ANALYSIS OF RECENT MONTANA CASES

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In the September 27, 2011 hearing before the Revenue and Transportation Interim Committee, Director Dan Bucks discussed at a very high level some decisions that he believes support the Department's litigation position in cases involving centrally assessed taxpayers. The decisions he cited are favorable to the Department. However, the issues addressed are generally focused on very discrete issues, and do not address a variety of issues that continue to plague Montana taxpayers, and telecommunications companies in particular. This paper will discuss each of those cases, analyze the scope of the issues resolved by the cases, and highlight those issues that remain to be litigated or that need to be addressed through legislation.

In. *Department of Revenue v. PPL Montana*, 172 P.3d 1241 (2007), the issue was whether PPL Montana was denied its constitutional right to equal protection where its generation assets were being assessed at a relatively higher value than similar assets owned by Avista and Puget Sound Electric. The Court ruled there was no constitutional violation because the unit approach to valuation was consistently and uniformly applied. The focus of the unit approach is to determine value of the entire unit of assets, operating as a going concern. That overall unit value may be greater than the sum of the individual asset values. In the *PPL Montana* case, the unit value of PPL Montana was simply greater than the value of the other companies, in part because of differences in regulation. Although this case discussed the unit method, there was no issue in the case as to when the use of that method is required or how exempt assets may be deducted from a unit value.

The issue in *Verizon Wireless v. Department of Revenue* was a very narrow one: whether wireless companies could be considered "telephone companies" in a way that would subject them to taxation in Class 13 – at twice the rate they had been taxed previously. The district court held they could fit in that class. However, in another case not cited by Director Bucks, the Supreme Court held the Department was wrong in trying to classify a taxpayer as a centrally assessed

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taxpayer subject to tax in a higher-rate classification. *Omimex Canada, Ltd. V. Department of Revenue,* 2008 MT 403.

In *Puget Sound Energy v. Department of Revenue*, 2011 MT 141, the issues were also very discrete: whether the State Tax Appeal Board ("STAB") is empowered to raise the value over the Department's initial assessment, after a taxpayer appeal, or whether the appeal is limited to the taxpayer's claim for a reduction in value. The Court held that because STAB is authorized to conduct a full evidentiary hearing and to make an independent determination of value, it may set value either above or below the initial assessment.

There are two cases on Director Bucks' list that involve the PacifiCorp company — one decided in January of this year by STAB (involving the 2006-07 tax years) — and the other decided in February by the Supreme Court (involving the 2005 tax year). The two cases presented similar issues and reached similar results. The most relevant is obviously the Supreme Court decision. Here, the Court found that a controversial valuation method – direct capitalization – satisfied the requirement in the Department's rules that methods be "commonly accepted." The Court noted that this method has been used by the Department in the past, and was supported by the Department's experts who testified in the case, as well as by the National Conference of Unit Value States ("NCUVS"). However, the Department apparently did not dispute the claim that other states do not use this method, and one reason they do not is because the method captures more value related to exempt intangible property. The Court distinguished the practices of other states because those states purportedly determine value without considering exempt property throughout the assessment process, while the Montana practice is to determine the value of the entire unit, including intangible property, and then deduct the exempt property from the individual until indicators. There was no discussion in the case of the difficulty of deducting that exempt value under the Montana direct capitalization method, or whether that difficulty affects the utility of this valuation approach even if it is theoretically an accepted method.[2]

[2] There were two other issues addressed in the Supreme Court decision. First, the Court held that the evidence supported the conclusion of STAB and the Department that it was not necessary to adjust for additional obsolescence in the cost approach, beyond the depreciation recorded in PacifiCorp's financial statements. Second, the Court held it was not error for STAB or the Department to consider evidence of value from the sale of PacifiCorp following the assessment date, in evaluating the reasonableness of the assessment.

The *PacifiCorp* cases do authorize the Department's use of the direct capitalization method. The use of this method and a related method – the stock and debt method – is one reason why there are large differences between the values the Montana DOR determines for centrally assessed taxpayers and the values other states derive for the same "unit" of property. (Montana is consistently 25-50% higher, or more.) However, the differences are more a function of the weight other states give to this method. Although Idaho formally prohibits the use of this method and Utah has a rule discouraging the use of this approach and the stock and debt method, the taxing authorities of most states simply choose not to use either method, or not to give them much weight if they are calculated. If the state of Montana is motivated to avoid the stigma now attached to its property tax system, it would be well-advised to limit in some way the use of these methods as other states have done.

There is another reason why Montana's values are so much higher than those of other states – for a comparable "unit" of property – and it is related to the use of these aggressive valuation methods (i.e., direct capitalization and stock and debt). As the Supreme Court seemed to acknowledge in the *PacifiCorp* case, these methods produce higher values because they include intangible property to a greater extent than other methods. The Court viewed this as an advantage, because Montana's practice is to first value the entire unit of property – including both tangible and intangible property. However, the second step in this process – unaddressed by the Supreme Court, but an implicit premise for its decision – is that the intangible property must be excluded because of the exemption contained in M.C.A. § 15-6-218. Most other states also have an exemption for intangible property, but no taxing agency is as restrictive as the Montana DOR in limiting deductions of such property from the higher unit value that is derived using these controversial methods. In *PacifiCorp*, the Supreme Court must have assumed that if a method is used that produces higher values because it captures all intangible property value, then some method must be in place to extract the portion of that higher value that is exempt. In fact, the Department does not have a good method or any consistent practice for allowing deductions for intangible property beyond the default percentages set forth in its rules (15% for telecommunications companies). Indeed, its rules and practices make it difficult for taxpayers to deduct exempt property from the unit value.

Those practices were at issue in the *Qwest* case included in Director Bucks' list, and the Department has cited that case as a validation of its practices in limiting intangible property deductions from its high unit values. However, a close reading of the STAB decision in that case shows the Board did not give a

meaningful analysis of the issues affecting the intangible property deduction. Further, the case was appealed, and was fully briefed before the district court when the parties settled the case in a way that resulted in substantial refunds to Qwest (albeit, far less than it contended should be paid). The settlement of a case after an appeal should lead any rational observer to seriously question the decision's precedential value.[3]

The Board did not state what standards or tests must be satisfied to determine what property should be considered intangible property eligible for the exemption. At one point, it stated that assets such as customer relationships and intellectual property were too ill-defined to constitute intangible property, even though they are recognized as intangible assets for financial accounting purposes and in generally accepted appraisal principles (and even though "intellectual property" is simply a catch-all term to describe patents, copyrights and trademarks that are specifically referenced as exempt in section 15-6-218).

Although the Board in *Qwest* did not adopt any tests for determining exempt intangible property status, it did recite the testimony of the Department's witnesses who addressed that issue, and those tests have now been made part of the Department's rules, adopted in December 2010. For instance, it was the testimony of the Department's experts – and is now part of the rule – that an asset must be "separable" from the operating unit, and if the asset cannot be separated without affecting the value or operation of the unit, it cannot be exempt. However, that test would exclude from exempt status some intangible property that is specifically included in the non-exclusive list set forth in section 15-6-218. For instance, FCC licenses are vital to the operation of a wireless business and so are not "separable" and would fail this test, but licenses are stated as an example of exempt property in the statute. Goodwill does not satisfy the test of being "separable," since it is created as part of and is integral to the operating unit; yet again that asset is specifically mentioned in section 15-6-218. Obviously, then, the tests advocated in the *Qwest* case cannot be valid if they would not even capture the types of assets specifically listed as exempt in the statute.

[3] One obvious error in the Board's decision was its holding that a taxpayer should be precluded from presenting appraisal or other evidence before the Board that was not presented to the Department during the appraisal process. In the *Puget Sound Energy* case discussed above, the Supreme Court made it very clear that STAB is authorized to conduct an evidentiary hearing and to hear all new evidence that may come before it related to the valuation issues. In that case, such evidence included new evidence offered by the Department itself purporting to show a higher value for the property.

In addition to restricting the types of intangible property that may be deducted from the high-value direct capitalization and stock and debt methods, the Department's rules and practices limit taxpayers in other ways. The Department has a rule requiring that the intangible property deduction must be established in each of the three valuation indicators. (Those are the income approach – which includes the direct capitalization method; the market approach – which includes the stock and debt method; and the cost approach.) [4] This rule can be satisfied quite easily for the cost approach, since the financial statements show the recorded "cost" of the intangible property. However, in recent depositions taken in pending litigation, the Department witnesses and its expert have stated that it is virtually impossible, as a practical matter, for a taxpayer to satisfy this requirement in the income or market approaches. Moreover, the expert noted his concerns with the use of the cost approach, so the result could be that there is only one valuation method in which the Department would recognize an intangible property exemption, and even this method would be given little weight. The effect is to eviscerate the intangible property exemption. And this means there is a failure of the premise on which the Court in *PacifiCorp* validated the high-value direct capitalization method – that the high intangible property value would in fact be deducted from the higher unit value.

AT&T Mobility's situation in 2011 illustrates this problem. About 80% of the assets on the company's books are intangible assets such as FCC licenses and goodwill. The DOR allows those exemptions in the cost approach, but it has never seen a method used in the income or market approaches in which intangible property value can be isolated, and has never allowed a deduction in either approach other than the "default" 15% factor contained in its rules. As a result, AT&T's 2011 intangible property deduction is only about 20%, yet its overall value is extremely high because of methods that capture intangible property value at a very high level.

One solution to the current dilemma is for the Department to use only the cost approach, rather than the unit approach, for industries like the telecommunications industry, where intangible assets represent such a large

[4] This rule is in direct contravention of the NCUVS standards discussed in the *PacifiCorp* case, and also the Western States Association of Tax Administrators Manual, both of which were adopted by the Department in December 2010 as official sources of appraisal principles. Both of these publications recommend against deduction of intangible property in each valuation method, and instead recommend that the deduction be taken in one step after the three approaches are reconciled into a single until value. This recommended practice, if implemented by the Department, would eliminate many of the issues facing telecommunications companies.

proportion of the total unit value. None of the cases in Director Bucks' list requires the use of the unit approach. One of the Department's rules states that the unit approach should be used "whenever appropriate." Another rule provides that a valuation approach should not be used unless intangible assets can be excluded. And section 15-6-218 provides that if the unit approach is used, exempt intangible property must be excluded. The clear mandate is that if intangible property cannot be fully excluded (as the Department's witnesses are suggesting), the unit approach should not be used. Intangible property can be fully excluded in the cost approach, and this is the approach used in states such as California and Florida.

In summary, the DOR's values are significantly higher for centrally assessed taxpayers in Montana than for the same unit of property in other states. The reasons include the use of methods that incorporate significant levels of intangible property value, combined with the failure by the Department to extract that higher intangible value at the end of the process. There currently exists in Montana a system which could be described as a Catch 22: "a situation in which a desired outcome or solution is impossible to attain because of a set of inherently illogical rules or conditions." The Department's practices and/or some of its rules are frustrating the ability of taxpayers to obtain fair taxation in Montana.