition. From an appraisal perspective, I am not sure the rationale for the use of an operating cash tax rate. The proposed definition calls for the use of the change in deferred income tax liability attributable to operating assets, which may prove difficult for some taxpayers to separate the change in their deferred income tax liability between operating and non-operating assets. Instead of defining “operating cash tax rate,” it may be more useful to define an “effective” tax rate and describe how it would be better used in an appraisal assignment. Union Pacific recommends defining an “effective tax rate” and removing any definition of “operating cash tax rate.”
- *Lines 106- 107 R884-24P-62 (5)(b)(i)(A)* – The proposal deletes language restricting cash flow to the operating property in existence on the lien date. A fundamental premise of property tax law is that only those assets in existence on lien date should be valued. Otherwise, an appraiser could be put into a position whereby he/she will try to speculate as to future growth opportunities and the inclusion of the value of intangible assets both of which are clearly not taxable for property tax purposes in Utah. Removing the restriction to valuing only operating assets in existence on the lien date could result in valuations reflecting enterprise business value instead of appraised property value. Union Pacific recommends keeping the language in Rule 62 which provides for restricting cash flow to operating property as of lien date.



- *Lines 131 – 132 R884-24P-62 (5)(b)(i)(B)* – This section of Rule 62 relates to the calculation of the discount rate to be used in the income valuation approach.

The rule should clearly specify that the weighted average cost of capital (WACC) or “k” is not adjusted for inflation. As part of the yield income approach, it may be appropriate to consider the effect of inflation on the growth rate (*i.e.*, “g”), but it is separate from the WACC or “k”. Under certain valuation techniques, the discount rate is adjusted for growth when determining value. It should be noted that inflation does not necessarily equate to the growth rate. As such, defining the discount rate to include an inflation adjustment would not be proper because other valuation techniques use a discount rate that is not adjusted for growth.

The proposal would also adjust the discount rate for the operating cash tax rate. However, the definition should clarify the operating cash tax rate only applies to the cost of debt and should not be applied to the cost of equity when calculating a discount rate. The proposed language does not clearly reflect this distinction and it should do so.

- *Line 134 R884-24P-62 (5)(b)(i)(B)(i)* – The proposal suggests using the typical credit rating for comparable companies within the industry to determine the cost of debt. This is consistent with how most states determine the cost of debt when calculating the discount rate. Union Pacific supports this change.
- *Lines 145 – 146 R884-24P-62 (5)(b)(i)(B)(ii)(Dd)* – Adding language that an equivalent source for the beta should only be used in the instance when Value Line is unavailable is unnecessary. While it is true that Value Line has typically been a reliable source for beta information, there are other sources for beta information that may be equally creditable and should be allowed consideration. Union Pacific does not support the stringent requirement to only use other sources of beta information if Value Line is unavailable.
- *Lines 150 – 151 R884-24P-62 (5)(b)(i)(C)* – The proposal would change the measurement of the growth rate or “g” from the growth in the future cash flow attributable to the assets in place on the lien date and any future replacements to simply a measure of inflation. From a valuation standpoint, the significant question is how growth will affect the net (*i.e.*, free) cash flows generated by the operating property. While inflation may influence growth, it is fundamentally wrong to assume inflation is the only influence on the net cash flows. Inflation may increase gross cash flows, while leaving net cash flows unchanged. In this



example, it would be incorrect to measure the growth rate or "g" as inflation. Because one is valuing the property as it exists on the lien date, it must be the net cash flow attributable to the assets in place on the lien date and any future replacements. If the net cash flows are not limited to those generated by assets in place on the lien date (with assumed future replacements) then you are not valuing the assets in existence on the lien date properly for property tax purposes. As a consequence, an appraiser could easily end up valuing the business enterprise rather than the operating property.

As a separate matter, the Commission's proposal to change the Division's default rate of growth to the difference between 20-year US Treasury bonds and 20-year Treasury Inflation Protected Security (TIPS) bonds makes sense when the Division does not have better evidence of what a proper growth rate.

- *Line 167 R884-24P-62 (5)(b)(i)(C)(i)(ii)(C)* – Deleting current language which states that growth may not be attributed to assets not in place as of the lien date is contained in the proposal. An appraisal for property tax purposes should only consider the growth that can be attributed to those assets which are in place on the lien date. To consider any growth attributed to assets not in place may lead to a value more akin to an enterprise valuation and, therefore; Union Pacific does not support this change.
- *Line 193 through 210 R884-24P-62 (6)(a)* – The proposal would delete current language addressing the valuation of cost regulated utilities. Although railroads are not currently regulated on a cost basis, it is our understanding that these provisions were drafted to ensure that valuation of utility property is focused on the property itself and not on the value of the enterprise. Enterprise valuation is not appropriate in determining value for property tax purposes.

Comments on Union Pacific's Proposed Changes to Rule 62

It is Union Pacific's understanding that the Commission has graciously agreed to consider changes proposed by taxpayers as well. Union Pacific welcomes the opportunity to provide comments and looks forward to hearing from you and/or the Commissioners with the time frame for such proposals.

Comments on Proposed Legislation Defining Intangible Property

In addition to the Commission's effort to revise Rule 62, the Commission is proposing legislation to amend Utah Statute §59-2-102 regarding the definition of "Intangible"



property. Union Pacific would like to take this opportunity to comment on the proposed legislation as well.

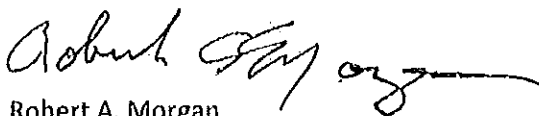
It appears the proposed legislation amending the definition of "intangible property" would seek to harmonize the current definition with a similar definition of intangible property adopted by the IAAO. Union Pacific has the following concerns with the proposed legislative change.

- The existence of intangible property is not dependent upon evidence of ownership or documentation of other substantive rights.
- There is no basis for requiring the ability to legally transfer the ownership of or rights to intangible property in order for the property to exist or be valued.

The current definition of intangible property found in Utah law has evolved as a result of a long history of court cases. At this time, it is prudent to leave the current definition stand as is.

Again, I would like to thank you for the opportunity to provide comments on both Rule 62 and the proposed legislative changes to the definition of "intangible property." I look forward to further discussions regarding the proposed changes such that any changes to Rule 62 or legislative definitional changes are deliberate and have been fully explored by all interested parties. If you have any questions or need further clarification, please feel free to contact me.

Sincerely,



Robert A. Morgan
Senior Director Property Tax
Union Pacific Railroad Company





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VIA EMAIL: lcwalters@utah.gov

July 10, 2020

Commissioner Lawrence Walters
Utah State Tax Commission

Dear Commissioner Walters:

On behalf of Union Pacific Railroad Company ("Union Pacific"), I wish to express my appreciation to both the Utah State Tax Commission ("Commission") and to you for including Union Pacific and other taxpayers in the Commission's efforts to revise Utah Rule R884-24P-62 ("Rule 62"). Union Pacific understands Rule 62 undoubtedly presents many "thorny" issues and we support your approach to take the necessary time to ensure any recommended revisions would truly improve Rule 62.

Union Pacific trusts you received our initial comments dated December 12, 2019. We are happy to discuss any of those comments with you if you would find it helpful.

Pursuant to your request dated June 11, 2020, Union Pacific provides the following additional comments related to the topic of obsolescence.

First, the concept of obsolescence is an integral part of the cost approach, which is a widely-recognized approach to value for certain industries. However, one must be careful not to confuse "cost" as an appraisal (value) concept with "cost" as presented in a taxpayer's financial statements (reporting and expense allocation concept). After all, they can be, and often are, two very different concepts.

For a rate-of-return regulated entity, the historical cost and depreciation shown on financial statements may hold some relevance as an appraisal concept if the historical cost less depreciation ("HCLD") is used to develop a rate base upon which the entity sets its rates and earns a return. For entities that are not rate-of-return regulated, HCLD may have little to no relevance as an indicator of value. It should be up to the appraiser to demonstrate its relevance. If the appraiser decides that HCLD is relevant, all forms of obsolescence must be measured and recognized.

As mentioned previously, the complexity of Rule 62 is evident in the necessity that it apply to taxpayers in a variety of different industries. Rule 62 should continue to specify the differences in application of the Rule to different industries. For example, Union Pacific supports the current language of Rule 62 which provides the following related specifically to the railroad industry:

"The cost indicator should generally be given little or no weight because there is no observable relationship between cost and fair market value." See Rule 62 at §6(b)(ii).

Union Pacific respectfully requests that this language remain in any revised Rule 62.

Finally, Union Pacific would support further reflection and discussion of this matter before any changes are proposed. I look forward to further discussions regarding the proposed changes such that any changes to Rule 62 or legislative definitional changes are deliberate and have been fully explored by all interested parties. If you have any questions, or need further clarification, please contact me.

Sincerely,



Robert A. Morgan
Senior Director Property Tax
Union Pacific Railroad Company





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ROBERT A. MORGAN

SENIOR DIRECTOR PROPERTY TAXES
(402) 544-4872

VIA EMAIL: lewalters@utah.gov

December 23, 2020

Commission Lawrence Walters
Utah State Tax Commission

Dear Commissioner Walters:

On behalf of Union Pacific Railroad Company ("Union Pacific"), we appreciate your continued inclusion of Union Pacific and other taxpayers in the Utah State Tax Commission's ("Commission's") efforts to revise Utah Rule R884-24P-62 ("Rule 62"). It is our understanding you received our initial comments on December 12, 2019 as well as our July 10, 2020 comments regarding obsolescence. Pursuant to your request dated November 13, 2020, Union Pacific provides the following additional comments related to the new topic of intangible valuation.

You note the valuation of intangible property can be a difficult task and is considered "one of the thorniest." While we appreciate it can be difficult, you correctly noted that valuing intangible property is required to comply with Utah law which requires the removal all intangible property from taxable value for property tax purposes. We applaud your desire to develop a practical method for identifying and valuing intangible property yet caution against moving too quickly with a method that fails to properly remove all intangible value.

In the section of your communication entitled "The Path Forward," you suggest the following steps for allowing the value of all exempt intangible property to be deducted from the reconciled unit value, including:

- A. Identification of booked goodwill and other capitalized intangible value.
- B. Documentation obtained to allow for the valuation of exempt intangible property, capable of separate ownership.

- C. Calculation of the normal rate of return on assets of guideline companies using NOI/HCLD and then compared to the actual return on assets for the subject company. If this comparison indicates that the subject property earns a rate of return on assets above the norm, the adjustment will be the company's return on assets divided by the normal return on assets (minus 1).

You propose the adjustment to the reconciled unit value for the intangible assets be the greater of A and B above, or the result of C. Since both #1 and #2 above are currently in practice by the Commission, I am providing comments related only to a "Normal Rate of Return" concept identified in C above.

Using the rate of return on assets as a catch all proxy for valuing the intangible property of a company is an interesting concept, but we have the following concerns.

1. Differences between "comparable" companies.

The concept outlined above relies on book accounting for both the subject company and the comparison class. There are many completely appropriate adjustments made for book accounting purposes that could impact the comparability among companies.

Second, trying to compare companies that have gone through transactions requiring either the write-up or write-down of assets to companies that have not (and still report original acquisition cost) will not be meaningful. Differences in accounting methods used to account for these transactions (*i.e.*, purchase vs. pooling-of-interests) will likewise make comparisons difficult, if not impossible, to interpret. How would the new Rule address these common differences among comparable companies?

2. What is an appropriate comparison class or comparable company?

Developing the appropriate comparison class will be important and may require consideration of a more diverse pool of companies. For example, in today's competitive marketplace it is not uncommon for airlines, freight companies and railroads all to compete for the same business. Will the new Rule account for this expanded view of comparable companies?

3. What is the appropriate income measure when comparing companies?

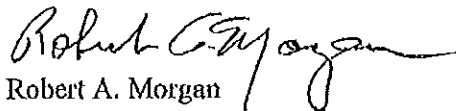
The Commission values centrally assessed companies, both regulated and non-regulated. To be truly comparable, it will be imperative that a consistent and representative income measure be utilized. The income measure should exclude the income attributable to the intangible assets

of the comparison class companies. Any differences in leverage between the subject company and the comparison class may also need to be addressed.

Further, the income measure being suggested is generated by both the tangible and intangible assets of the companies. To be meaningful, the income attributable solely to the tangible assets of the comparison class companies would need to be utilized in order to be able to isolate the value produced by the intangible assets of the subject company. In the railroad example, all the railroads in the comparison class utilize software. The comparison class companies could not generate the level of returns they do without software. If the net operating income for the railroads is used "as is" in the calculations, the NOI is measuring not only income generated by the locomotives, freight cars and other tangible property but also the software and all other intangible assets. In its current form, the proposed rate of return on assets formula would only measure the relative "competitive advantage" the subject company has over its comparison class. Competitive advantage may be an intangible asset but it certainly isn't the only intangible asset. Under Utah law, all intangible assets must be removed from the property tax base. How will the new Rule address the requirement that all intangible value must be removed from the unit?

Union Pacific supports the Commission's efforts to ensure the value of intangible assets is properly removed from all taxpayers' assessments. We also recognize it is a very complex topic, and believe it appropriate to take the requisite time to ensure an appropriate outcome. We look forward to further discussions regarding this and other proposed changes to Rule 62 and appreciate being included in the process. If you have any questions, or need further clarification, please contact me.

Sincerely,


Robert A. Morgan



Ralph Chamness
Chief Deputy
Civil Division

Lisa Ashman
Administrative
Operations

SIM GILL
DISTRICT ATTORNEY

Jeffrey William Hall
Chief Deputy
Justice Division

Blake Nakamura
Chief Deputy
Justice Division

May 17, 2021

Sent via electronic mail.

Utah State Tax Commission - Property Tax Division
Attn: Chantay Asper
210 N. 1950 W.
Salt Lake City, UT 84134
casper@utah.gov

Re: *Salt Lake County Assessor Comments on proposed Rule 884-24P-62 Amendments.*

Dear Utah State Tax Commissioners,

Salt Lake County Assessor respectfully submits the following concerns with the proposed amendments to Rule 884-24P-62.

Proposed Change	Comment
1. Fiscal Information, paragraph 5.B. “could result in a minor shift in the source of property tax revenue from centrally assessed taxpayers to locally assessed taxpayers.”	The Counties believe the risk is high that a tax shift will occur and that the shift could be large, depending upon the taxing area. Many of the appraisal concepts proposed by the Rule, such as the new intangible adjustments, are untested in practice so the consequences are unknown. Additionally, while Rule 62 is limited to specific types of properties, there is a risk of uniformity arguments being raised in the context of oil, gas, and mining properties, further compounding the impact of the changes.
2. Section 3(b)(i) “booked goodwill and other capitalized value . . . shall be identified and deducted from the unit value based on their proportional contribution to the unit.” (Emphasis added).	Presently, intangible value is removed from the indicators prior to reconciliation. This ensures there is a match to the intangible value subtracted and the intangible value included in the indicator. The proposed rule seems to suggest that it be removed after reconciliation. If that is the case, then intangible value needs to be added to the indicators

	that do not capture it, such as a cost approach, prior to reconciliation and deduction of the intangible property. Such rigor introduces another layer of subjectivity.
3. Section 3(b)(iii),(vi) the subtraction of an excess return as an intangible	The concept of an excess return as an intangible requires a subjective adjustment that will result in additional litigation. Comparable operating units do not exist. Each are unique and would typically be considered special use property for appraisal purposes. Further, the proposed rule assumes, without any analysis, that an excess return relates to intangible property and not tangible property, such as taxable enhancement. <i>See Wiltel.</i>
4. Section 5(a)(i) depreciation.	The Rule should provide that depreciation should be analyzed consistent with the unitary concept and not at individual items of property.
5. Section 5(a)(i)(III) measuring economic obsolescence relative to performance to other firms.	This provides additional depreciation based upon a comparison of economic performance. The Rule does not answer the question of what happens when the comparison suggests enhancement? The Rule should be consistent and require that enhancement be added to the cost approach as required by <i>Wiltel</i> . Why does under performance to peers pertain to the physical tangible assets in place but an excess return does not? The Counties are concerned about the inconsistency created by the proposed Rule's use of economic performance comparisons in the income and cost approaches. Under the proposed Rule, if there is underperformance, it is treated as additional economic obsolescence in the physical assets and results in a lower HCLD cost approach but if there is overperformance (excess return) it is considered to be the result of intangibles (and not physical assets or their attributes) and results in a lower income approach.
6. Sections 5(b)(i)(A)(II), 5(b)(i)(C), 5(b)(ii)(C) (limiting capital expenditures, growth, and cash flows to the assets in place)	The proposed Rule retains the “valuation of assets in place” restriction in the income approach. This has always been an <i>ad hoc</i> assumption that conflicts with how the market views and values assets. However, the problems are enhanced by the proposed intangible deduction provisions in the draft Rule. The conflict is this – by limiting cash flow and “g” growth assumptions, the income approach is lower. However, intangible assets, particularly goodwill, are not valued with this same restriction. A classic mismatch of assumptions results when the intangible property is then removed from an indicator of value that did not capture it in the first instance.

<p>7. Section 5(b)(i)(B)(II)(Aa) and (Ee) eliminating the 50% requirement to the CAPM and opening the door to any risk premium, rather than the long-run returns on stocks.</p>	<p>The Rule currently requires 50% weight to a CAPM with specific defined factors. While the presently described CAPM resulted in a high estimate, a benefit for taxpayers, the trade-off was it provided consistency and uniformity. The proposed rule only requires a preference for the CAPM, but essentially opens the door to any CAPM because of the allowance of “implied risk premiums” rather than the fixed historical returns to calculate the risk premium. This newly created uncertainty will likely result in annual litigation over the cost of equity. If the Commission prefers this open-ended route, perhaps it should establish the risk premium through hearing each year prior to assessments to prevent the endless string of individual property tax appeals. The current Rule has always permitted consideration of “implied risk premiums” but not as the preferred CAPM. The proposed Rule opens the door for repetitive litigation.</p> <p>The CAPM is generally preferred by valuation analysts and academics. Regardless of the model, it needs to be consistent with a perpetuity, growth restricted cash flow model as required by the subject Rule. A similar statement in the Rule is helpful to prevent unnecessary appeals where the cost of equity uses assumptions inconsistent with those used to estimate the cash flows.</p>
<p>8. Sections 6(a)(i). Maintains the subtraction of accumulated deferred income taxes from the cost approach.</p>	<p>The section for rate regulated utilities maintains the deduction for accumulated deferred income taxes from the cost approach where the regulatory body deducts deferred income taxes to arrive at rate base for rate setting purposes. The irony is that a regulatory body could choose instead to adjust for the cost-free capital on collected but unpaid income taxes by adjusting the allowed rate of return used to set rates. The financial result to the company would be the same either way because rates for electricity would be the same under either method. Nevertheless, the Rule requires an inconsistent result in the cost approach depending upon the method used by regulators to account for the cost-free use of accumulated deferred income taxes.</p>

Thank you for your consideration of these comments.

Sincerely,
/s/ Timothy A. Bodily

PRESIDENT

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2020-2021

April 22, 2021

Ms. Chantay Casper
Utah State Tax Commission
Property Tax Division
210 N 1950 W
Salt Lake City, UT 84134

Ms. Casper:

I am the President of the Western States Association of Tax Representatives ("WSATR") and our group saw that the proposed modifications to Rule 62 was published in the Utah State Bulletin on April 15, 2021. Pursuant to Utah Code Ann. § 63G-3-302, this email is a written request from an interested association of at least 10 members to the Utah State Tax Commission requesting a public hearing on the proposed modifications to Rule 62.

WSATR is an organization of roughly 40 individual members that make up taxpayers in the western United States. Please let us know if any further action is necessary to require a hearing.

Sincerely,

John N. Reed
President, WSATR
Sr. Director – Property Tax
Charter Communications