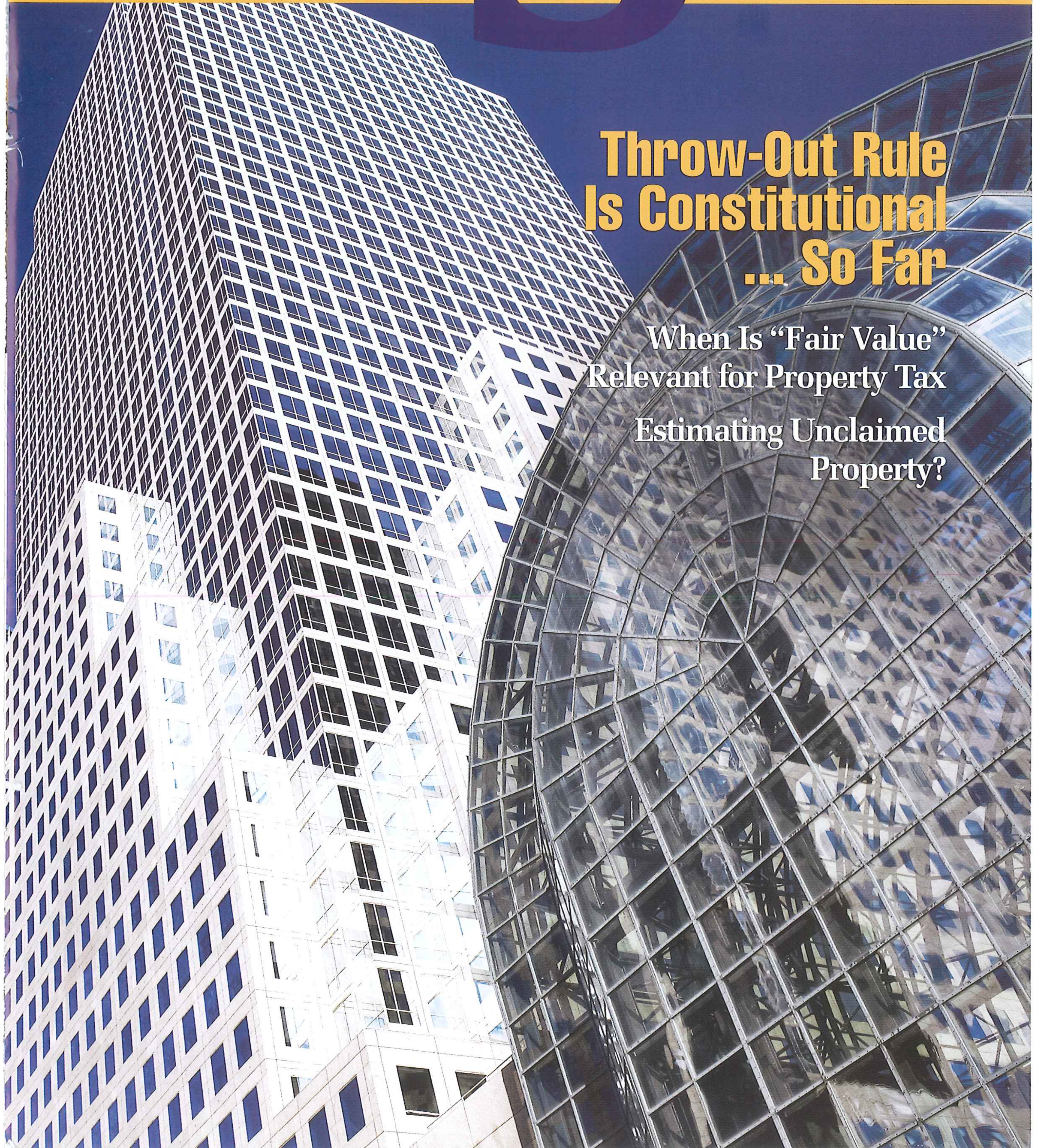
JOURNAL OF
MultiState
TAXATION AND INCENTIVES
JANUARY 2012



Throw-Out Rule Is Constitutional ... So Far

When Is "Fair Value" Relevant for Property Tax

Estimating Unclaimed Property?

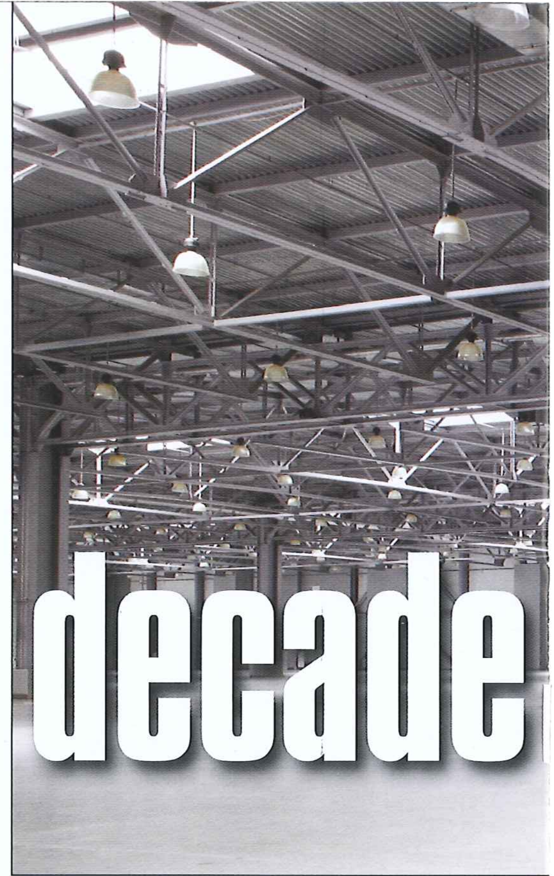
The Relevance of Fair Value Measur

IT IS NOT APPROPRIATE TO RELY ON A VALUATION FOR PURCHASE ACCOUNTING PROPERTY FOR PROPERTY TAX PURPOSES WITHOUT ANALYZING AND UNDERSTA

AARON M. ROTKOWSKI, RICHARD G. SMITH, AND JOHN C. RAMIREZ

ements for Property Tax Purposes

PURPOSES TO ESTIMATE THE FAIR MARKET VALUE OF TAXPAYER CORPORATION
NDING ANY DIFFERENCES THAT EXIST BETWEEN THE TWO VALUATION PURPOSES.



Over the last decade

a large number of mergers and acquisitions took place. According to Accounting Standard Codification (ASC) 805, "Business Combinations" (formerly the Financial Accounting Standards Board's Statement No. 141(R)), in a business combination the costs to acquire a target company are allocated to the fair value of the target company individual assets acquired and liabilities assumed. This purchase price allocation is based on the cost to acquire the target company, which may include synergies, the present value of growth opportunities, and intangible assets. Also, the purchase price allocation standard of value is "fair value," and not the "fair market value" standard of value that is commonly used for property tax purposes.

There are important differences between fair value and fair market value. These differences may or may not cause the fair value of an asset to exceed the fair market value of the same asset. Taxpayers should not accept on faith alone the taxing authority's claim that an asset's fair value estimated for purchase price allocation is equal to the asset's fair market value. The differences discussed in this article will explain situations where (1) fair value analyses are not relevant to a fair market value valuation, and (2) fair value analyses are relevant to a fair market value valuation.

Introduction

Many state taxing authorities use the "unit" principle valuation method to value utilities, railroads, telecommunication companies, and other companies that are "centrally assessed" for property tax purposes.

The unit principle valuation method values all of the taxpayer operating assets collectively (as a single "unit"). The total bundle of taxpayer operating assets are valued in aggregate as one integrated going-concern business enterprise. Application of the unit method often starts with the valuation of the business enterprise, using some combination of the cost, income, and/or market approach valuation methods. Then, the values of non-operating assets and exempt property are deducted.

Property tax assessors or administrators often use market information from mergers or acquisitions as evidence of the fair market value of a taxpayer company's taxable unit. Taxpayers also may seek to use that information for certain purposes. The mergers or acquisitions could involve companies unrelated to the taxpayer. Or, they could involve the taxpayer itself, such as when the taxpayer is acquired by another company.

Property tax assessors or administrators may rely on the purchase price to estimate the fair market value of the acquired company, or they may rely on the purchase price allocation performed following the acquisition as evidence of the fair market value of the taxpayer company's taxable unit.

The following discussion summarizes the valuation differences between (1) the estimation of fair value of a taxpayer company's taxable unit for purchase accounting purposes, and (2) the estimation of fair market value of a taxpayer company's taxable unit for property tax purposes.

The focus of this discussion is to compare (1) the fair value standard of value as it relates to a purchase price allocation with (2) the fair market value standard of value as it relates to property tax assessments.

This discussion also addresses whether the transaction purchase price represents the fair market value of the acquired business enterprise. If it does not, the transaction purchase price will not provide relevant evidence of the fair market value for the business enterprise. Even if the transaction purchase price represents the fair market value of the business enterprise, the purchase price *allocation* may not. This is because the standard of value

AARON M. ROTKOWSKI, CFA, ASA, is a manager at Willamette Management Associates in Portland, Oregon. With more than a decade of business valuation experience, his practice focuses on forensic analysis and dispute resolution, business and stock valuations, and valuations for other purposes. He can be reached at (503) 243-7522 or amrotkowski@willamette.com. RICHARD G. SMITH, Esq., CPA, is a partner in the Boise, Idaho office of the law firm of Hawley Troxell Ennis & Hawley LLP, where he is chairman of the firm's tax group. His practice emphasizes the representation of taxpayers in tax disputes in state and federal courts, before the IRS, and before tax commissions and boards of tax appeals throughout the U.S. He has participated in tax litigation in various states involving every major type of tax, and before the federal courts on IRS matters. He served as managing editor of the Georgetown Law Review, and is member of the Idaho, Montana, and Washington Bars. He can be reached at (208) 388-4932 or rsmith@hawleytroxell.com. JOHN C. RAMIREZ is a senior associate at Willamette Management Associates in Portland, Oregon. His practice focuses on business valuation for property taxation and litigation services including bankruptcy, dissenting shareholder rights claims, intellectual property, and other valuation analyses. He can be reached at (503) 243-7506 or jcramirez@willamette.com.

used in the purchase price allocation is fair value, and not fair market value.

For purposes of this discussion:

- "Property tax fair market value analysis" refers to a valuation prepared for state or local ad valorem taxation purposes. In particular, it refers to a property tax valuation prepared using the unit principle valuation method with regard to a centrally assessed taxpayer.
- "Purchase accounting fair value analysis" refers to a valuation prepared for compliance with "generally accepted accounting principles" (GAAP) in the U.S. In particular, the provisions of GAAP that relate to the fair value measurement of acquired assets for purposes of the purchase method of accounting.
- "Valuation differences" refer to any differences in both (1) the generally accepted valuation principles that would apply for each of the two above-mentioned purposes, and (2) the application of the individual generally accepted valuation approaches, methods, and procedures that would apply for each of the two above-mentioned purposes.

For the reasons discussed herein, one should not assume, without further analysis, that a valuation conducted for GAAP purchase accounting purposes would produce the same results as a fair market value valuation conducted for unit principle property tax compliance purposes. Similarly, one should not assume that a transaction purchase price represents fair market value.

An analysis of a transaction purchase price relative to the fair market value standard of value is presented in the next section of this discussion. The valuation differences between financial accounting valuations and property tax valuations are addressed in a subsequent section.

Standard of Value Definition Differences

Within the valuation analyst's lexicon, the definition of value is referred to as the "standard of value." The three relevant standards of value for purposes of this discussion: (1) fair value for purchase accounting purposes, (2) fair market value for unit principle property tax purposes, and (3) investment value, are discussed below.

The differences between these standards of value are not merely semantic (i.e., technical wording differences). Rather, these standard of value differences relate to differences in the valuation analyst's application of generally accepted valuation approaches, methods, and procedures. The standard of value differences may result in a different quantitative value conclusion for the same bundle of acquired assets.

Fair value for purchase accounting purposes. The standard of value used by both accounting and valuation professionals for purchase accounting purposes is fair value, as described in ASC 820, "Fair Value Measurements and Disclosures." This guidance was issued by the Financial Accounting Standards Board (FASB) for purposes of "increased consistency and comparability in fair value measurements and for expanded disclosure about fair value measurements."[1]

Transactions may be accounted for under the purchase method of accounting, as described in ASC 805, "Business Combinations," which requires that the transaction purchase price be allocated to the target company acquired assets based on the fair value of those acquired assets. A valuation prepared for financial reporting purposes under ASC 805 estimates the fair value of the target company assets acquired (and the liabilities assumed) as part of a business combination.[2]

According to ASC 820, "fair value" is defined as:

> "[T]he price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."
>
> "The transaction ... is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability. Therefore, the objective of a fair value measurement is to determine the price that would be received to sell the asset or paid to transfer the liability at the measurement date (an exit price)."[3]

The market participants assumed under the fair value con

As described in this discussion, the fair value standard of value is different from the (1) fair market value standard of value and (2) investment value standard of value.[4]

Fair market value for unit principle property tax purposes. For ad valorem tax purposes, nearly all states require that taxpayer property be valued at fair market value (or at some conceptually similar standard of value). Many states use different terms to describe their statutory valuation standard, such as "actual value" or "true cash value."[5] Nonetheless, these different terms typically are defined to mean fair market value.

A common definition of fair market value is: the price paid in a transaction between a hypothetical willing seller and a hypothetical willing buyer, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts.

Investment value. A third standard of value is investment value. According to one authority:

"Investment value represents the value of a specific property to a particular investor. As used in appraisal assignments, investment value is the value of a property to a particular investor based on that person's (or entity's) investment requirements. In contrast to market value, investment value is value to an individual, not necessarily value in the marketplace."[6]

If the acquiring company in a transaction expects to realize synergies or other benefits that are not shared by other buyers in the marketplace, the transaction purchase price may represent investment value.

Investment value is not consistent with the definition of fair market value. That is, investment value should not be included in a fair market value analysis.[7] This is because, "[f]rom a common sense approach, the synergistic buyer will always be willing to pay more than a financial buyer because the synergistic buyer has personal and unique advantages that the financial buyer does not have."[8] These "personal and unique advantages" include, for example, the ability of the strategic buyer to reduce corporate overhead expenses. A buyer with a "personal and unique advantage" is not a hypothetical buyer, which is the buyer that must be considered under the fair market value standard of value.

Transaction Prices and Fair Market Value

In a unit principle valuation for property tax purposes, property tax assessors or administrators sometimes rely on a transaction purchase price as the fair market value of the taxpayer company's tangible and intangible assets. If the transaction purchase price represented investment value (and not fair market value), this comparison will be problematic.

It is particularly important to evaluate the motivations of the parties to a merger or acquisition in order to determine the usefulness of data derived from the merger or acquisition. These motivations should be analyzed in order to make comparisons between (1) the transaction purchase price and (2) the fair market value of the taxpayer company's taxable unit for property tax purposes.

In recent years, there has been a wave of mergers and acquisitions between companies in the telecommunications industry and, to a lesser extent, companies in the energy and transportation industries. In some cases, the transactions are the result of deregulation in the respective industries and the desire to expand and/or defend a company's market position.

Property tax assessors and administers may be tempted to calculate a transaction pricing multiple (e.g., value to: megawatts of capacity, miles of rail line, miles of gas distribution pipeline, telecommunications capacity, or telecommunications customer volume), and apply that pricing multiple to the taxpayer's business enterprise. Such a temptation should be resisted, or at least tempered significantly, because of the myriad of problems in comparing both the subject company to the merged or merging companies, and the other economic, competitive, and financial considerations involved.

The first problem with analyzing these transactions for property tax purposes is that they typically involve the acquisition of shares of stock and the assumption of debt, rather than an acquisition of the taxpayer company's taxable unit. The stock and debt securities enjoy attributes of value, such as liquidity, that are not necessarily shared by a large unit of operating property.

The second problem is that the aggregate stock and debt value also includes all property of the acquired company, not just the operating property that is subject to assessment. Extracting the value of only the taxable property from this total can be a difficult process.

The third problem is that the transaction purchase price may include value considerations that are not appropriate in ad valorem taxation. For instance, the purchase price may include the present value of future growth opportunities, which cannot be realized without the acquisition of assets after the assessment date. Those assets are not subject to property taxation, since they have not yet been acquired. For example, in *Union Pacific Railroad Co. v. State Board of Equalization,*[9] the court held that the taxpayer was not required to produce information from its strategic plans that related to future income from its future property.

The fourth problem with using transaction purchase prices for property tax purposes is that mergers and acquisitions are often completed at investment value, use value, or some other standard of value that is different from fair market value. In the ad valorem tax context, however, we are not dealing with some alternative definition of value but, instead, are attempting to determine fair market value. In *Matter of Southern Railway Co.,*[10] the court concluded that valuing a railroad from the perspective of the present owner and to the exclusion of a willing buyer was erroneous.

In another case, the court noted that "this approach abandons the concept of market value or value in exchange and looks to the value to the owner. While there may be circumstances where this is appropriate, they must be extremely rare."[11]

To the extent there are synergies that have justified mergers and acquisitions, we can assume that those synergies are peculiar to the transaction involved. If there were comparable synergies available between the subject company and some potential acquirer, we can also assume that an acquisition would already have occurred. Since it has not, we can conclude that there are no comparable synergies, and that other mergers and acquisitions are of limited or no value in appraising the subject company for property tax compliance purposes.

Even with respect to mergers or acquisitions involving the subject company itself, the existence of synergies or special investment considerations of the buyer should preclude reliance on the transaction purchase price as evidence of fair market value. This conclusion may not affect the relevance of the purchase price allocation, since the extra value recognized from synergies may affect only the measurement of goodwill, and may not affect the value of the other assets valued in the purchase price allocation. This discussion now turns to that subject—whether the values determined for purchase accounting purposes are relevant for property tax purposes.

Fair Value Analyses for Purchase Accounting vs. Fair Market Value Analyses for the Assets Acquired

The following factors should be considered in an analysis of any valuation differences between fair value valuations of individual asset groups for purchase accounting purposes and fair market value valuations of those assets for unit valuation property tax purposes:

1. Standard of value definition differences (i.e., fair value for purchase accounting purposes compared to fair market value for unit principle property tax purposes).
2. Differences in the assumed buyer and the assumed seller.
3. Differences in the assumed unit of account (i.e., the appraisal subject unit).
4. Differences in the assumed highest and best use of the unit of account.
5. Differences between the valuation approaches and methods relied on.

The following discussion considers the conceptual differences between the estimation of taxpayer property fair value for purchase accounting purposes and the estimation of taxpayer property fair market value for unit principle property tax purposes.

Differences in the assumed buyer and the assumed seller. The assumed buyer and the assumed seller in a fair value valuation for purchase accounting purposes are different from the assumed buyer and the assumed seller in a fair market value unit valuation for property tax purposes. The major difference, as discussed below, is that the buyer in a fair value valuation may include a strategic buyer.

Fair value buyer and seller. In a fair value valuation, the assumed buyer and the assumed seller are "market participants." According to ASC 805, market participants are defined as "buyers and sellers in the principal (or most advantageous) market for the [target] asset or liability." Such market participants have all of the following characteristics:

- They are independent of the reporting entity (that is, they are not related parties).
- They are knowledgeable, having a reasonable understanding about the asset

cept include both strategic buyers and financial buyers.

or liability and the transaction based on all available information, including information that might be obtained through due diligence efforts that are usual and customary.

- They are able to transact for the asset or liability.
- They are willing to transact for the asset or liability (that is, they are motivated but not forced or otherwise compelled to do so).[12]

The fair value standard market participants are any of a multitude of actual industry participants, each with potentially different strategic and/or financial motives. That is, the market participants assumed under the fair value concept include both strategic buyers and financial buyers.[13]

Fair market value buyer and seller. In contrast, the fair market value standard is based on a transaction between a hypothetical willing seller and a hypothetical willing buyer, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. In other words, "[f]air market value assumes conditions as they actually exist and a hypothetical buyer and seller, with no special, unique motivations or circumstances."[14]

A significant valuation difference between the fair market value standard and the fair value standard is that the fair market value willing buyers/willing sellers are assumed to be (1) hypothetical persons and (2) financially motivated—and not strategically motivated. This requirement excludes investment value transactions discussed above.

These differences in the assumed buyer and the assumed seller—and in particular the strategic buyer—can lead to significantly different value conclusions for the same bundle of taxpayer assets. For this reason, the fair value standard of value is appropriate for purchase accounting GAAP compliance purposes. For the unit valuation of a centrally assessed taxpayer for property tax compliance purposes, however, fair value is not the appropriate standard of value.

Nonetheless, where a merger involves a strategic buyer and creates investment value, the purchase accounting allocation still may provide evidence useful in the property tax context, if the entire extra increment of synergistic value is included in goodwill.

Furthermore, the values for tangible assets and many intangible assets may not be materially different for a strategic buyer compared to other buyers, depending on how that strategic buyer intends to use the assets. For instance, when two electric utilities merge, one would not expect the valuation of the generating assets, transmission assets, or customer relationships to be different for fair value purchase accounting purposes than for fair market value property tax compliance purposes, even if there are other synergies involved in the transaction. For other intangible assets, the answer may be different. For example, if the buyer plans to use its own computer software systems for the combined company, the software intangible asset might have a lower value in a fair value valuation prepared for purchase accounting purposes than a fair market value valuation prepared for property tax compliance purposes.

A careful analysis of (1) the transaction purchase price and (2) the purchase price allocation should be conducted in order to determine if it is appropriate to rely on transaction-related data/evidence in a property tax fair market value analysis.

Differences in the assumed unit of account. The unit of account can be the integrated assemblage of the taxpayer corporation operating assets (i.e., the total unit). Or, the unit of account can be individual real estate and personal property assets of the taxpayer corporation. The unit of account is the lowest level at which (1) the valuation analysis is performed and (2) the valuation conclusion is reached.

Under the fair value standard for purchase accounting purposes, the "unit of account" is defined as "[t]hat which is being measured by reference to the level at which an asset or liability is aggregated (or disaggregated)."[15] In other words, the unit of account for fair value accounting purposes is each individual asset (both tangible and intangible) general ledger account of the acquired business enterprise. This fair value concept of the unit of general ledger account is analogous to the summation valuation principle. Under that principle, each individual asset component of a company is valued separately—and then summed to estimate the value of the taxpayer's total property. This summation valuation principle is different from the unit valuation principle.

Under the unit valuation principle, the unit of account is the entire business en-

With regard to a unit valuation, the analyst will conclude one HABU for

[1] See Statement of Financial Accounting Standards (SFAS) No. 157, "Fair Value Measurements," now codified in ASC 820. The Financial Accounting Standards Board (FASB) is the designated organization in the private sector for establishing standards of financial accounting and reporting. These standards, which govern the preparation of financial reports, are officially recognized by the Securities and Exchange Commission (SEC) and the American Institute of CPAs (AICPA). For more information, see the Board's website at www.fasb.org.

[2] ASC 805-10-05. (These ASC citations, as aaa-bb-cc-dd, refer to the "topic" (e.g., Topic 805 is "Business Combinations"), "subtopic," "section," and "paragraph.")

[3] ASC 820-10-35-2, 820-10-35-3.

[4] See JP Morgan Chase & Co. v. CIR, 458 F.3d 564, 98 AFTR2d 2006-5956 (CA-7, 2006).

[5] *Property Taxation* (3d ed., Janata, ed.; Institute for Professionals in Taxation, 2004), page 640.

[6] *The Appraisal of Real Estate* (13th ed., Appraisal Institute, 2008), pages 28-29.

[7] Pellegrino, "Misusing Fair Market Value," 11 Valuation Strategies 12 (Mar/Apr 2008).

[8] Hood, "Must Synergistic Buyers Be Considered in Fair Market Value Analysis?" 13 Valuation Strategies 30 (Jul/Aug 2010).

[9] 776 P.2d 267 (Cal., 1989).

[10] 328 S.E.2d 235, 243 (N.Car., 1985).

[11] Joseph Hydro Associates, Ltd. v. Dept. of Revenue, 10 Or. Tax 277, 283 (Ore. Tax Ct. 1986) (in considering the value of a newly constructed electric generating facility, the court noted that "[i]ncome tax consequences to the seller should not be considered in establishing the amount that would justly compensate the owner for loss of the property"). See also Matter of Wabash Valley Power Ass'n, Inc. 72 F.3d 1305, 1312 (CA-7, 1995) (the value of Wabash to its members exceeds the value to any third-party buyer).

[12] ASC 805-10-20 (Glossary).

[13] ASC 820-10-55-27.

[14] Pratt, *The Market Approach to Valuing Businesses* (2d ed., John Wiley & Sons, Inc., 2005), page 148.

[15] ASC 820-10-20 (Glossary).

[16] *Property Taxation, supra* note 5, page 583.

[17] *Id.*

[18] ASC 820-10-20 (Glossary).

[19] *Property Taxation, supra* note 5, page 436.

[20] ASC 820-10-55-54.

[21] ASC 820-10-35-28.

[22] ASC 820-10-35-37.

the total taxpayer unit; this HABU is typically 'value in continued use.'

tity, viewed on a unitary basis, (i.e., as an integrated business enterprise without functional or geographic division of the whole).[16] This integrated business enterprise/total taxpayer unit collectively includes all of the tangible assets and all of the intangible assets of the overall taxpayer business enterprise.

The assumed unit of account may be different depending on the valuation purpose and the valuation standard of value. For example, the valuation analyst may rely on summation principle valuation methods in a fair value analysis for GAAP compliance purposes, and unit principle valuation methods in a fair market value analysis for property tax compliance purposes.

If summation principle valuation methods and unit principle valuation methods are applied consistently (i.e., using the same standard of value), both the summation valuation methods and the unit valuation methods should theoretically reach the same total value conclusion for the subject taxpayer corporation assets. If the valuation standard of value is different, however, then use of summation valuation methods and unit valuation methods may result in *different values* for the same bundle of subject taxpayer corporation assets. This is primarily because of differences related to (1) the measurement of obsolescence, and (2) the assumed "highest and best use" (HABU) of the unit of account.

One difference between the unit valuation principle and the summation valuation principle is that, under the unit valuation principle, obsolescence is considered at the taxpayer overall unit level. Under the summation valuation principal, obsolescence is often measured only at the individual asset level.

Consider, for example, a unique and inefficient railroad company track structure. A valuation analyst who analyzed one mile of the subject track would not necessarily discover that the railroad company's track structure was unique and inefficient. This obsolescence conclusion would be reached only by analyzing the total taxpayer unit. In this example, an analysis of the total unit may reveal obsolescence that is not revealed in an analysis of the unit's individual assets.

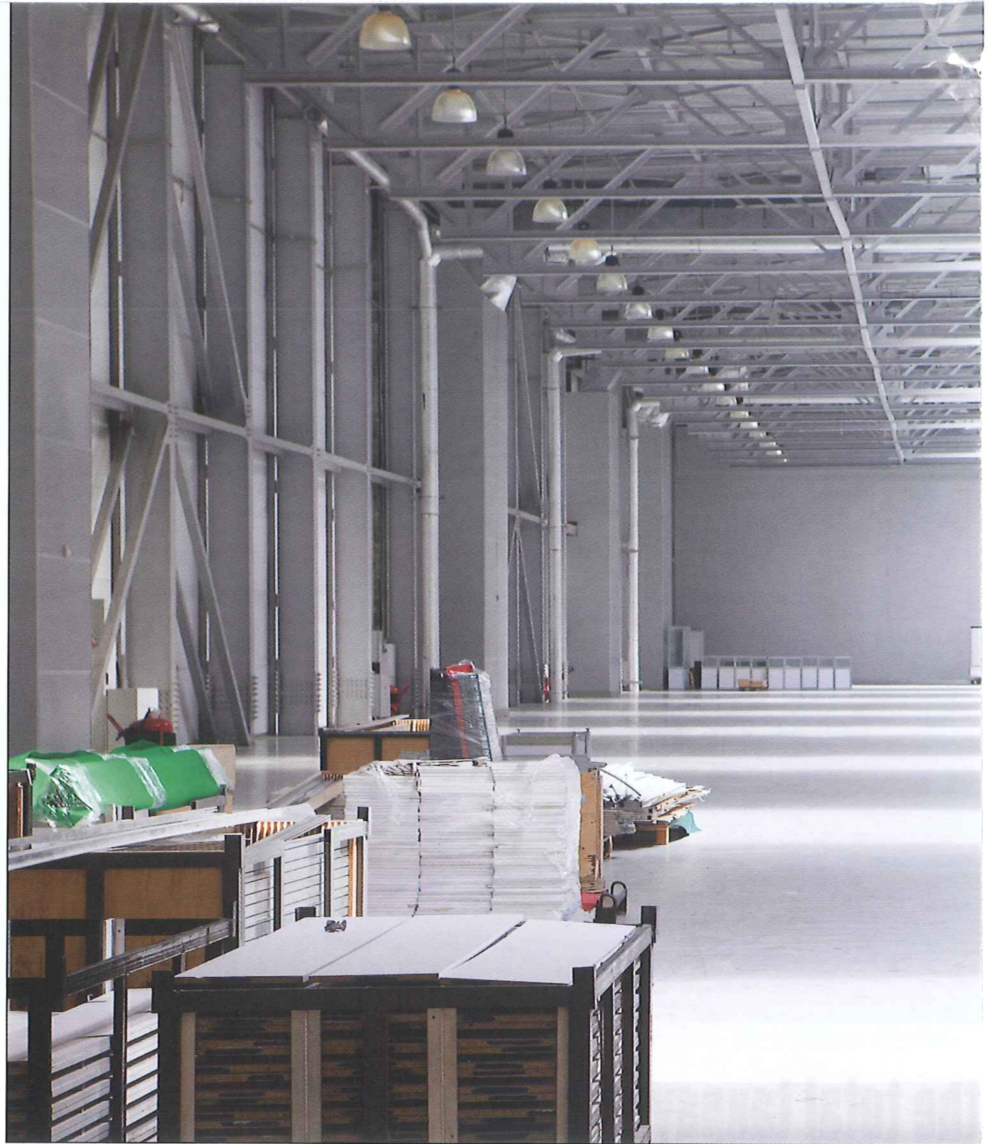
A second difference between the unit valuation principle and the summation valuation principle relates to the assumed HABU of the unit of account. Under the unit valuation principle, all of the subject operating assets, collectively, are assumed to contribute to the total business enterprise value.[17] Thus, all of the taxpayer operating assets are valued collectively, assuming one overall highest and best use for the total unit of taxpayer assets.

Conversely, under the summation valuation principle, a value is estimated for each individual component of the taxpayer asset or property, assuming a separate HABU for each individual taxpayer asset account. Thus, under the summation valuation principle, the valuation analyst determines the HABU for each taxpayer company unit of account—and not for the total unit.

The account-by-account summation valuation principle is appropriate (and, in fact, required) for fair value account-

ing/GAAP compliance purposes. In contrast, the summation valuation principle is not always appropriate for the valuation of a centrally assessed taxpayer unit for property tax purposes. First, the summation principle is not necessary unless the analyst needs to value the specific components of the taxpayer unit, in addition to valuing the total taxpayer unit. Second, if the HABU of some of the individual asset accounts is not the same as for the total taxpayer unit, there is a matching issue—or "apples and oranges" problem. If the individual asset accounts in a summation principle valuation have a HABU different from that of the business enterprise (or total taxpayer unit), the summation principle fair value valuation may not be relevant to a fair market value valuation for property tax purposes. If, however, the HABU of the individual asset accounts is the same as the HABU in a unit principle valuation, the account-by-account summation principle valuation may not preclude use of the purchase accounting valuation for property tax purposes. This concept is discussed in greater detail below.

The conceptual differences in the assumed unit of account—summation (for financial accounting purposes) versus unit (for centrally assessed property tax purposes)—is a primary valuation difference between (1) fair value analysis for accounting purposes and (2) fair market value unit valuation for property tax purposes.



ASC 820 prioritizes the valuation approaches and methods on which the

Differences in the assumed highest and best use of the unit of account. The HABU analysis and conclusion in a fair value valuation for GAAP purchase accounting purposes may be different from the HABU analysis and conclusion in a fair market value unit valuation for property tax purposes.

Under the fair value standard of value for purchase accounting purposes, the concluded "highest and best use" of the subject asset is defined as "the use of an asset by market participants that would maximize the value of the asset or the group of assets within which the asset would be used."[18] In other words, the concluded HABU is considered at the individual asset, or the individual asset unit of account, level. This means that the various taxpayer asset accounts could each have a different HABU. This level of detail corresponds to the general ledger asset account level (as discussed above). In other words, for fair value purchase accounting purposes, the valuation analyst is required to consider the HABU for each individual taxpayer unit of account—that is, general ledger asset account. This means that the various taxpayer asset accounts (including the various property, plant, and equipment accounts) each could have a different HABU.

Under the fair market value standard for property tax purposes, the concluded HABU of the subject taxpayer unit is considered at the taxpayer total business entity level—and not at the individual taxpayer asset (or asset account) level. That is, for a centrally assessed taxpayer, the HABU of all of the subject assets is typically the current use of the total assets within the taxpayer business entity (e.g., value in use)—and not the HABU of each individual asset account for possible alternative uses (e.g., value in exchange).

The fair value HABU principle is conceptually different from the HABU principle typically applied in a fair market value unit valuation of a centrally assessed taxpayer. This is because the fair value HABU conclusion is considered at the taxpayer individual asset or asset group level—and not at the taxpayer total business entity (or unit) level.

Therefore, with regard to a unit valuation, the analyst will conclude one HABU for the total taxpayer unit. This HABU is typically "value in continued use." In fact, in some states, the value in continued use HABU conclusion is required for unit valuation purposes. In contrast, with regard to financial accounting valuations, the analyst may conclude a different HABU for each individual taxpayer asset account.

These differences in the assumed HABU of the unit of account can lead to signifi-

The second example is a merger of two telecommunication companies. A purchase price accounting for this hypothetical merger may require an examination of the real property account. Telecommunication company real property is comprised mostly of central offices that would be considered special purpose buildings—with high ceilings and reinforced floors to handle heavy equipment. In this example, the HABU of the central offices would be the same as for the total taxpayer unit, because of the special purpose nature of these buildings. Therefore, in this example fair value may approximate fair market value.

The greater the differences between the HABU of each individual asset account (valued in exchange) and the total taxpayer unit (valued in continued use), the greater the differences between fair value for purchase accounting purposes and fair market value for property tax purposes.

Differences between the valuation approaches and methods relied on. Under the fair value standard, the market approach, income approach, and cost approach may be used by the valuation analyst, depending on the circumstances of the valuation.[21] ASC 820, however, prioritizes the valuation approaches and methods on which the valuation analyst should rely to

valuation analyst should rely to conduct a purchase accounting valuation.

conduct a purchase accounting valuation under ASC 805.

cantly different value conclusions for the same taxpayer bundle of assets. Consider, for example, the unit principle property tax valuation of a golf course. For property tax purposes, the HABU of the taxpayer land would be as a golf course business enterprise—and not as some alternative use (such as residential housing development land).[19] This is because the HABU of the taxpayer unit is "value in continued use."

In contrast, the fair value of the land used in the taxpayer golf course would be based on the higher of (1) its value in-use (as a golf course) or (2) its value in-exchange (assuming some alternative use, such as residential housing development).[20] This is because the HABU of the taxpayer land is "value in exchange," even though the HABU of the taxpayer golf course business unit is "value as a going concern."

Combining unit of account and HABU concepts. Let us combine the unit of account and HABU concepts and compare two situations. One situation shows differences between fair value and fair market value. The other situation shows no significant differences between the two standards of value.

The first example involves a merger of companies in the railroad industry. A purchase price accounting for this hypothetical merger may require an examination of the land account, and the appropriate units of value would be distinct parcels of land in that account. The HABU of the urban parcels of railroad land might be in a commercial, highly valuable use (for downtown office buildings, for instance), rather than in continued use as part of the railroad operation. When all of these urban parcels are valued in this manner and then totaled with all other land in the summation method in a fair value analysis, the value would likely be far greater than the fair market value of all the land when valued as part of the operating taxpayer unit in a fair market value valuation.

As promulgated in ASC 820, "[t]he fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3)."[22] Under this GAAP-related valuation guidance, the valuation analyst is generally directed to rely principally on the market approach in a fair value valuation performed for purchase accounting purposes. Where there is no market for the property being valued, however, the analyst may use other methods.

Conversely, in a fair market value unit valuation for property tax purposes, the valuation analyst is not bound by a GAAP or another regulatory hierarchy to prioritize one valuation approach over any other valuation approach. Therefore, in the unit valuation, *(Continued on page 40)*

were not even sufficient to recover the costs of upgrading the system or maintaining the electrical distribution line and substation that the city owns and operates. While these facts were cited in support of the Commission's holding that the city was not engaged in any "business," the Commission did not indicate whether a price markup or profit might cause a different result in the case.

Supreme court finds a taxable "business" service. After considering the facts presented to the Commission, and the decision of the lower court, the Missouri Supreme Court looked to its own earlier decision, *St. Louis Country Club v. Administrative Hearing Commission of Missouri,* 657 S.W.2d 614 (Mo. banc, 1983), in which the court construed Mo. Rev. Stat. § 144.010.1(2), which defines the term "business." In that earlier case, the court stated: "This language [in § 144.010.1(2)] is very broad, and is surely designed to make transactions which might not otherwise be covered taxable." The Department of Revenue had cited that earlier case, along with another case, *City of Springfield v. Director of Revenue,* 659 S.W.2d 782 (Mo. banc, 1983), to show the error of the Commission's "not taxable" decision.

Those two earlier cases. In *St. Louis Country Club,* the court found that private country clubs were engaged in the business of providing the clubs' facilities for members' guests for a fee. There, the court reasoned that club members undoubtedly considered "the opportunity to entertain guests to be important for social or business reasons." Thus, because club members received a benefit from guests being able to come to the clubs, the clubs also received a benefit since the clubs "exist only for the benefit of their members." This benefit was sufficient for the court to find "at least an indirect benefit or advantage from guest fees" such that the country club was engaged in business, even though the clubs were nonprofit corporations and their budgets regularly showed a deficit at the end of the year.

Relying on its decision in *St. Louis Country Club,* in *City of Springfield* the court held that the fees charged by a city to operate its recreational programs, as mandated by the city's charter, are taxable. The court noted that those fees, including admission fees, participation fees, and sales of concessions, "seldom exceed[ed] and often [did] not meet the direct costs of the program," and that the city often had to subsidize most of the programs through property taxes. The court also noted that the funds to pay for the activities and the sales taxes to be imposed "are appropriated and come from public funds of the City." Nevertheless, the court found that the city of Springfield was engaged in a business, and the fees were taxable.

Supreme court applies its earlier rulings. In *City of Kansas City,* the supreme court observed that as suggested in *St. Louis Country Club* and *City of Springfield,* "nothing in the definition of 'business' suggests that an entity engaging in business must recover a profit or even break even." Rather, the court said, to be engaged in business "the city only needs to receive an indirect gain, benefit or advantage." The court, quoting the Commission's decision, noted that in this case, Kansas City "provides a public service with its airport, and the provision of electricity is a necessary incident to that service. *The use of the electricity is for the purpose of furthering the City's governmental interest* in leasing the airport facilities." (Emphasis added by the court, internal quotation marks omitted.)

The court also noted that "Kansas City admits that it had other options it could have pursued in ensuring its tenants received electricity, but it would have been economically imprudent for the city to do so." Clearly, the court said, "Kansas City's interest in leasing its airport facilities is furthered by providing electricity to its tenants and subtenants, and the city is receiving an indirect benefit." With regard to the issue of taxation, "[i]t is immaterial that Kansas City's provision of electricity is simply something the city does as part of its charter-mandated ownership and management of an airport."

Commentary. In light of the decision in *City of Kansas City,* it seems the Department of Revenue has found another avenue for taxing some additional governmental services, as it has successfully done in *City of Springfield,* and in rebutting taxpayers' arguments that they are not engaged in a business, as in *St. Louis Country Club.* As a result, local governments might be wise to contemplate whether other municipal services might be considered taxable under this line of cases. ■

WILLIAM B. PRUGH
POLSINELLI SHUGHART PC
Kansas City, Missouri

Property Taxes

(Continued from page 21) the valuation analyst has more judgmental discretion to select any appropriate valuation approach or method.

Naturally, the extent to which these differences are significant depends on the methods that would be used in the fair value analysis compared to the choices an analyst would use to estimate fair market value. Returning to the telecommunications company example, although the market approach is generally preferred for fair value accounting, there is no real market for used network equipment. Therefore, this large category of telecommunications property would likely be valued using a cost approach, which is also the preferred approach to estimate the fair market value of this type of property.

Summary and Conclusion

The above discussion examined whether transactions involving taxpayer corporations are useful for property tax purposes. Specifically, whether it is appropriate to rely on a valuation conducted for GAAP purchase accounting purposes to estimate the fair market value of taxpayer corporation property for property tax purposes.

As presented throughout this discussion, we believe it is problematic to rely on a transaction purchase price for property tax purposes because the transaction purchase price may represent investment value (and not fair market value). And, it is not appropriate to rely on a valuation for purchase accounting purposes to estimate the fair market value of taxpayer corporation property for property tax purposes without analyzing and understanding the many differences that exist between the *fair value* standard of value (under ASC 820) and the *fair market value* standard of value.

The differences between these two standards of value primarily relate to (1) the hypothetical transaction, (2) the highest and best use of the subject property, (3) the assumed buyer and seller, and (4) the assumed unit of account.

A qualified and experienced valuation analysts should analyze the (1) transaction purchase price and (2) purchase price allocation, in order to determine if it is appropriate to rely on transaction-related data/evidence in a fair market value valuation for unit principle property tax compliance purposes. ■