[Bond Case Briefs]

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TAX - MINNESOTA

[Minnesota Energy Resources Corp. v. Commissioner of Revenue]

Supreme Court of Minnesota - November 9, 2016 - N.W.2d - 2016 WL 6635550

Taxpayer, a natural gas utility, sought judicial review of determination by Commissioner of Revenue valuing its natural-gas pipeline distribution system for purposes of taxing personal property.

The Tax Court reduced valuation and ordered recalculation of tax liability. Taxpayer and Commissioner appealed.

The Supreme Court of Minnesota held that:

- Evidence supported Tax Court's exclusion of company-specific risk factor in calculating taxpayer's cost of equity;
- Tax Court failed to adequately explain its determination of beta factors used in calculating taxpayer's cost of equity, thus requiring remand for further explanation;
- Evidence supported Tax Court's rejection of build-up method of calculating taxpayer's cost of equity;
- General evidentiary principles, rather than heightened standard, applied to determination of whether taxpayer demonstrated external obsolescence, abrogating *Guardian Energy, LLC v. Cty. of Waseca*, 2014 WL 7476215, *Am. Crystal Sugar Co. v. Cty. of Polk*, 2009 WL 2431376;
- Taxpayer's intangible assets and working capital were exempt from taxation;
- Taxpayer acted within its discretion in deviating from formula for making specific deductions under regulation;
- Evidence supported Tax Court's use of 5% deductions for working capital and intangible assets; and
- Tax Court did not clearly err in declining to consider prior sale when estimating market value of system.

Tax Court's decision to exclude company-specific risk factor from its calculation of cost of equity for taxpayer, a natural-gas utility, as a component used to calculate value of pipeline distribution system under income approach to valuation of system for purposes of taxing personal property, was factual determination subject to clear error standard of review, not legal issue subject to de novo standard of review. Tax Court excluded company-specific risk factor from taxpayer's cost of equity based on lack of evidentiary support in record for proposition that taxpayer's business was riskier than the market, not because it determined, as a matter of law, that a regulated entity's cost of equity could never be augmented to account for additional risk.

Evidence supported Tax Court's exclusion of company-specific risk factors from calculation of cost of equity for taxpayer, a natural-gas utility, as component used to calculate value of pipeline distribution system under income approach for purposes of taxing personal property, though taxpayer's expert appraiser opined that addition of risk factor to cost of equity for small, undiversified firms was appropriate based on business valuation publication. Independent appraiser testified that there was no conclusive empirical evidence supporting risk premium, and Department of Revenue's employee largely agreed with independent appraiser, stating that he had not seen support for application of additional risk factor other than one relied on by taxpayer's expert.

Tax Court, in calculating taxpayer's cost of equity, as component used to calculate value of taxpayer's natural gas pipeline distribution system under income approach for purposes of taxing personal property, failed to adequately explain adoption of beta factor of less than one to account for relative volatility of specific investment compared to volatility of market as whole, and thus remand was warranted for further explanation. Other than stating that beta factor was less than one for each tax year in question, Tax Court did not specify value of beta factors it used for each year, much less explain how or why it selected them.

Evidence supported Tax Court's decision to reject build-up method of calculating cost of equity for taxpayer, a natural-gas utility, as component used to calculate value of pipeline distribution system under income approach to valuation for purposes of taxing personal property, though taxpayer's expert incorporated build-up method into his calculation. Independent appraiser identified problems with use of build-up method by taxpayer's appraiser, and nothing relied on by taxpayer contradicted independent appraiser's testimony regarding appropriate use of build-up method.

General evidentiary principles, rather than heightened standard requiring taxpayer claiming external obsolescence for natural gas pipeline distribution system to offer probative evidence of cause of claimed obsolescence, quantity of obsolescence, and that asserted cause of obsolescence actual affected subject property, applied to determination of whether system suffered from external obsolescence, so as to support downward adjustment to estimated value of system under cost approach to valuation for purposes of taxing personal property. Fact that taxpayer could not identify specific causes of external obsolescence and precisely calculate contribution of each to decreased revenues or profit margins did not mean that property did not suffer from external obsolescence, and external obsolescence could exist and be difficult to quantify, resulting in variation amongst experts in their estimation of impact of external factors on fair market value of certain properties; abrogating *Guardian Energy, LLC v. Cty. of Waseca*, 2014 WL 7476215; *Am. Crystal Sugar Co. v. Cty. of Polk*, 2009 WL 2431376.

Intangible property, including intangible assets and working capital, of taxpayer, a natural-gas utility, was not subject to tax as personal property under statute and relevant regulations granting Commissioner authority to tax pipeline systems' mains, pipes, and equipment attached thereto, and thus was required to be deducted from valuation of taxpayer's pipeline distribution system under income approach for valuation of property, though Commissioner of Revenue asserted intangible assets and working capital were taxable as reflecting going-concern value of property. Statute and relevant regulations allowed Commissioner to tax only tangible property, and deduction for intangible assets did not reduce taxpayer's going-concern value.

Tax Court, in determining valuation of taxpayer's natural gas pipeline distribution system under income approach for purposes of taxing personal property, acted within its discretion in making specific deductions for value of taxpayer's nonoperating and tax-exempt property, namely deductions of 5% for working capital and 5% for intangible assets, from income indicators of value, rather than following process set forth in regulations and making deductions after each indicators of value had been considered and weighed in calculating property's unit value, since regulations allowed for exercise of discretion when deviating from formula would lead to more accurate valuation.

Tax Court did not clearly err when it declined to consider prior sale of natural gas pipeline distribution system to taxpayer in calculating estimated value of system under market approach for valuing pipeline for purposes of taxing personal property. Taxpayer's purchase did not just include system, purchase price captured overall value of entire enterprise, including intangible assets, goodwill, investments, and working capital, some of which was nontaxable, as well as appliance-repair business that was completely separate from system, trial court was authorized to reject market approach after determining it was unreliable and unhelpful, and experts did not rely on market approach or sale in their valuation analyses.