

AN ERROR IN METHODOLOGY: INCLUSION OF EXTERNAL COSTS OF SALES IN PROPERTY VALUATIONS

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I. INTRODUCTION – EXCESSIVE TAXATION OF TANGIBLE PERSONAL PROPERTY

Ad valorem tax-According to value. A tax imposed on the value of property. A tax levied on property or an article of commerce in proportion to its value, as determined by assessment or appraisal.² “Saleable value, actual value, market value, fair value, reasonable value, and cash value may all mean the same thing and may be designed to effect the same purpose.”³

Two business owners with comparable businesses purchase similar assets for use in the production of their respective products. They are both located in taxing jurisdictions that do not provide any special tax exemption rules. Both jurisdictions tax tangible personal property according to standard tax and depreciation schedules. Yet, according to the overwhelming majority of states’ taxing methodology rules, when property tax returns are due, one business owner may face a significantly higher property tax expense than the other.

The difference in taxable value for the same asset based upon its taxable situs is due to the inclusion of external costs directly related to the acquisition of the asset. Sales tax, freight and other shipping costs, as well as installation costs may all serve to drive up the basis and thus

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2. BLACK’S LAW DICTIONARY 51 (6th Ed. 1990) (emphasis added).

3. *Cummings v. Nat’l Bank*, 101 U.S. 153, 162 (1879) (emphasis added).

the initial valuation for property tax purposes. Thus, the value of tangible personal property for ad valorem tax purposes can be markedly different, depending on where the property is returned for tax purposes and how property appraisers and the courts treat the taxable value of the property. For example, in Kansas and Florida the taxable value of an asset can be significantly lower than the same asset located in South Carolina, Colorado, or even California.

The taxation of tangible personal property involves several steps: (1) arriving at the value of the property using one of several generally accepted appraisal methods; (2) assessing the appraised value of the property using a ratio provided under state or local tax law; and (3) mailing the tax bill to the owner of the property for remission of the ad valorem tax due. Under the constitutional or statutory guidelines of the states that levy an ad valorem tax on tangible personal property, property must be uniformly valued at a "just value" or "market value."⁴

During this process, the potential for the inclusion of costs that increase the taxable value of property above its true or market value is high. One reason for this is because most states include the external costs of sale to the value of the property for ad valorem appraisal purposes. External costs of a sale can include expenditures such as sales tax, freight or shipping charges, installation costs and the like. The problem is whether the inclusion of these external costs of sale in the valuation of property for ad valorem property tax purposes is proper. Adding these costs to the value of the property is unconstitutional, both at the state and the federal levels, because it violates the notion of uniform and just valuation for all property similarly situated within a state.⁵ However, only a handful of states have addressed this issue and, of those, only two concluded that the inclusion of external costs of sale

4. A good example of the language found in many state constitutions is as follows:
The legislature shall provide for the uniform general ad valorem taxation of real and tangible personal property not exempt by law except for taxes. . .The legislature shall provide for the determination of true cash value of such property; the proportion of. . .which such property shall be uniformly assessed. . .and for a system of equalization of assessments.

MICH. CONST. art. IX, § 3. A decision rendered by the Florida supreme court underscores the need for this language in states' constitutions, providing that "[t]he valuation of property for less than its full cash value for tax purposes does not constitute willful, arbitrary, and intentional discrimination against a taxpayer so long as there is uniformity in the assessed valuation[.]" Blumberg et al. v. Petteway, 91 So. 2d 297 (Fla. 1956). See also, OHIO CONST. art. XII, § 2, PA. CONST. art. VIII, § 1, TEX. CONST. art. VIII, § 1 for good examples. Other states' uniformity in taxation clauses are discussed throughout this note.

5. See *supra* note 4.

constitute excessive taxation to the purchaser.⁶

This simple error of including the external costs of sales in property valuations has serious consequences. It creates excessive valuation and, therefore, disproportionate ad valorem taxation on the purchase of tangible personal property, whether used for personal or business reasons. Although most states have an exemption from ad valorem taxation of personal, or household, tangible property up to certain limits, many businesses still suffer from the excessive valuation due to their capital intensive production processes. Therefore, businesses are being taxed on a higher value of property than what is the actual market or true value of the property. Even accounting for depreciation and other factors, the purchase of tangible personal business property should carry with it a caveat; ad valorem assessment of the property's value most likely will be too high due to the inclusion of external costs of the sale.

Ironically, courts have upheld the protectionist policies behind the counterpart to the sales tax—the use tax. The application of the use tax serves the dual purpose of preventing the out of state migration of purchases of tangible personal property and to ensure a steady flow of revenue to the state treasury coffers.⁷ This dual purpose is based on a primary goal: to prevent avoidance of the sales tax. However, unlike sales taxes, use taxes paid on items of tangible personal property are not added to the value of the property for property tax assessments. This dichotomy presents serious problems for owners with large amounts of capitalized assets when it comes time to pay the property tax bill.

II. THE STATES AT THE FOREFRONT OF THIS PROBLEM

A. *Two states that got it right*

A survey of states finds a paucity of court decisions on point with this issue.⁸ Of the states that did address whether external costs of the

6. Those states include: Florida, Kansas, South Carolina, California, Colorado and Maryland. The two states, Florida and Kansas, that reached the conclusion that external costs should not be included in the valuation of the property did so by applying different reasoning to reach the same result. This article discusses their respective methodologies.

7. *See, e.g., Terco, Inc. v. State, Dep't of Treasury, Revenue Div.*, 339 N.W. 2d 17, 21 (Mich. Ct. App. 1983). The court decision reviews the history behind the implementation of the use tax and recognizes the validity of its purpose in protection in-state merchants of tangible property.

8. Those courts that did decide this issue were Colorado, South Carolina, California, Florida, Maryland and Kansas. Each state's respective decision is discussed in this note. Other court decisions addressed the issue as either an ancillary matter or did not reach a conclusion on the merits. They include: *Connecticut (Conn. Mut. Life Ins. Co. v. City of Hartford, No. CV*

sale should be assessed as part of the property's value, only two agreed with the taxpayer that they should not be included.⁹

1. Florida

The first of these two cases is a recent decision by the Fifth District Court of Appeals of Florida in *Wal-Mart Stores, Inc. v. Mazourek*.¹⁰ The court concluded that the external costs of sales taxes should not be included in the valuation of property for ad valorem tax purposes. In its decision, Wal-Mart contested the inclusion of some 2 million dollars of sales taxes that it paid on two of the retail stores and a distribution center it owned and operated.¹¹

Wal-Mart relied on the language of F.S.A. §§ 193.011(1) and (8) for its argument.¹² The statutes provide factors to use in arriving at a "just valuation of property" as required under the Florida constitution. Article VII, sec. 4.¹³ The statute also forms the basis for the Florida

930525603, 1996 WL 367778 (Conn. Super. Jan. 23, 1996)); Michigan (*Aptco Auto Auction v. City of Taylor and County of Wayne*, No. 163076, 1996 WL 172791 (Mich. Tax Trib. March 13, 1996)); Montana (Dep't of Revenue of Montana v. World Wide Press, Inc., No. PT-1991-311, 1992 WL 275722 (Mont. Tax App. Bd. Sept. 17, 1992)), and; Washington (*Mack Aviation Co. v. Scott Noble, King County Assessor*, Nos. 42694 & 42893, 1993 WL 558024 (Wash. Bd. Tax App. Dec. 23, 1993)). These cases centered around the appropriate methodology to use in valuing property and whether the methodologies could include external costs of sale. Whether those external costs of sale should be included was not at issue however.

9. See *supra* note 5.

10. *Wal-Mart Stores, Inc. v. Mazourek*, 778 So. 2d 346 (Fla. Dist. Ct. App. 2000).

11. *Id.* at 350.

12. *Id.*

13. The relevant portion of the statute dealing with the factors to consider is:

(1) The present cash value of the property, which is the amount a willing purchaser would pay a willing seller, exclusive of reasonable fees and costs of purchase, in cash or the immediate equivalent thereof in a transaction at arm's length.

(2) The highest and best use to which the property can be expected to be put in the immediate future and the present use of the property, taking into consideration any applicable judicial limitation, local or state land use regulation, or historic preservation ordinance, and considering any moratorium imposed by executive order, law, ordinance, regulation, resolution, or proclamation adopted by any governmental body or agency or the Governor when the moratorium or judicial limitation prohibits or restricts the development or improvement of property as otherwise authorized by applicable law. The applicable governmental body or agency or the Governor shall notify the property appraiser in writing of any executive order, ordinance, regulation, resolution, or proclamation it adopts imposing any such limitation, regulation, or moratorium;

(3) The location of said property;

(4) The quantity or size of said property;

(5) The cost of said property and the present replacement value of any improvements thereon;

(6) The condition of said property;

(7) The income from said property; and

Department of Revenue's instruction manual for its property assessors. The manual, *Assessment of Tangible Personal Property and Inventory*, specifically excludes sales tax from the assessment of the value of property for ad valorem purposes.¹⁴

Nonetheless, the property appraiser maintained that there was no error in his valuation because sales tax was a part of the property's value based on two fronts: (1) the tax return form included the sales tax and other costs of sales and; (2) he should not be bound by the Department of Revenue's instruction manual because it was incorrect.¹⁵

The court concluded that all "external costs of sale are uniformly excluded from 'just value' because they add nothing to the actual value of property."¹⁶ Of these external costs, sales tax is included. The court held that because the property appraiser included this cost into the property's assessed value, the presumption of correctness of the appraiser's assessment was invalid and the property must be re-assessed to exclude this and any other external costs.¹⁷

Unfortunately, this decision is in jeopardy in Florida. The court in *Wal-Mart Stores, Inc. v. Jim Todora, etc.*¹⁸ reached a decision contrary to the Fifth District Court of Appeals' holding as discussed above. In this case, the Second District Court of Appeals, found that the presumption of correctness in the property appraiser's valuation of personal property was not tainted by the inclusion of the external costs of sales, including sales tax.¹⁹ The court held that, the standard definition of costs related to acquisition of an asset include not only the

(8) The net proceeds of the sale of the property, as received by the seller, after deduction of all of the usual and reasonable fees and costs of the sale, including the costs and expenses of financing, and allowance for unconventional or atypical terms of financing arrangements. When the net proceeds of the sale of any property are utilized, directly or indirectly, in the determination of just valuation of realty of the sold parcel or any other parcel under the provisions of this section, the property appraiser, for the purposes of such determination, shall exclude any portion of such net proceeds attributable to payments for household furnishings or other items of personal property.

F.S.A. §§ 193.011(1), (8) (2000).

14. *Wal-Mart Stores, Inc. v. Mazourek*, 778 So. 2d at 349, n.1. This manual was issued in 1997. When this case was decided a mere three years later, the property appraiser claimed that the manual was "flawed and outdated." The court didn't buy this argument when it ruled against the county appraiser. *Id.* at 349.

15. *Id.*

16. *Id.* at 350, citing language from *Hausman v. VTSI, Inc.*, 482 So. 2d 428, 431 (Fla. Dist. Ct. App. 1985).

17. *Id.* at 8, 13-14.

18. *Wal-Mart Stores, Inc. v. Todora*, 791 So.2d 29 (2001). 26 Fla. L. Weekly D 1034 (Fla. Dist. Ct. App. Apr. 18, 2001).

19. *Id.* at *31.

purchase price but also the freight, installation and other fees.²⁰ This holding was reached despite language in the Florida Department of Revenue's manual prohibiting the inclusion of such costs.²¹

The *Todora* court recognized that external costs of sales, including sales tax, should not be included in the valuation of personal property when the property appraiser uses the market approach to valuation.²² However, because the Second District Court of Appeals lacked precedent within its own jurisdiction in determining whether to exclude sales tax from property value, it declined to extend the exclusion to other methods of property valuation.²³ Instead, the court found that where the appraiser relies on the cost approach to valuation, the inclusion of these external costs do not upset the presumption of correctness with regard to the property appraiser's valuation of tangible personal property.²⁴

In a brief dissent to this opinion, Judge Fulmer exhorted the court to follow the reasoning of the Fifth District Court of Appeals' decision in *Mazourek*.²⁵ The dissent did not list why that decision should be followed instead of the majority opinion of *Todora*. One can only assume that the dissent agrees, without reservation with the logic of the *Mazourek* decision. The majority opinion did not agree with the *Mazourek* opinion and certified the issue to go before the Florida Supreme Court.²⁶

2. Kansas

The court in *Board of County Commissioners of Leavenworth County, Kansas v. McGraw Fertilizer Service, Inc., et. al.* reached a similar conclusion to the *Mazourek* opinion.²⁷ In this decision, the relevant issue was whether sales tax, freight and installation (external costs of sales) should be included in the "retail cost when new" valuation of tangible property for purposes of ad valorem tax assessment.²⁸

20. *Id.* at *31.

21. *See infra* note 459.

22. *Todora*, 791 So.2d at 31. The court relied on a previous ruling in *Turner v. Tokai Fin. Servs., Inc.*, 767 S.2d 494 (Fla. Dist. Ct. App. 2000). The *Turner* decision to exclude sales tax was based on the cost method of valuation and no opinion was reached as to whether the exclusion should apply to other property valuation methods. *Id.* at 499, n.2.

23. *Id.* at 499, n.2.

24. *Todora*, 791 So.2d at 31.

25. *Id.* at *31.

26. *Id.*

27. *Bd. of County Comm'rs. Of Leavenworth County, Kansas v. McGraw Fertilizer Serv. Inc.*, 933 P.2d 698 (Kan. 1997).

28. *Id.* at 705. "Retail cost when new" is the term of art used as the valuation standard for

In declining to include external costs to the value of the property, the court noted an interesting example of the disparity that could exist between two taxpayers owning identical pieces of equipment, but with different returned values of that equipment:

[A] troublesome feature of the proposition that freight, installation and sales tax be included in the 'retail cost when new' for calculating ad valorem property taxes is that ad valorem taxes must be based on valuations that are uniform and equal. For example, suppose two companies, A and B, purchase the same piece of equipment with a retail cost of \$1,000. Taxpayer A has the equipment delivered by the same company they bought it from for a delivery fee of \$75. Added to the \$1,075 is a sales tax of 6.5% for a total of \$1,144.87. Company B, on the other hand, purchases the equipment from an out-of-state firm (thus paying no Kansas sales tax) and pays a third party to ship the equipment. On January 1 (and every year thereafter for the life of the equipment), Taxpayer A (cost = \$1,144.87) would have a higher valuation than B (cost = \$1,000) for the exact same item, purchased on the same day and for the same sale price.²⁹

This disparity was in direct conflict with the uniformity section of the Kansas constitution that requires all property be taxed the same as other property within the same taxing jurisdiction.³⁰ The court looked to a previous decision where it held: "Uniformity in taxation implies equality in the burden of taxation, and this equality cannot exist without uniformity in the basis of valuation. Uniformity in taxation does not permit a systematic, arbitrary, or intentional higher valuation than that

returning the value of tangible personal property in Kansas. KAN. CONST. art. 11, § 1(b), class 2 (E). "Retail cost when new" is unique to Kansas; no other state uses this phrase in deciding on the valuation of tangible personal property for taxation purposes. This came about in 1985 when the Kansas state legislature amended the state constitution from a uniform standard of valuation to a classification standard and substituted the words "fair market value" to "retail cost when new." *McGraw*, 933 P.2d 698, 703. Thus, it was easier for the state supreme court to arrive at the conclusion that the assessed value of property should not include external, or "post-acquisition," costs. To add such costs would violate the legislative mandate that all valuations of property within the same class be uniform and equal. *Id.* at 705.

29. *Id.* at 705.

30. KAN. CONST. art. 11, § 1. Indeed, this simple example as used in the *Greenshaw* decision results in a valuation for Company B's tangible assets at 87 percent of the valuation for Company A's assets. *See, Bd. of Johnson County Comm'rs. v. Greenshaw*, 734 P.2d 1125 (Kan. 1987). Multiplied over tens or hundreds of thousands of dollars worth of tangible personal property, this difference results in a significantly higher tax burden for Company A. I would also point out that had the Court included these costs in the valuation of the property, in-state sellers of tangible personal property subject to ad valorem tax would face a competitive disadvantage from out of state sellers of the same equipment. *See supra* note 26 for more on this point. Thus, this decision makes good economic sense for the taxpayers in the state of Kansas.

placed on other similar property within the same taxing district.”³¹ Thus, the court, uncomfortable with the proposition that taxpayers purchasing the same property via different means would face different tax burdens, held that the assessed value of the property should be its market value and not include ancillary and external costs of sale.³² This same real-world conflict also exists in every other state that taxes tangible personal property based on a return of its assessed value.³³

Together, the decisions reached in Fifth District and Kansas tell us two important things: (1) Sales tax and other external costs of sale do not add anything to the value of the property subject to assessment and; (2) to add such external costs of sales to the assessed value of property ignores the fact that our system of free transferability of goods through interstate commerce will create disparity in the taxable value of those goods situated within the same taxing jurisdiction. It also should be noted that although Company B in the *Greenshaw* hypothetical may be required to pay a use tax because it didn’t pay state sales tax, that cost will not be added to the basis of Company B’s property as it was with Company A who did pay the in-state sales tax.³⁴

B. The states that got it wrong

A review of other court decisions in this area is illustrative.³⁵ In general, these decisions can be characterized as attributing the external costs of sale of an asset to the value of the asset itself. The circuitous routes these holdings take to reach the same outcome result in economic consequences that help larger businesses at the expense of their smaller competitors; this is an expansion of the property tax base through the use of separate sales tax methodologies, and the institution of “protectionist” policies³⁶ that ignore the realities of our free-market economy which relies on the exchange of goods flowing through interstate commerce.

31. *McGraw*, 933 P.2d 698, 710, quoting *Bd. of Johnson County Comm’rs. v. Greenshaw*, 734 P.2d 1125 (Kan. 1987). Ironically, the tax commissioners contended that *not* including freight, installation, and sales tax as an assessable component of “retail cost when new” violated the “uniform and equal rate of assessment and taxation” language of the Kansas Constitution. *Greenshaw*, 734 P.2d 1125, 1131.

32. *McGraw*, 933 P.2d 698, 713.

33. *See supra* note 4.

34. *See supra* note 30.

35. *See supra* note 7.

36. *See generally supra* note 6 and *infra* note 45.

1. South Carolina

In *Crown Cork and Seal Co., Inc. v. South Carolina Tax Commission*,³⁷ the court addressed whether installation costs should be included in the value of property for tax assessment purposes.³⁸ The court ruled affirmatively, finding that the inclusion of the installation costs reflected the assets' "true value in money."³⁹ Their finding was based on a reading of S.C. Code Ann. § 12-37-930, which states:

All property shall be valued for taxation at its true value in money which in all cases shall be held to be the price which the property would bring following reasonable exposure to the market, where both the seller and the buyer are willing, are not acting under compulsion, and are reasonably well informed as to the uses and purposes for which it is adapted and for which it is capable of being used . . . Provided, further, fair market value of manufacturer's machinery and equipment used in the conduct of the manufacturing business . . . shall be determined by reducing the original cost by an annual allowance for depreciation . . . [.]⁴⁰

This decision overlooks two points. First, it ignores the constitutional mandate that all taxes shall be imposed in a fair and uniform manner.⁴¹ This uniformity of taxation, within each classification of property, ensures that no single taxpayer bears a higher or lesser burden than other similarly situated taxpayers. Indeed, in *State ex rel. Daniel v. Textile Hall Corp.*,⁴² the court pointed out that, due to the arbitrary nature of personal property taxation, the taxpayer enjoys the right of uniformity of taxation under the state constitution.⁴³

Here, however, the taxpayer is arbitrarily burdened with the additional costs of installation of its assets added to the taxable base value. Installation costs are separate from "fair market value"; it does not add value to the machinery itself but rather is a distinct and external

37. *Crown Cork & Seal Co. v. South Carolina Tax Comm'n.*, 394 S.E. 2d 315 (S.C. 1990).

38. *Id.* at 316.

39. *Id.* at 316.

40. *Id.* at 316 (citing S.C. CODE ANN. § 12-37-930 (Com. Supp. 1989)).

41. S.C. CONST. art. X, § 1. *See also* S.C. CODE ANN. § 12-4-310 which states:

Mandated powers and duties [of the South Carolina Tax Commission]

The commission shall:

.....

(2) formulate and recommend legislation to enhance *uniformity*, enforcement, and administration of the tax laws, and secure just taxation and improvements in the system of taxation (emphasis added).

42. *State ex rel. Daniel v. Textile Hall Corp.*, 194 S.E. 66 (S.C. 1937).

43. *Id.* at 68. *See also, supra* note 26, where Florida's supreme court reached the same conclusion.

cost of doing business.

The second point is that the court overlooked the far-reaching economic effects its decision will have for South Carolina businesses. As the *Greenshaw* decision⁴⁴ illustrates, multiple manufacturers may follow different methods of purchasing the same types of equipment for use within the state. A manufacturer that purchases in-state and installs the equipment using in-state labor will face a higher tax burden than that of a manufacturer that uses an out-of-state purchasing system and/or contracting service; not exactly an incentive to buy locally.⁴⁵

At the very least, the court should have cursorily examined what effects its ruling have for the future. By permitting external costs of sale to be included within the assessed value of the property, it tacitly encouraged South Carolina businesses to either purchase property out of state or to structure the purchase of its tangible assets through separate, but controlled, companies located outside the state. For example, examine the following:

[In this case], the statutory definition of “original cost” is clear and unambiguous. Crown elected to add its installation costs to the manufacturer’s cost in determining gross capitalized costs for income tax purposes. As a result of this decision by Crown, [the] Tax Commission was compelled to include these installation costs in assessing the property tax.⁴⁶

Crown’s mistake of capitalizing installation costs for South Carolina depreciation purposes can be rectified by having entities outside the state conduct the purchasing and installation of in-state tangible assets. A non-South Carolina entity, by virtue of its location outside of the state, will more likely be conducting its purchases outside of the state as well. Additionally, other costs, such as installation service

44. See *supra* note 30.

45. Refer to *Terco, Inc. v. State, Dep’t of Treasury, Revenue Div.*, *supra* note 7. In the *Terco* decision, the Court of Appeals of Michigan reviewed the policy behind use tax laws and noted:

The sales tax, powerful though it was, was vulnerable to avoidance. If the purchase, possibly of an automobile, were made not in Michigan but in a neighboring State the Michigan sales tax would not apply. Thus not only did the State of Michigan lose the tax moneys (sic) but a Michigan merchant lost the sale.

.....

Through its enactment (of the use tax) the flight across the border was blocked, and the Michigan merchant [was] protected in his competitive position, and the State tax funds safeguarded.

Id. at 21. Thus, there is some recognition to the state’s protectionist policies toward in-state merchants.

46. *Crown Cork & Seal Co. v. South Carolina Tax Comm’n.*, 394 S.E.2d 315, 316-17 (S.C. 1990).

charges, will probably be purchased through the non-South Carolina entity when it hires non-South Carolina contractors to handle the transaction(s). Thus, the attempt to increase the taxable base of the state will most likely result in negative economic repercussions in the long-term.

2. California

California joins South Carolina in reaching a similar conclusion that may have long-term deleterious effects. In *Xerox Corp. v. County of Orange, et. al.*,⁴⁷ the taxpayer argued on four different grounds that the sales tax and freight charges for certain tangible personal property assets should not be included in the value of those assets for property taxes. The arguments were:

- (1) The sales tax that a seller may collect is not part of the “price” that the parties would agree upon in [terms of market value];
- (2) The sales tax and freight charges are not a part of the “cost” of the property;
- (3) The inclusion of sales tax is a distortion of the income method of property valuation, and;
- (4) The sales tax is an item in which the taxpayer has no interest.⁴⁸

In addressing the first argument, the court noted that the “sales tax is an element of value [to the buyer].”⁴⁹ This statement is at odds with the court’s previous assertion that the “tax [is] a direct obligation of the retailer and, so far as the consumer is concerned, a part of the price paid for the goods and nothing else, it is neither in fact nor in effect laid upon the consumer.”⁵⁰ In its ruling, the court attempted to reconcile these two statements by stating that the ultimate burden of the tax is on the consumer and forms part of the bargained for purchase price and thus the value of the asset to the consumer.⁵¹

What the court overlooks is the fact that the purchaser may be exempt from sales tax, have purchased the asset outside the state, or in

47. *Xerox Corp. v. County of Orange*, 136 Cal. Rptr. 583 (Cal. Ct. App. 1977).

48. *Id.* at 588-89.

49. *Id.* at 590.

50. *Id.* at 589, quoting from the earlier decision of *Western L. Co. v. State Bd. of Equalization*, 11 Cal.2d 156, 164, 78 P.2d 731 (1938) (distinguished on other grounds).

51. *Id.* at 590.

some way have avoided paying the tax altogether. When confronted with paying the tax or not paying the tax, the choice is clear. Therefore, the tax is not, as the court put it, “an element of value” to the buyer.⁵² The court’s decision unfortunately places an effectively higher property tax burden on the taxpayer who is forced to include sales tax (as well as other external costs) in the property’s value where they have no other choice but to pay the tax.

The second argument that, sales tax and freight are not part of the costs of the assets was also dismissed by the court.⁵³ Relying on generally accepted accounting principles for the determination of the replacement cost of an asset, the following includable costs were listed; brokerage commissions, duties, transportation, and other costs associated with placing the asset in use.⁵⁴ Again, this is a misplaced argument. Replacement or reproduction costs should not be considered the same as assessed value. Again, this is simply due to the fact that many of the external costs associated with the asset are variable in nature. The actual cost of the asset itself is fairly immovable in its relation to market value or, as *Greenshaw* denotes, “retail cost when new.”⁵⁵ Property valuation is not the same as its cost of reproduction; the former is true or market value the latter is insurable value.

As with South Carolina and Kansas, the example of a small business comes to mind. Economies of scale tell us that the larger the purchaser, the more clout it carries in negotiating external costs of sales. The purchase and installation of fifty large pieces of equipment carries with it a concomitant reduction in freight, labor and other external costs. A smaller business that purchases only five of the same pieces of equipment most likely does not have the clout to reduce, in any significant manner, the external costs of the sale. Following the logic of the *Xerox*⁵⁶ decision, the smaller business will be harder hit at property tax time because each individual piece of equipment will carry with it a larger assessed value. Should the smaller business carry the greater tax burden? According to the *Xerox* opinion, it must.⁵⁷

The taxpayers third argument that the inclusion of sales tax distorts the income method of valuation, also had no sway with the court.⁵⁸ The

52. *Id.*

53. *Xerox Corp.*, 136 Cal. Rptr. 583, 592.

54. *Id.* at 591. The decision cited the ACCOUNTANT’S ENCYCLOPEDIA 168-69 (1962).

55. *See supra* note 30.

56. *See supra* note 47.

57. *Xerox Corp.*, 136 Cal. Rptr. 583, 592.

58. *Id.* at 591.

court assumed that the appraiser's methodology relied on multiplying the gross return to the taxpayer on the equipment and not the net return.⁵⁹ Had the appraiser used net return on income, then the external costs would not have been properly accounted for in determining income to the owner/taxpayer.⁶⁰ Relying on this assumption, the court reasoned that the income produced as a result of calculating gross return on the appraised assets should include the taxpayer's external costs of those assets.⁶¹

This is faulty reasoning. Using the previous example of the small business, from the basis of this court's discussion, the smaller business would have to charge a higher price on its goods produced when using this income method of valuation in order to properly allocate gross return on the cost of the asset because of its inflated assessed value.⁶² The larger business, in addition to having the advantage of a lower overall assessed value on its equipment,⁶³ can also charge a lower price on its goods because of a lower assessed value on the equipment, if the income methodology is used. Once again, this decision favors an economy of scale that tips away from fairness to all businesses and favors those with larger economies of scale. Thus, ad valorem taxation of assets must be dependent upon the value of the property itself, not on the income stream it produces to the taxpayer.

In the fourth argument, the taxpayer advanced the proposition that, because the seller has no "interest" in the tax, he has no value relative to the property.⁶⁴ This was dismissed by the court when it stated:

The price at which a willing and informed seller will sell, in the absence of some exigent circumstances, will always include his costs

59. *Id.* at 592-93. This assumption was due to the fact that the taxpayer never objected to the methodology that the appraiser relied on inasmuch as the multiplier used to calculate return on income to the taxpayer. Therefore, the court assumed that the appraiser had used a gross return methodology, which would have included the external costs of sale in the assets' value relative to producing income. This assumption had to be relied on as net return would not have properly included such external costs, and hence, would not have properly reflected the true cost of producing the goods using the appraised machinery.

60. *Id.*

61. *Id.* The court stated, "List price does not equate with market value; it is not the total price of the property at the highest level of exchange, and it does not reflect all of the consumer's costs under the cost approach to value." *Id.*

62. This allocation of income to gross cost of the asset relies on the so-called "multiplier" made reference to in the decision. *Id.*

63. Due to the lower costs that it can negotiate as a result of its economic clout. The lower assessed value burden on the large business taxpayer in turn leads to a lower property valuation/taxation burden as well.

64. *Xerox Corp.*, 136 Cal. Rptr. 583, 592-93.

of production, materials, overhead, advertising and other costs of doing business. The sales tax is merely another cost of doing business, measured by the gross receipts of that business. The same reasoning supports the inclusion of freight or installation charges.⁶⁵

For purposes of assessing the value of property for ad valorem tax, the above quoted language is misplaced reasoning. The value of the property is returned by the taxpayer or consumer, but not the seller. Thus, the seller's costs of doing business are of no relation to the assessed value of the property, which ultimately ends up in the taxpayer's hands. Additionally, sales tax is not a cost of doing business to the seller simply because the seller passes it on to the customer. The court should have stated instead, that "the costs of doing business with respect to external costs of sale rest squarely with the consumer, not the seller." The court's failure to recognize this fact places a double burden on the consumer; first, he must pay the external costs and, second, he must pay an inflated ad valorem tax on the property because the external costs are included in the assessment of the property.

3. Colorado

These type of decisions are not limited to the East or West coast. Notably, the Court of Appeals of Colorado, in its decision in *IBM Credit Corporation v. Board of County Commissioners of the County of Jefferson*,⁶⁶ included external costs such as transportation and set up fees to the assessed value of computer equipment.⁶⁷

In that decision, the cost approach methodology was used in arriving at a fair market value of certain types of computer equipment leased by the taxpayer to a third-party. The taxpayer contested the valuation of the equipment and asserted that a market approach to valuation should have been used.⁶⁸ Additionally, the taxpayer claimed that obsolescence further reduced the value of the computer equipment.⁶⁹ The Jefferson County Board of Commissioners' property appraiser countered by stating that the cost approach was more accurate in determining value. This approach, claimed the appraiser, did not include functional and/or economic obsolescence but rather relied on a

65. *Id.* at 593.

66. *IBM Credit Corp. v. Bd. of County Comm'rs. of the County of Jefferson*, 870 P.2d 535 (Colo. Ct. App. 1993), *aff'd.*, 888 P.2d 250 (Colo. 1995).

67. *Id.* at 539.

68. *Id.* at 536.

69. *Id.* at 535-36.

standard depreciation schedule.⁷⁰

Interestingly, the appraiser did not agree with the taxpayer's inclusion of external costs of set up and transportation to the market price of equipment, as compared with the cost of the assets under appeal.⁷¹ Apparently, the disparity in the value of the used computer equipment as compared to the newer equipment, which included the external costs of sale, did not reflect an accurate cost comparison for the County.⁷² This issue was not discussed at length by the court, and the taxpayer offered no reasons for the inclusion of such costs.⁷³ Presumably, because the equipment at issue was leased to a third-party, costs were recovered either under the lease agreement or reflected a higher basis to the taxpayer resulting in a larger write-down over a shorter depreciation period.

4. Maryland

When a cable television company contested the inclusion of "make ready costs" in the valuation of its assets, it received little help from the court. In *State Dep't. of Assessments and Taxation v. Metrovision of Prince George's County, Inc.*,⁷⁴ the taxpayer contested the inclusion of "make-ready" costs in the valuation of the property's value for tax return purposes.⁷⁵ Surprisingly, no objection by the taxpayer was made as to the inclusion of other external costs of sales, including labor costs, sales tax and other intangible expenses.⁷⁶ The value of the assets in question were appraised using a "market" method of valuation.⁷⁷

The lower court had excluded these "make-ready" costs from the

70. *Id.* at 536. Neither party introduced evidence at trial that the income approach methodology should have been used. *Id.*

71. *Id.*

72. *IBM Credit Corp.* 870 P.2d 535. However, the County probably would not have objected had the taxpayer included the external costs of sale in the value of the computer equipment that they were returning for ad valorem tax purposes since this would have resulted in an increased valuation (and hence more tax revenue).

73. *Id.*

74. *State Dep't. of Assessments & Taxation v. Metrovision of Prince George's County, Inc.*, 607 A.2d 110 (Md. Ct. Spec. App. 1992).

75. "Make-ready costs" included "reimbursements to utility companies for costs incurred for pre-inspection, adaptation for cable use, and post inspection of their utility poles." *Id.* at 112.

76. *Id.* at 119. These costs were included as part of a cost valuation approach in ascertaining the value of the assets in question.

77. *Id.* at 117. This methodology is similar to the cost approach in that the value is based on a "full cash value" or what the price would be agreed upon between a willing buyer and seller without limitations or coercion.

valuation of the assets.⁷⁸ On appeal, the conclusion was reached that these costs may be included in their value.⁷⁹ The basis for this inclusion was formed from the Taxation Department's regulations, which define the value of an asset to include "all costs necessary to get an asset operational."⁸⁰ Such an approach generally relies upon the following propositions: (1) "all costs necessary to get an asset operational must be included" in the basis of cost; and (2) "cost would include the invoice price of the asset, the freight, the sales tax, installation, site preparation."⁸¹

Therefore, by the court's interpretation, "all costs necessary to make an asset operational" apply to external costs not related to the asset itself.⁸² Chief among these costs is sales tax. The costs of rendering an asset operational can vary from taxpayer to taxpayer, and those costs can fluctuate based on what services or products are purchased, when they are purchased and where they are purchased.

It is unfortunate that the court did not explain why sales tax was a necessary cost that would render an asset operational in terms of producing income. It was also unfortunate that the taxpayer did not dispute the inclusion of this cost and thus the court did not have to address this specific issue.⁸³

III. EQUALITY AND UNIFORMITY IN THE STATES' TAX LAWS?

Taxation, by its very nature, is arbitrary.⁸⁴ Therefore, it is important that taxes be imposed in an equal and uniform manner no matter what is taxed, or how the revenues are collected. A review of states' constitutions underscores the importance of this statement; many states have similar provisions that ensure equality and fairness in the states' imposition of the tax burden.⁸⁵

As the cases discussed illustrate, the issue of uniformity and fairness in taxation of property is a serious matter.⁸⁶ However, the issue receives short thrift however when it comes time for the court to examine whether the *methodology* used by property appraisers in

78. *Id.*

79. *Id.* at 119.

80. *Metrovision*, 607 A.2d 110, 118. The court relied on expert testimony from the state supervisor for personal property.

81. *Id.* at 118.

82. *Id.*

83. *Id.* at 118.

84. *See Greenshaw*, 734 P.2d 1125, 1131.

85. *See supra* note 4.

86. *See, e.g., supra* notes 27-31.

assessing property values is just and fair. All too often, the focus is at the fairly topical level of whether the appraisal method selected by the appraiser is statutorily acceptable and used in a consistent manner. Courts fail to delve into the implementation of the selected methodology to ascertain whether there are inherent flaws present, or whether the process of implementation can be shaped to suit differing policy needs.⁸⁷

An excellent example of this disparate treatment in taxation is illustrated by the opposing opinions reached in Kansas' *Greenshaw*⁸⁸ decision and South Carolina's *Crown Cork and Seal Co.*⁸⁹ decision. As discussed previously, the *Greenshaw* court concluded that the inclusion of external costs of sale for property assessment purposes was unconstitutional. The *Crown Cork and Seal* court concluded that the inclusion of such costs was permissible.⁹⁰ Yet, these two states share similar constitutional provisions for uniformity in taxation.⁹¹ These provisions have been interpreted as precluding one taxpayer from having to bear a higher tax burden than another similarly situated taxpayer.

In South Carolina, the state supreme court addressed this uniformity in taxation issue when it held that, "uniformity is obtained when property taxes are levied equally within the [taxing jurisdiction]."⁹² Due to this uniformity of taxation at the collection level, with its implicit notion of fairness to those paying the taxes, it is not required for the taxing jurisdiction to distribute the funds in a like manner; uniformity is necessary only where the moneys are collected.⁹³

Kansas also addressed the issue of uniformity but took the additional step of proclaiming that uniformity also relies on proper methodology in the valuation process. In *Addington v. Board of County Commissioners*, the state supreme court held that "uniformity in taxes implies equality in the burden of taxation, and this equality cannot exist without uniformity in the basis of assessment as well as in the rate of taxation."⁹⁴ Furthermore, in a separate opinion, the supreme court of Kansas held that, "a faulty valuation methodology which fails to achieve a constitutionally mandated standard" will not be upheld where the

87. See, e.g., *supra* notes 47-55.

88. See *supra* note 84.

89. See *supra* note 46.

90. See *supra* notes 31 and 37, respectively.

91. See *supra* notes 30 and 40.

92. *Westvaco Corp. v. South Carolina Dep't. of Revenue*, 467 S.E.2d 739, 744 (S.C. 1995) (emphasis in original).

93. *Davis v. County of Greenville*, 443 S.E.2d 383, 386 (S.C. 1994).

94. *Addington v. Bd. of County Comm'rs.*, 382 P.2d 315, 317 (Kan. 1963).

faulty methodology is nevertheless uniformly applied to all taxpayers.⁹⁵

This examination of the underlying valuation methods in order to ensure that uniformity of taxation is achieved, is a crucial step. Where the focus on uniformity is on whether the selected valuation method meets statutory guidelines, a faulty implementation of the valuation process will pass muster with the court, as it did in South Carolina.⁹⁶ However, where the court indicates a willingness to examine the underlying methodology used in accordance with the statutorily correct valuation method, errors by the property assessors will come to light, as the Kansas decision illustrates.⁹⁷

IV. CAN DEPRECIATION OR OTHER FACTORS MITIGATE THIS PROBLEM?

Depreciation comes in several forms such as physical depreciation, functional or technical obsolescence and economic obsolescence. Together, they allow for the value of a tangible asset to be reduced over time (and invariably its use), usually according to a preset timeline or table of declining value.⁹⁸ Accordingly, the taxable value of the asset is reduced over time in proportion to its declining value in the marketplace or in the production of income of the taxpayer who is reporting the asset for ad valorem tax purposes.

Physical depreciation is the most common form of all the depreciation methodologies. It is the physical wear and tear an asset incurs in its everyday use. A piece of machinery used as part of a regular production or manufacturing process would have a life expectancy associated with this use. For example, an asset with a five-year life span for depreciation purposes would be considered physically exhausted after those five years and thus have no remaining value. For property tax purposes, its ad valorem assessment should reflect this loss.

Functional obsolescence is depreciation related to design and technological changes or advances. Computer chips and associated computer hardware peripherals are a common example. Although the American Society of Appraisers separates functional from technological obsolescence, they are closely related in terms of how they affect the valuation of an asset. A common example is a new product that allows a

95. *McGraw*, 933 P.2d 698, 710 (distinguished on other grounds).

96. *See supra* notes 37-41, and 46.

97. *See supra* notes 94-95.

98. Examples of depreciation tables include those used in the Internal Revenue Code, § 168 (2001) and as adopted by the states.

manufacturer to produce goods more efficiently and at less cost than the assets they currently use in the manufacturing process.

Economic obsolescence generally occurs as a result of market forces over which a company has no control. Environmental contamination, supply and demand and other external influences can greatly determine whether an asset has value unrelated to its actual physical condition. For example, a specialized piece of machinery that produces carpet stain protectants; the determination that the stain protectant may have a causal effect in human health problems renders the market for the product obsolete. If the specialized machinery cannot be modified for another purpose, it too is rendered economically obsolete despite its actual age or physical condition.

These factors discussed above may, over time, mitigate, but not cure, the problem of excessive valuation of tangible personal property where external costs of sale are included in their respective valuations. This is because the original basis of the property still reflects these external costs. The declining value of the assets, no matter how far along the depreciation scale it may be, still reflects a basis that is premised upon an inflated value.⁹⁹

Revisiting the example first discussed in the *Greenshaw* decision, Business A returns on their property tax a value of \$1,144.87 for its first year. This value will progressively decline over the years until a residual value is reached. Business B, which owns the same asset, starts with an initial value of \$1,000 on its first property tax return. With an effective property tax rate of 2.5 percent,¹⁰⁰ Business B will pay nearly 13 percent less tax than Business A.¹⁰¹ This can amount to large sums of money when this tax rate disparity is multiplied over tens or hundreds of thousands of dollars worth of assets. Clearly, this disparity would seem to be in violation of the states' equal and uniform tax provisions as discussed previously.¹⁰²

99. Note the example used by the court in the *Greenshaw* opinion, discussed *supra*, where two taxpayers with the same asset had a difference of thirteen percent in the original basis values. See also note 30 and the following discussion.

100. National average, based on information from CCH STATE TAX REPORTER SERIES.

101. An asset with an effective tax rate of 2.5 percent will amount to \$28.62 for Business A and \$25.00 for Business B. The difference in these two final amounts results in Business B paying only 87.35 percent of the tax that Business A owes on the same asset used in the same manner and depreciated over the same ten-year period.

102. See generally *supra* notes 4 and 30.

V. CONCLUSION

Taxpayers should not be penalized, at property tax time, simply for an assessed value of property that may be significantly higher than others who own the same type of property. Currently, the permissible inclusion of external costs of sale in property valuations penalizes smaller businesses, businesses that buy production assets in-state and other taxpayers who lack the economic clout to take advantage of complicated purchasing systems.

Taxpayers seeking to contest their property valuation based on the inclusion of external costs would do well to persuade their taxing authority to adopt the analysis used in the *Greenshaw* decision.¹⁰³ The *Greenshaw* court recognized that taxpayers who purchase the same type of asset via different means may face disparate tax burdens even though the assets command similar market values.¹⁰⁴ Uncomfortable with this proposition, the court held that uniformity in taxation can only exist where true market values are returned, absent external costs of sale.¹⁰⁵

Other states would do well to adopt a similar conclusion when faced with this issue. The states that have already addressed this issue (South Carolina, California, Maryland and Colorado) may wish to reconsider their decisions, especially in light of the adverse economic consequences that may result. If not, savvy manufacturers may capitalize on this difference in taxable values when it comes time to relocate or expand capital-intensive production facilities.

103. See generally *supra* note 31.

104. See, generally *supra* note 31.

105. *Greenshaw*, 734 P.2d 1125, 1131.