



Memorandum

To : Mr. Jim Williams

Date : April 30, 1987

From : Robert R. Keeling

Subject : May Company v. County of Los Angeles, Second Civil No. B009324, Court of Appeal, Second Appellate District; Investment Tax Credit as an Element of Value

You asked that I review the May Company brief with respect to their position that the investment tax credit is an element that serves to reduce the market value of equipment purchased.

Petitioners' reasoning is misguided, but cleverly presented. It relates discounts, rebates and manufacturer's credits with the investment tax credit. We can agree that discounts, rebates and credits are an element to be considered in the valuation process because they reduce both the net income to the seller and the cost to the buyer. However, the ITC does not reduce the net income to the seller, but is merely an income tax benefit afforded the buyer; it is a government subsidy to those adding plant equipment. May Company cleverly relates discounts, rebates and credits with the ITC, but the ITC is not a seller afforded credit to the buyer and, therefore, is not at all akin to seller afforded credits.

May Company mistakenly concludes that the "cost" of property is impacted by the ITC. However, cost of a property is the labor and material cost, plus all other costs to bring the property to a finished state for sale (Rule 6b). Petitioner treats ITC as a negative cost, but it is not. As between seller and buyer ITC has nothing to do with cost. ITC is a government assistance payment to promote plant purchases and has nothing to do with production cost or distribution cost.

Petitioner also misconstrues sales tax and freight charges with the ITC. All agree that sales tax and freight charges are a part of cost (Xerox case), but the ITC is not in that category. Both sales tax and freight charges are additive elements to be considered for trade level adjustment for an increase to cost (price) of property as the property progresses through production and distribution channels. ITC is not an element which has anything to do with trade level; it is only, to repeat, a government subsidy afforded a particular purchaser.

Petitioners' reliance on the Xerox case is misplaced. Xerox deals with sales tax and freight charges as an added cost to get the property to the hands of the consumer. ITC has nothing to do with consumer cost; it merely affords the purchaser an income tax benefit when new plant equipment is purchased. ITC does not allow (or is it intended to allow) the seller to lower its price and, therefore, could not be construed to be a negative cost to the purchaser.

ITC must be distinguished from a discount rebate or seller's credit in that these seller afforded discounts are something a seller gives to make its product more competitive or saleable, while ITC is something over which the seller has no control whatsoever. ITC is entirely within the control of the buyer, but only if the buyer purchases new plant equipment and only if the buyer has an income tax liability against which to take the ITC.

In the case where new plant equipment is leased, the lessor could retain the ITC giving the lessee no ITC benefits. By petitioners' rationale the property tax liability to the lessee would vary depending upon whether the ITC is retained or passed through to the lessee. Such a conclusion would lead to an irrational method for determining market value for property tax purposes. As between private parties (government regulated utilities not included) it should make no difference in market value of the plant equipment whether the ITC is passed through or not. For example, the purpose of purchasing new plant equipment is to generate new income. The net operating income generated by equipment is reflective of market value. The income generated by new plant equipment is not determined by whether the ITC is afforded the purchaser or not. Therefore, the value of the equipment as reflected by net income would be the same whether the ITC is afforded the purchaser or not. For example, if a ten percent ITC reduces market value of new equipment to ninety percent in the cost approach to value, then the net operating income in the income approach must be correspondingly reduced ten percent so that the two approaches produce value indicators on an equal basis. This illustrates the illogic in May Company's position in that there is no reason to believe that plant equipment upon which a ten percent ITC is taken should earn ten percent less than equipment where such ITC is not taken.

The ITC only impacts capital outlay, not market value. Market value is the exchange value the property possesses. The fact that the ITC is afforded does not diminish the exchange value the property possesses so it follows the ITC could not diminish market value. The position that ITC diminishes market value would therefore be inconsistent with the

definition of market value as set forth in section 110 of the Revenue and Taxation Code.

With the above discussion in mind, let me turn to commenting on May Company's Points and Authority:

Under IIA May Company says:

"Under the cost approach to value the true or net cost of the asset to the consumer is what must be considered in arriving at market value."

May Company's statement is simply not true. As above discussed the price paid to the seller is the measure of market value, not the out-of-pocket cost to the buyer. The fact that the investment tax credit subsidizes the purchase of plant equipment is not cause to conclude investment tax credit is determinative of market value. For example, rule 10 (Trade Level) calls for value to the seller to be his price less gross profit, so it follows that value to the consumer is the seller's price (his cost plus profit). Market value of plant equipment in the hands of the buyer could not logically be measured differently than market value of plant equipment in the hands of the seller.

May Company's point in IIB is:

"The investment tax credit was enacted with the purpose of reducing the cost of equipment."

May Company's point is a half truth. The whole truth is that the ITC was enacted to promote business activity in the marketplace by encouraging the purchase of new plant equipment by affording a reduction of income tax liability to such purchasers. May Company misuses the word "cost" in this context. The basic cost of equipment is the same whether the ITC is taken or not. For example, the ITC can be taken only after a bargain is struck between the seller and purchaser for the purchaser to pay the seller's price. The price agreed upon is the indicator of value. The ITC is not an element of price and, therefore, does not give the seller any price advantage over any other seller. It, therefore, is not an element of value.

May Company in part IIC says:

"Investment tax credits must be considered in determining true or net cost of the property for assessment purposes."

May Company's statement is simply untrue. Whether the ITC must be considered or not is the ultimate question. May Company cites a superior court case (Burroughs Corporation v. County of Los Angeles) to the effect the court upheld May Company's position. In my view, the Burroughs court was mistaken. As repeatedly said herein the better view is that the ITC does not impact market value.

May Company in part IID says:

"The investment tax credit is not distinguishable from other factors which effect values such as discounts, rebates and sales tax."

May Company is simply making a illogical connection between discounts, rebates, sales taxes and the ITC. The ITC is an income tax saving the government affords the purchaser. The discounts, rebates and seller's credits are a benefit the seller affords the purchaser. The sales tax is something the seller must pay for purchasing plant equipment in California. The ITC is simply not the same and cannot be lumped with discounts, rebates and sales tax. May Company's illogical connection of sales tax and seller credits with the ITC is apparently shared by the trial court as expressed in the citation on page 32 of May Company's brief. The court misconnects the ITC with planning and engineering costs, transportation and insulation costs as part of plant machinery costs which reflects the machinery's value. As discussed earlier these costs are clearly a cost of production and, therefore, are reflective of value. However, the ITC is not a production cost, but is a benefit peculiarly personal to the buyer, having no connection with the seller other than encouraging the buyer to purchase plant machinery for the income tax benefits the purchase will afford. The court is mistaken in its conclusion that ITC should be a factor in determining market value for each piece of equipment for which the ITC is available. Obviously, the court fails to understand that the ITC is not available as to the property purchased, but it available as to the income tax liability experienced by the purchaser. If the court's reasoning is followed, the market value of the same piece of equipment would hinge upon whether the ITC is taken or not. That conclusion would lead to the result that two purchasers of the same piece of equipment would incur a different property tax liability depending upon whether or not their income tax position allowed them to take the ITC. We know from other property tax cases that the property tax liability is not determined by the income tax position of the buyer.

The May Company then says in Part IIE:

"The assessor presents no legal justification for refusing to consider investment tax credits as a matter of value under the cost approach."

May Company goes on for several pages saying there is no rule nor regulation to oppose their position. It discounts Vern Walton's assessor tax letter 83/21 by saying the letter is merely advice of a Board employee and not a called-for mandatory action by the assessor. May Company also discounts my opinion letter dated February 1, 1983, to Riverside County reflecting the view that ITC is not an element of value. May Company continues to confuse ITC with manufacturer's costs in order to downplay the advice given in both these letters. Copies of both these letters are attached for your use.

I found a few references in the cases concerning the impact of the investment tax credit on value. In the case Colonial Pipeline Company v. North Carolina Property Tax Commission (before the Supreme Court of North Carolina, 347 SE 2d 382) the Court found the Department of Revenue erred in including Colonial's projected income from investment tax credits. The court reasoned there was no evidence to conclude the investment tax credits would continue over the long haul and, therefore, there was no support for including the ITC income in future cash flows. Although the Court does not reject the ITC on the grounds I would like, at least the Court was not impressed with the idea that investment tax credits create income which would capitalize to value. I would rather have had the Court say that the ITC credit does not relate to the earning capacity of the property and, therefore, should be ignored in the income approach to value.

In the case Board of Assessors of Boston v. Diab (Supreme Judicial Court of Massachusetts, 487 NE.2d 491) the trial court refused to consider the cost approach value indicator because it thought the investment tax credit was not available as of the time of the date of valuation. The court reversed because the trial court was in error as to when the investment tax credit was available. The court remanded to the trial court to reconsider in light of the fact that the investment tax credit provisions were available to the buyer contrary to the trial court's understanding. Unfortunately, the case does not support the proposition that the investment tax credit should not be used in the valuation process at all.

Copies of these cases are attached.

RRK/rz

Attachments

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