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California Supreme Court Confirms That Intangible Assets Are (Still) Not Subject to Property Taxation

In a unanimous decision issued on August 12, 2013, the California Supreme Court held that the California State Board of Equalization (the BOE) may not assess the value of intangible Emission Reduction Credits (ERCs) when valuing taxable power plant property. *Elk Hills Power, LLC v. Board of Equalization* (Aug. 12, 2013, S194121) __ Cal.4th __ (*Elk Hills*). Though it involved just one type of intangible asset, *Elk Hills* has far broader implications. The California Supreme Court's decision makes clear that property taxation of virtually all intangible assets is prohibited under California law.

Background

The taxpayer, Elk Hills Power, LLC, purchased five ERCs for approximately \$11 million to construct and operate an electric power plant in Kern County, California. ERCs are part of a local emission offset system whereby existing pollution sources that voluntarily reduce their emissions below certain levels may receive ERCs. ERCs are marketable once approved by local regulatory authorities and can be traded or sold for profit.

The BOE used the replacement cost approach and the income capitalization approach to derive a unit value of the taxpayer's power plant for property tax purposes. In applying the replacement cost approach, the BOE added the estimated cost of replacing the ERCs in calculating the total replacement cost for the taxable power plant. Under the income capitalization approach, which estimates the present value of the taxable property's expected future income stream, the BOE did not deduct the value of the ERCs from the overall value of the taxable power plant.

Elk Hills challenged the BOE's valuation on the ground that ERCs are intangible assets and exempt from property taxation under California law. The BOE argued that it was permitted to "assume the presence" of the intangible ERCs when valuing the taxable power plant because the ERCs are necessary to put the power plant to beneficial or productive use. The BOE equated "assuming the presence" of the ERCs to including some or all of the value of the ERCs in the power plant's unit value. Thus, the BOE posited that intangible assets are not exempt from property taxation when they are necessary to put taxable property to beneficial or productive use.

The trial court upheld the BOE's assessment but concluded that ERCs are "attributes of real property" and may be assessed under California law. *Elk Hills Power, LLC v. Board of Equalization* (Super. Ct. San Diego County, 2010, No. 37-2008-00097074-CU-MC-CTL). The appellate court also upheld the assessment, but it did so on different grounds. The Court of Appeal adopted the BOE's arguments and concluded that the contribution of the ERCs to the power plant's unit value could be considered because the ERCs are necessary for its beneficial and productive use. *Elk Hills Power, LLC v. Board of Equalization* (2011) 195 Cal.App.4th 285 [123 Cal.Rptr.3d 906].

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Sutherland Observation: Many practitioners and taxpayers following *Elk Hills* were concerned that a ruling in the BOE's favor would narrow the constitutional and statutory exemption for intangible assets and open the door to taxing *all* intangible assets that are necessary to put taxable property to beneficial and productive use.

California Law Exempts Intangible Assets from Property Taxation

Article XIII, § 2, of the California Constitution prohibits the taxation of all intangible assets (except for those that are specifically enumerated, none of which are relevant here). Consistent with the constitution, the California Legislature enacted a property tax exemption for intangible assets and rights under Cal. Rev. & Tax. Code § 212(c), which provides, in relevant part:

Intangible assets and rights are exempt from taxation and, except as otherwise provided in the following sentence, the value of intangible assets and rights shall not enhance or be reflected in the value of taxable property. Taxable property may be assessed and valued by assuming the presence of intangible assets or rights necessary to put the taxable property to beneficial or productive use.

For purposes of valuing taxable property, Cal. Rev. & Tax. Code § 110 provides, in relevant part:

(d) Except as provided in subdivision (e), for purposes of determining the “full cash value” or “fair market value” of any taxable property, all of the following shall apply:

(1) The value of intangible assets and rights relating to the going concern value of a business using taxable property shall not enhance or be reflected in the value of the taxable property.

(2) If the principle of unit valuation is used to value properties that are operated as a unit and the unit includes intangible assets and rights, then the fair market value of the taxable property contained within the unit shall be determined by removing from the value of the unit the fair market value of the intangible assets and rights contained within the unit.

. . . .

(e) Taxable property may be assessed and valued *by assuming the presence* of intangible assets or rights necessary to put the taxable property to beneficial or productive use. (Emphasis added.)

The issue before the California Supreme Court was an issue of statutory interpretation—did Cal. Rev. & Tax. Code § 110(e)'s permissive “assume the presence” language trump Cal. Rev. & Tax. Code § 110(d)'s prohibition on the taxation of intangible assets and permit the BOE to assess the ERCs. The court acknowledged that there was some ambiguity in the statute and looked to legislative history and 65 years of case law regarding the property tax treatment of intangible assets for help.

Sutherland Observation: One of the focal points of the case was what it means to “assume the presence” of intangible assets when valuing taxable property when such intangible assets are necessary to put taxable property to beneficial or productive use. In this case, the BOE was permitted to assume the presence of the ERCs in valuing the power plant as an **operating** power plant (i.e., at its highest and best use). Hypothetically, if California law did not permit the BOE to assume the presence of the ERCs, the value of the power plant likely would be its salvage value.

After reviewing the relevant case law, the court held that Cal. Rev. & Tax Code §§ 110(d) and (e) and 212(c) can be, and should be, read in harmony. Drawing on these statutory provisions, the court announced four principles: (1) the value of intangible assets, other than intangible assets specifically enumerated in the California Constitution, cannot be taxed directly or subsumed in the value of taxable property; (2) when valuing taxable property, assessors may assume the presence of intangible assets that are necessary to put the taxable property to beneficial or productive use; (3) assuming the presence of intangible assets permits the value of taxable property to be enhanced from salvage value to fair market value; and (4) when a unit value includes the direct valuation of an intangible asset or includes income attributable to enterprise value, those values must be accounted for and removed.

Sutherland Observation: The appellate court’s decision threatened to uproot well-established California precedent. In reaffirming its prior decisions, the California Supreme Court resolved the confusion created by the appellate court. The high court also validated several important intermediate appellate cases that stand for the proposition that the value of intangible assets necessary to the beneficial or productive use of taxable property cannot be “subsumed” in the value of the taxable property. *See, e.g., Shubat v. Sutter County Assessment Appeals Bd. No. 1*, 17 Cal. Rptr. 2d 1 (Cal. Ct. App. 1993) (right to conduct business, subscriber list, going concern); *County of Orange v. Orange County Assessment Appeals Bd. No. 1*, 16 Cal. Rptr. 695 (Cal. Ct. App. 1993) (franchises, licenses to construct, goodwill); *GTE Sprint Commc’ns Corp. v. County of Alameda*, 32 Cal. Rptr. 2d 882 (Cal. Ct. App. 1994) (enterprise-related intangible assets); and *County of Los Angeles v. County of Los Angeles Assessment Appeals Bd. No. 1*, 16 Cal. Rptr. 2d 479 (Cal. Ct. App. 1993) (right to do business).

The Treatment of Intangible Assets Under the Replacement Cost and Income Capitalization Approaches

The California Supreme Court, citing the Assessors’ Handbook developed by the BOE as authority, found that the BOE impermissibly included the fair market value of the ERCs within its unit value calculation under the replacement cost approach. The court held that including the fair market value of the ERCs in the power plant’s unit value amounted to impermissible direct taxation of the ERCs. “[A]ssuming the presence of intangibles is permitted,” the court explained, “[h]owever, including the fair market value of an intangible asset within the unit whole amounts to the direct taxation of those assets.

Sutherland Observation: *Elk Hills* arguably will strengthen future arguments that the cost of intangible software should be excluded from the replacement cost calculations of technology-rich tangible personal property.

With respect to the income capitalization approach, the court distinguished between intangible assets that have an “indirect” contribution to a business’s income stream and intangible assets that have a “direct” contribution to a business’s income stream. The former type of intangible asset permits taxable property to generate income when put to its beneficial or productive use, whereas the latter type of intangible asset directly contributes to the going concern value of the business.

Under California law, the income stream from an intangible asset that contributes indirectly to a business's income stream, such as use permits and Federal Communications Commission licenses, need not be deducted from an income stream analysis prior to taxation. In contrast, the income stream from an intangible asset that contributes directly to a business's income stream, such as goodwill, customer base, and favorable franchise terms, must be deducted. The California Supreme Court determined that ERCs contribute indirectly to the business's income stream, as the ERCs enabled the power plant to function and produce income as a power plant. As a consequence, the BOE was not required to deduct the fair market value of the ERCs from the fair market value of the unit.

Sutherland Observation: The distinction between intangible assets that make indirect contributions versus direct contributions to a business's income stream will almost certainly be a focal point in future litigation, as taxpayers have an incentive to characterize intangible assets as directly contributing to going concern value. Further, the court noted that Elk Hills did not introduce any credible evidence identifying the portion of its business's income stream that was attributable to the ERCs. This finding, coupled with the court's conclusion that the ERCs have an indirect contribution to the business's income stream, suggests that whether an intangible asset is indirect or direct may turn on the weight of the taxpayer's evidence.

Conclusion

Elk Hills is a resounding victory for California taxpayers. It solidifies the standing of 30 years of appellate decisions affirming the nontaxability of intangible assets in a variety of contexts. Since most tangible personal property in California is valued under the cost approach, the decision will lend considerable weight to future arguments that the cost of intangible assets may not be included in the replacement cost approach.



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