

Minnesota Attorney General: Administrative Rules Proceedings

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Version 3
August 20, 2018

Our File 577
Jerry

Permanent Rule_____

Temporary Rule X

RULES REVIEW CHECKLIST

DATE RULES RECEIVED 2/28/80 DUE DATE 3/6/80

Resubmitted and Received_____

a. Returned to Agency w/o Filing w/Secretary of State 3/3
b. Approved_____Date Sent Back to Agency_____

- -

1. Rules as Adopted_____

2. Rules as Proposed_____

3. Certificate of Board's
Authorizing Resolution, where applicable_____

4. Order for Hearing_____

5. Notice of Hearing_____
Sufficiency_____

6. Secretary of State's List_____(one copy only)

7. Certificate of Acquisition of
Secretary of State's List_____

8. Secretary of State's Certification of Delivery
of Secretary of State's List to Agency_____

9. Affidavit of Mailing_____
At least 30 days prior to hearing_____

10. Publication in State Register_____
At least 30 days prior to hearing_____

11. Statement of Need and Evidence_____

12. Hearing Examiner's Report_____

13. Agency's Findings of Fact_____

14. Certificate of Board's Resolution
Adopting Rules, where applicable_____

15. Order Adopting_____

16. Report of Chief Hearing Examiner_____

17. Order Approving Incorporation by Reference,
where applicable_____

18. Certificate of Compliance with Rulemaking Procedures_____

19. Copy of Notice of Intent to Solicit Outside Opinion,
where applicable_____

20. Petition by Public, where applicable_____

Our File: 577

ATTORNEY GENERAL

DOROTHY A. McCLUNG
Research Attorney
Department of Revenue

March 3, 1980

JERRY S. ANDERSON
Special Assistant
Attorney General

296-1288

Temporary Rules Governing Assessment of Railroad Property

As we discussed, the rules in the above-captioned matter have not been approved by this office for the following reasons.

1. In § 1.0023 A., the statement that "[m]uch of the data used in the evaluation, allocation and apportionment process will be drawn from reports submitted to the Department" suggests that some data will be obtained from unstated sources. Minn. Stat. § 15.0412, Subd. 3 (1978), however, requires an agency to establish by rule "every agency statement of general applicability and future effect." (Emphasis added.) Clearly, all of the data that will be used in the subject determination are "agency statement[s] of general applicability and future effect" and must be established by rule, but the way that the rule is phrased presently permits the agency to require or consider data in an ad hoc fashion. While the rule need not set forth explicitly all possible information or reports that might be considered, to the extent possible the rule should state the other types of data that might be considered and the instances or purposes under which such data will be required.

2. The use of the word "may" in § 1.0023 B. permits the Commissioner to grant or to deny applications for extension and to consider unstated criteria in that decision. Similar to the above discussion, a rule must provide for predictability and nondiscriminatory action by stating explicitly the criteria on which such a decision will be based. Apparently, however, what is intended is that all applications for extension will be approved; therefore, the "may" should be changed to "shall."

Upon consideration of the issues raised in this memorandum, and any subsequent action taken by the Department on these rules, three (3) copies of the rules as amended and the new Order Adopting said rules may be resubmitted to this office. Please contact me if you have any questions regarding this matter.

JSA/bw
Encl.
cc: Duane Harves
Susan Robertson

Attachment A
AG Work Copy

Department of Revenue

Ad Valorem Tax ~~Regulations~~ Rules

Chapter Two: Valuation and Assessment of Railroads

13 MCAR §1.0021 General Procedures. The 1979 Minnesota Legislature included in its Omnibus Tax Bill a Section, Article VII, dealing with the taxation of railroads. The article provides for an ad valorem tax on railroads in place of the gross earnings tax. The Article also charges the Commissioner of Revenue with the responsibility of developing rules ~~and regulations~~, both temporary and permanent, which will implement the provisions of the law dealing with the ad valorem method of taxing railroads.

The first valuation of railroad operating property will be made for the assessment year 1979. No apportionment of value to the local taxing districts will be made until 1981 for ad valorem taxes payable in 1982.

The methods, procedures, indicators of value, capitalization rates, weighting percents, allocation factors and apportionment standards will be used as described in this chapter for 1979 and subsequent years, or until in the opinion of the Commissioner of Revenue, circumstances or changes in condition justify a change.

13 MCAR §1.0022 Definitions. As used in this chapter, the following words, terms and phrases shall have the meanings given to them by this ~~regulation~~ rule, except when the content clearly indicates a different meaning. Some of the words, terms and phrases listed below are defined by statute but are included here for completeness.

A. Allocation --- the process of dividing the unit value of a railroad company among the states in which the railroad operates.

B. Apportionment --- the process of distributing that portion of the railroad's unit value which has been allocated to Minnesota after deducting exempt and non-operating property to the various taxing districts in which the railroad company operates.

C. Book depreciation --- the depreciation shown by a railroad company on its corporate books, and allowed the company by the Interstate Commerce Commission.

D. Capitalization rate --- an anticipated rate of return from an investment; a rate at which income is processed (capitalized) to indicate the probable capital value. This rate is usually expressed as a percentage.

E. Exempt property --- property which is non-taxable for ad valorem tax purposes by statutes. Examples of such property are approved pollution control equipment for which an exemption has been granted, and personal property such as office furniture and licensed vehicles.

F. Non-operating property --- all property owned by a railroad company which does not fall under the definition of operating property. Nonoperating property shall include real property which is leased or rented or available for lease or rent to any person which is not a railroad company. Vacant land shall be presumed to be available for lease or rent if it has not been used as operating property for a period of one year preceding the valuation date. It shall also include land

which is not necessary and intregal to the performance of railroad transportation services and which is not used on a regular and continual basis in the performance of these services. This property shall be valued by the local or county assessor rather than by the Commissioner of Revenue.

G. Operating property --- all property owned or used on a regular basis by a railroad company in the performance of railroad transportation services, including without limitation franchises, rights-of-way, bridge trestles, shops, docks, wharves, buildings and structures.

H. Original Cost --- the amount paid for an asset as recorded on the railroad's books in accordance with ICC accounting rules and regulations.

I. Railroad Company --- any company which as a common carrier operates a railroad or a line or lines of railway situated within or partly within Minnesota.

J. System --- the total tangible property, real and personal, of a company which is used in its railroad operations in all states in which it operates.

K. Unit value --- the value of the system of a railroad company taken as a whole without any regard to the value of its component parts.

L. Weighting --- the confidence or reliability given to a factor or indicator. It is usually expressed as a portion of 100%.

13 MCAR §1.0023 Reports Required.

A. ~~Much of~~ The data used in the valuation, allocation and apportionment processes will be drawn from reports submitted to the Department of Revenue by the railroad companies. These reports are to be filed with the Commissioner on or before April 30 of each year and shall include:

1. The Minnesota Department of Revenue Annual Railroad Report.

2. Annual Report to the Interstate Commerce Commission (ICC).

3. Annual Report to the Minnesota Public Service Commission (P.S.C.)

4. Annual Stockholders Report.

B. Periodic examination of the supporting data for these reports will be made by the Department of Revenue. The Commissioner may, upon written application from the railroad, extend the filing date 30 days.

C. In the event any railroad company shall fail to file the required reports, the Commissioner shall make a valuation according to his best judgment based on available information.

13 MCAR §1.0024 Valuation.

A. General: The Minnesota Legislature has specified that railroads must be valued using the unit basis of estimating value. The approaches to value which will be used in determining the estimated unit value of railroad operating property are cost, capitalized income, and stock and debt except as provided for in 13 MCAR §1.0024, D and F. It is the decision of the Commissioner of Revenue that for 1979 and subsequent years, until economic or technological factors dictate a change, the value of railroad property will be determined using these three approaches to value, where applicable, in the manner provided for in this section.

B. Cost approach to valuation. The cost factor that will be considered in the railroad valuation method is the original cost of the railroad system, plus the original cost of construction work in progress on the assessment date. The railroad system shall be considered to be made up of the following I.C.C. accounts: all road and equipment accounts, all general expenditures and other elements of investment accounts, and railroad property owned but leased to others. As required by statute, no depreciation or obsolescence shall be allowed as a deduction from the original cost of the railroad's assets enumerated above.

The following is an example of how the cost indicator of value is to be computed:

XYZ Railroad

Account	Amount
Road	$13,000,000
Equipment	9,000,000
Construction Work in Progress	1,000,000
Leased Property	500,000
General Expenditures	1,500,000
Cost Indicator of Value	$25,000,000

This cost indicator of value computed in accordance with this regulation will bear a weighting of 25 percent of the total unit value estimate of the railroad's property, except in the case of bankrupt railroads, or railroads with no income to be capitalized as provided for in 13 MCAR §1.0024, F.

C. Income approach to valuation. The income indicator of value will be calculated by averaging the Net Railway Operating Income (as defined by the I.C.C.) of the railroad for the most recent five years preceding the assessment. This average income shall be capitalized by applying to it a capitalization rate which will be computed by using the Band of Investment Method. This method will consider:

1. The capital structure of railroads.
2. The cost of debt or interest rate paying particular attention to imbedded debt of railroads.
3. The yield on preferred stock of railroads.
4. The yield on common stock of railroads.

For 1979 and subsequent years this capitalization rate will be 11%. This rate will be effective until in the opinion of the Commissioner economic conditions such as rates of return, interest rates, and risk factors change in such a manner as to effect the above mentioned capitalization rate. At such time the Commissioner will institute the proper rule making procedures necessary to effect a change in the capitalization rate.

An example of a computation of the capitalized income approach to value is as follows:

XYZ Railroad

Net Railway Operating Income

1974	$1,500,000
1975	2,000,000
1976	2,600,000
1977	3,001,000
1978	2,600,250
Total	$11,701,250
Average	$ 2,340,250

Five year average Net Railway Operating Income Capitalized at 11% (2,340,250 ÷ 11%) equals $21,275,000.

The income indicator of value computed in accordance with this regulation will be weighted 50 percent of the total estimated unit value of the railroad's property except in the case of bankrupt railroads or railroads have no net operating income as provided for in 13 MCAR §1.0024, F; and railroads not meeting the requirements for the use of the stock and debt indicator of value. Where no stock and debt indicator of value is used the income indicator will be weighted 75%.

D. Stock and Debt approach to valuation. The "Stock and Debt" approach to value is the third method which will be used to estimate the unit value of the railroad operating property. This approach to value is based on the accounting principle: Assets = Liabilities + Equity. Therefore, when the value of a company's liabilities (debt) is found and this added to the worth of its stock, a value can be established for its assets (property).

The use of this approach to value will be limited to only those railroads meeting certain qualifications listed below:

1. The stock of the railroad must be traded on a recognized stock exchange.

2. The bonds of the railroad must be traded or have a rating by a recognized financial rating service.

3. If the railroad is part of a diversified company the value of the railroad portion of the total stock prices must be able to be separated on an earnings basis.

For example if a railroad is part of a conglomerate whose stock sells at $100 per share and 50% of the net earnings of the conglomerate are from railroad operations then the value of the railroad's portion of the stock is $50 per share.

If a railroad has no net earnings, making it impossible to separate the stock value into its parts, then the stock and debt indicator of value will not be used.

The value of the stock used in the stock and debt method shall be an average of the month ending stock prices for the twelve months immediately preceding the assessment date. The value of the bonds, equipment obligations and conditional sales contracts and other long term debts

shall also be an average of the cost of money quotes for the twelve months immediately preceding the assessment date. The source for these stock and bond prices shall be Standard and Poor's Stockguide, or other applicable financial service.

An illustration of a computation of the stock and debt approach to value is as follows:

XYZ Railroad Company

Shares of Common Stock issued x Average price for preceeding year	1,000,000 x $12 = $12,000,000
Shares of Preferred Stock x Average price for preceeding year	100,000 x $15 = $ 1,500,000
Rate and face value of bonds x Average price for class of bonds for preceeding year	
A rated 8% bonds $10,000,000 x 99% of par =	$ 9,900,000
Stock and Debt Indicator of Value	$23,400,000

After the gross stock and debt indicator of value has been computed an allowance will be made for the effect, if any, of revenue from other than railway operations included in this indicator of value. This allowance shall be based on the ratio of a five year average of Net Revenue from Railway Operations, as defined by the I.C.C., to a similar five year average of Income Available for Fixed Charges as defined by the I.C.C. The five year average will be the most recent five years preceding the assessment date.

An example of this computation is as follows:

XYZ Railroad Company

	Net Revenue from Railway Operations	Income Available for Fixed Charges
1974	$ 3,000,000	$ 3,500,000
1975	4,000,000	4,300,000
1976	5,200,000	5,700,000
1977	6,000,000	6,800,000
1978	5,200,000	5,400,000
	$ 23,400,000	$25,700,000
Average	$ 4,680,000	$ 5,140,000

Ratio $4,680,000 ÷ $5,140,000 = 91%

Gross Stock and Debt Indicator of Value	$23,400,000
Ratio of Operating to Non-Carrier Earnings	91%
Net Stock and Debt Indicator of Value	$21,300,000

The stock and debt indicator of value computed in accordance with this regulation will bear a weighting of 25 percent of the total unit value of the railroad's property, except in the case of bankrupt railroads, or railroads with no income to be capitalized as provided for in 13 MCAR §1.0024, F.

E. Unit Value Computation. The estimated unit value of the railroad property will be the total of the three weighted indicators of value.

The following is an example of the computation of the unit value.

XYZ Railroad

Valuation Approach	Value		Weighting	
Cost indicator of value	$25,000,000		25%	6,250,000
Income indicator of value	21,275,000	x	50%	10,637,500
Stock and debt indicator of value	21,300,000		25%	5,325,000
			Unit Value	$22,212,500

The weighting shown above may vary from railroad to railroad, as provided for in 13 MCAR § 1.0024 B, C, and D, depending on the conditions and circumstances involved in each valuation. For example a railroad with no outstanding stock would not have a computation for a stock and debt indicator of value, and therefore the income indicator of value would be weighted 75%.

F. Railroads Operating at a Loss and Bankrupt Railroads. Railroads which are involved in bankruptcy proceedings, or railroads having no net railway operating income will be valued using whatever indicators of value are workable. If the stock or bonds of such railroads are not traded, or do not meet the other requirements for use of the stock and debt indicator of value then these railroads will be valued using the cost approach to value only.

13 MCAR §1.0025 Allocation.

A. General. After the estimated unit value of the railroad property has been determined, the portion of value which is attributable to Minnesota must be established. This is accomplished through the use of certain allocation factors. Each of the factors in the allocation method shows a relationship between the railroad system operations in all states and its Minnesota operations. These relationships are expressed in a percentage figure. These percentages are then added and an average is computed. The resulting average of the factors, multiplied by the unit value, yields the Minnesota portion of the railroad property which will, after the adjustments described in §1.0025, be subject to ad valorem tax in the State of Minnesota.

B. Allocation Factors. The factors to be considered in making allocations of unit values to Minnesota for railroad companies are:

1. Miles of railroad track operated in Minnesota divided by miles of railroad track operated in all states.

2. Ton miles of revenue freight transported in Minnesota divided by ton miles of revenue freight transported in all states.

3. Gross revenues from transportation operations within Minnesota divided by gross revenues from transportation operations in all states.

4. Original cost of road property in Minnesota divided by the original cost of road property in all states.

The following example illustrates the allocation method to be applied to the unit value of railroad property.

XYZ Railroad

Minnesota miles of track / Total miles of track	100 / 500	= 20%
Minnesota ton miles of revenue freight / Total ton miles of revenue freight	2,200,000 / 9,000,000	= 24%
Minnesota gross transportation revenue / Total gross transportation revenues	$10,000,000 / $40,000,000	= 25%
Minnesota Cost of Road Property / Total Cost of Road Property	2,990,000 / 13,000,000	= 23%
Total		92%
Minnesota Percent of Unit Value		23%

Total Unit Value ($22,212,500) x
Minnesota Percent (23%) = Minnesota Portion of Unit Value $5,108,875

13 MCAR § 1.0026 Adjustments for non-formula assessed property or exempt property. After the Minnesota portion of the unit value of the railroad company is determined property which is either exempt from taxation, such as pollution control equipment and personal property, or classified as non-operating will be deducted from the Minnesota portion of the unit value to the extent that it has been included in the computation of this value.

Property which has been included in the computation of the unit value but has been defined as non-operating property will be valued by the local assessor. The Minnesota portion of the unit value will be reduced by the original cost of this property. Only non-operating property located within the State of Minnesota will be eligible for this exclusion.

The railroad company shall have the responsibility to submit to the Commissioner of Revenue, in the form required by the Commissioner, such schedules of non-operating property as he may require.

In addition to non-operating property which will be valued and assessed locally a deduction from the Minnesota portion of the unit value will be made for personal property. The unit value method presupposes that the value of any one portion of the unit is interdependent upon all other elements of the unit; therefore, it is extremely difficult to make a separation of this value into real and personal property.

B/c of this difficulty

A percentage of the Minnesota portion of the unit value after deducting non-operating and exempt property will be excluded as personal property. This percentage will be computed in the following way:

The following I.C.C. accounts for property within Minnesota will be totaled:

That portion of coal and ore wharves determined to be personal property less applicable depreciation;

Communication equipment less applicable depreciation;

Roadway machines less applicable depreciation;

Shop machinery less applicable depreciation;

Power plant machines less applicable depreciation;

Equipment, allocated to Minnesota on the basis of car and locomotive miles in Minnesota compared to total system car and locomotive miles, less applicable depreciation.

The total of these accounts will then be divided by the total of the Minnesota road, equipment, leased property, general expenditures, construction work in progress, and other elements of investment accounts; all less applicable depreciation. The resulting percentage will be used to determine the personal property amount of the Minnesota portion of the unit value. This portion will not be taxable for ad valorem purposes.

The following is an illustration of the computation for the personal property exclusion.

XYZ Railway

Personal Property Account	Amount in Minnesota	Depreciation	Net Amount in Minnesota
Coal & Ore Wharves	$ 500,000	$ 250,000	$ 250,000
Communication Equip.	100,000	50,000	50,000
Roadway Machines	200,000	100,000	100,000
Shop Machinery	100,000	50,000	50,000
Power Plant Machinery	500,000	203,000	297,000
Equipment*	2,250,000	1,250,000	1,000,000
			1,747,000

*Total Equipment Account	$9,000,000
Car and Locomotive Miles in Minnesota	1,000,000
Total Car and Locomotive Miles	4,000,000
Ratio of Minnesota to Total	25%
Minnesota Allocated Equipment Account	$2,250,000

Cost Account	Amount in Minnesota	Depreciation	Net Amount in Minnesota
Road	$2,990,000	$1,400,000	$1,590,000
Equipment	2,250,000	1,250,000	1,000,000
C.W.I.P.	800,000	-	800,000
General Expenditures	500,000	250,000	250,000
			$3,640,000

Minnesota Depreciated Personal Property Accounts	$1,747,000
Minnesota Depreciated Cost	$3,640,000
Ratio of Personal Property to Cost	48%

Minnesota portion of unit value	5,108,875
Personal Property exclusion at 48%	2,452,260
Taxable Minnesota Portion of Unit Value	$2,656,615

SP:N

ADMIN 1000 (Rev. 1/78)
SF-00006-01

STATE OF MINNESOTA

DEPARTMENT REVENUE

Office Memorandum

TO : JEAN HINDERAKER
Special Assistant Attorney General

DATE: 2/28/80

FROM : DOROTHY A. McCLUNG
Research Attorney

PHONE: 6-1022

SUBJECT: TEMPORARY RULES GOVERNING ASSESSMENT OF RAILROAD PROPERTY

Attached are three copies of the Order Adopting Rules, comments on the rules, and the Department's response to the comments.

If you have any questions, please call me or Jerry Garski. Jerry's number is 6-5134.

DAM:lmm

cc: Jerry Garski

Attachments

STATE OF MINNESOTA

DEPARTMENT OF REVENUE

IN THE MATTER OF THE PROPOSED ADOPTION OF RULES OF THE DEPARTMENT OF REVENUE GOVERNING THE VALUATION AND ASSESSMENT OF RAILROAD OPERATING PROPERTY.	ORDER ADOPTING RULES

Pursuant to Minnesota Statutes, 1979 Supplement, Section 270.81, Subdivision 5, a Notice of Intent to Solicit Outside Opinions was published in the State Register on June 18, 1979 (3 S.R. 225 3).

Following the publication of that Notice, public meetings were held to explore possible methods of valuing railroad operating property in Minnesota for ad valorem tax purposes. As a result of these meetings, temporary rules were drafted by the Department.

The attached temporary rules (attachment A) were published in the State Register on January 21, 1980 (4 S.R. 1169). The public comments which were received by the Department (attachments B and C) were considered and were further commented on by the Department (attachment D).

NOW, THEREFORE, IT IS ORDERED that the proposed temporary rules identified as Rules of the Department of Revenue Governing the Valuation and Assessment of Railroad Operating Property as published are adopted this 27th day of February, 1980, pursuant to authority vested in me by Minnesota Statutes, 1979 Supplement, Section 270.81, Subdivision 5.

STATE OF MINNESOTA

Clyde E. Allen Jr

CLYDE E. ALLEN, JR.
Commissioner of Revenue

Attachment B.

REVENUE
MAILROOM

FEB 11 1980

Grand Trunk Western Railroad Co

131 West Lafayette Boulevard
Detroit, Michigan 48226

February 7, 1980

Mr. Gerald Garski
Manager
State Assessed Property
Property Equalization Division
Department of Revenue
Centennial Office Building
St. Paul, Minnesota 55145

Dear Mr. Garski:

The Duluth, Winnipeg & Pacific Railway Company respectfully dissents from the imposition of the temporary rules, as presently drafted, governing the valuation and assessment of railroads for ad valorem tax purposes. The basis of this position is that certain portions of the rules are contrary to the Minnesota Tax Reform Act enacted in 1979. Moreover, these aspects of the rules would impose a discriminatory tax burden on railroads contrary to the mandates of the Railroad Revitalization and Regulatory Reform Act of 1976 ("the 4-R Act").

It must be recognized that the present draft creates an excellent framework from which to build the temporary and final rules. It serves to make a great deal of headway into a tremendously complex area by outlining factors to be used to arrive at a unit value of railroads, allocating that value to Minnesota and starting the process of determining the portion of the value which is due to non exempt property. However, certain aspects of the proposed rules need to be developed to comply with the Legislative guidelines noted above.

Specifically, the rules' lack of flexibility and use of a fixed capitalization rate results in the valuation of most, if not all, of the railroads being significantly at variance with the companies' true fair market value. Moreover, under these proposed guidelines, the railroads will be taxed,in part, on the value attributable to some of their personal property which, by law, should be exempt.

I. Legislative Mandates

A. The Proposed Rules Are Contrary to the Minnesota Railroad

In Section 280.84 subd. 1 of the Railroad Tax Reform Act, the Minnesota Legislature has required that "(t) he commissioneer shall...make a determination of the fair market value of the operating property of every railroad company doing business in this state..."(emphasis added). It is respectfully submitted that the proposed rules, by using an inflexible approach to income and assets, coupled with a single mandatory rate for capitalizing income, is unable to fulfill the statutory directive.

In Section 270.81 subd. 4, the Legislature has further mandated that "(i)n no event shall property owned or used by a railroad...be subject to tax hereunder unless such property is of a character which would otherwise be subject to tax under provision of Minnesota Statutes Chapter 272." In pertinent part, Chapter 272 exempts personal property from the tax levy.

This exemption includes"...tools, implements, machinery, and equipment attached to or installed in real property for use in the business or production activity conducted thereon..." Section 272.03 subd.(c)(i). It is submitted that the proposed rules give inadequate recognition to the contribution of the exempt property to the calculated unit value of the railroad. Thus, the rules effectively create a taxable value of the railroads which includes the value of exempt property; thereby taxing the exempt property in contravention of the legislative mandate of Section 270.81 subd 4.

B. The Proposed Rules Are Contrary to the Directives of the Railroad Revitalization and Regulatory Reform Act of 1976

In Section 306 of the 4-R Act Congress set out mandatory national guidelines on the taxation of railroads. In so doing it has directed that:

> It is unlawful for a State...or person acting on behalf of such State... to commit any of the following prohibited acts:
>
> (a) The assessment...for purposes of a property tax levied by any taxing district, of transportation property at a value which bears higher ratio to the true market value of such transportation property than the ratio which the assessed value of all commercial and industrial property in the same assessment jurisdicition bears to the true market value of all such other commercial and industrial property.
>
> (b) The levy or collection of any tax on an assessment which is unlawful under subdivision (a).
>
> (c) The levy or collection of any ad valorem property tax on transportation property at a tax rate higher than the tax rate generally applicable to commercial and industrial property in the same assessment jurisdiction.
>
> (d) ....

It is submitted that the inflexibility of the proposed rules in regard to assets and income to be capitalized in calculating the value of a railroad, coupled with the utilization of a rigid average capitalization rate must result in many railroads' calculated value for tax purposes being far in excess of their true market value. This in turn, must result in an assessed value of the property which bears a higher ratio to the true value than the ratio of assessed to true value for other industrial and commercial taxpayers. This is contrary to the Congressional mandate of the 4-R Act. Moreover it is submitted that the rules' inadequate recognition of the value given a railroad by its personal property further places an impermissable tax burden on railroads by effectively taxing them on property on which other commercial and industrial enjoy an exemption.

II. Analysis of the Proposed Rules

A. Purpose of the Proposed Rules

Before dealing with the specific problems created by the proposed rules, it is of value to place in perspective what their purpose is. In the ordinary situation the property tax is levied on each piece of property individually. This is accomplished by analyzing the nature, location, etc., of the property and finding the recent sales of comparable pieces of property. The comparable transactions are then analyzed to make the appropriate adjustments so they can be used to determine the value of the property in question.

In the railroad industry this method has proven impractical. The components of a rail-

road are too interrelated to permit the valuation of a piece or portion of the whole on its own. Moreover, there are little or no comparable sales available from which to extrapolate the valuation of the property.

Recognizing this problem the Legislature has directed that "...the commissioner shall value the operating property as a unit..." Section 270.84 subd 1. (emphasis added) ' The key here is the requirement that the valuation be of each railroad's taxable property as a whole. This encompasses only that tangible property which is subject to taxation. Thus, any valuation method must be able to demonstrate the true value of the taxable property of the particular railroad being valued. This concept does not allow the value subject to tax to reflect any worth not transferable as part of the taxable property. Nor does it permit a method which doesn't reflect that property's true value. Nor does it permit a value which includes worth attributable to exempt property.

B. A Set Capitalization Rate is an Improper Tool for Valuing Differing Property

In section 2.0004, C. the proposed rules state that a method of valuing the taxable property is to capitalize the average of the previous five years' net railway operating income. In determining the rate for this capitalization the rules say the following factors will be considered:

1. The capital structure of railroads.

2. The cost of debt or interest rate paying particular attention to imbedded debt of railroads.

3. The yield on preferred stock of railroads.

4. The yield on common stock of railroads.

Using these guidelines the proposed rules mandate an 11% capitalization rate for all railroads. The calculation of this figure used a debt: equity ratio of 55:45 based on an averag for a ten year period ending in 1977. It then applied a 7.21% cost of money based upon an average yield or bonds measured over a fifteen year period ending in 1977. The cost of equity, 15.23%, was a combination of dividend per share yield plus the percentage increase in earnings per share averaged over a five year period ending in 1977.

Without getting into the argument that the use of imbedded gives added value to property that is not transferable as true value of the asset, the calculation of the capitalization rate given is still questionable. The use of three different periods of time over which the components of the rate are calculated gets into the arena of "comparing apples and oranges" This problem is further exacerbated when it is recognized that the period over which the average is made is already two years old. Yet, in spite of the recent dramatic changes in such factors as the cost of money, the rate calculated, using this already outdated and non comparable information, is set in the proposed rules for an indefinite period.

Another significant problem is applying this calculated rate to all railroads. Assuming the rate were valid for the average railroad, (an assumption with which we do not agree) it cannot be applied to all railroads without creating dramatic distortions in value. An excellent example is the Duluth, Winnipeg & Pacific Railway. This company has virtually no debt. Yet, the proposed rules would apply a capitalization rate to the DWP which assumes it to have a 55:45 debt: equity ratio. This fact must, by definition, overstate DWP's value by nearly 40% under the guidelines in the proposed rules. Moreover, the set rate doesn't consider other factors such as risk potential in a particular railroad. To use such a single rate would be analagous to valuing all buildings according to their square footage without giving consideration to such factors as use, age, location and construction.

Thus, it is submitted that the information used for calculating the capitalization rate is outdated and the method is inconsistent. Consequently the use of the rate cannot"... make a determination of the fair market value of...operating property..." (emphasis added) Section 270.84 subd. 1. Moreover, the use of the single rate for all railroads, without recognition of the unique factors attributable to the varied properties, makes it impossible that the proposed rules follow the mandate to"...make a determination of the fair market value of the operating property of every railroad company..." (emphasis added) Section 270.84 subd. 1, supra.

It must also be recognized that the use of this fixed capitalization rate, by overstating the value of the property, creates an assessment which has a higher ratio to the individual property's true market value than the comparable ratio of other commercial and industrial property. This is a violation of the 4-R Act.

C. Flexibility in Determining the Income to be Capitalized is Necessary

In Section 2.004 C., the proposed rules state that the income to be used in the capitalization is "...Net Railway Operating Income (as defined by the ICC)..." This point is a valid starting position in the calculation. However, as with the capitalization rate, there is too little flexibility within the proposed rules.

The income stream being capitalized must be analyzed to determine that it properly reflects the value of the property to be taxed. After all, that is what the function of the capitalized income is to be. In some instances, such as when a company has elected to defer maintenance, this income stream will be too high. This, in turn, will cause the valuation being too high, with the result that the rules violate the mandates of the Tax Reform Act and 4-R Act.

D. Value Attributable to Exempt Property is Being Taxed

Under the proposed rules a portion of the value of the railroad as a whole is allocated to Minnesota. This value is then lessened by a percentage which purports to set the portion of the Minnesota value which is attributable to the exempt personal property. This is accomplished by taking the depreciated value of the following accounts attributable to Minnesota:

1. Personal property portion of coal and ore wharves.

2. Communication equipment

3. Roadway machines

4. Shop machines

5. Power plant machines

6. Equipment

This value is divided by the depreciated value attributable to Minnesota road, equipment, leased property (leased to others) general expenditures, construction work in progress and other elements of investment accounts. The result is considered to be the portion of the Minnesota value attributable to the exempt personal property.

It is submitted that this percentage inadequately reflects the value attributable to the exempt personal property. First, certain accounts which are exempt from tax and which have contributed to the value of the property under the proposed rules are not part of the exclusion percentage.

For example, materials and supplies, which are clearly exempt personal property, contribute to the value of the railroad as a whole. However, these assets are not included in the exemption exclusion. Other accounts have assets which would be personal property except for the fact that they are attached to or installed in real property. These items under Minnesota laws Section 272, including 272.03 noted above, are exempt from taxation to other commercial and industrial taxpayers. Consequently under Section 270.81 subd 4, supra, and the 4-R Act these accounts must likewise be exempt from railroad ad valorem taxation. These include ties, rail, other track material, ballast and signals and interlockers.

Secondly, many railroads lease their equipment from others. It is without question that this leased equipment contributes to the railroads' Net Railway Operating Income. For example, the Duluth, Winnipeg & Pacific Railway leases almost all of its rolling stock. Without these assets the company could not function, let alone be profitable. Yet, these items of exempt personal property are not part of the exclusion percentage. Again, this has the effect of taxing exempt property in contravention of the mandates of the Minnesota Legislature and the 4-R Act.

Finally, it seems incongruous to value a railroad at original cost and then say that the portion of that value attributable to exempt property should be calculated using depreciated cost. This again gets into the realm of "apples and oranges". The rules should be consistent so that the value of the exempt property as reflected in the total value of the railroad can be excluded from tax.

III. Conclusion

It is respectfully submitted that the proposed rules should not be enacted as drafted. The use of inflexible income with a set capitalization rate, which is based on inconsistent and outdated information results in a distortion of the value of most, if not all railroads. This in turn is contrary to the legislative guidelines the Minnesota Legislature has given the Commissioner and is a violation of the 4-R Act.

Moreover, the effect of the proposed rules is to tax railroads on exempt property. Again, this violates the legal requirements of the Tax Reform Act and the 4-R Act.

It is submitted that the proposed rules should give guidelines, and factors to consider, in setting a capitalization rate. However, the rules must give flexibility so that each year the rate will be set for each railroad based upon its particular situation under the current economic situation. Moreover, it is important that the income level to be capitalized be flexible within the rules so that each situation can be analyzed. Finally, the rules must give appropriate recognition to the contribution of all exempt property to the value of the railroad as a whole so that the taxable value will not be based on exempt property.

Representatives of the Duluth, Winnipeg & Pacific Railway Company, will continue to work with representatives of the state and local taxing authorities to develop these final changes. Please contact me if you have any questions.

Sincerely,

M. A. Letvin
Asst.Treas. Corporate Taxes

cc: R. L. Ritchie
R. M. Black
T. E. Fearnall

Attachment C



BURLINGTON NORTHERN

LAW DEPARTMENT

176 East Fifth Street
St. Paul, Minnesota 55101
Telephone (612) 298-2121

Rec'd 2/12/80 JMS

Mr. Gerald Garski, Manager
State Assessed Property
Property Equalization Division
Department of Revenue
Centennial Office Building
St. Paul, Minnesota 55145

February 12, 1980

Re: Proposed Temporary Rules Governing the Valuation and Assessment of Railroads

Dear Mr. Garski:

Following are comments on the proposed temporary rules governing the valuation and assessment of railroads as published at 4 S.R., pages 1169 through 1173, on January 21, 1980. While these comments generally represent the consensus of the railroads which will be subject to the rules, you should be aware that some of the railroads face special problems. Those railroads may make individual submissions relative to the effect of these temporary rules on their own special circumstances.

For purposes of clarity, the comments will refer to the proposed section and, where applicable, to the paragraph to which they relate.

13 MCAR §1.0021 General Procedures

The railroads which operate within Minnesota are extremely diverse in nature. There are major transcontinental railroads which operate in several states and short switching or terminal railroads which operate within the boundaries of one or two cities. There are railroads earning a generous return on investment and railroads mired in bankruptcy. Some of the railroads operate as a segment of major conglomerates and others have no interest outside of their transportation activities. Because of this extreme diversity, we do not believe it is proper to attempt to value their operating property through the use of a strict formulaic approach which utilizes both an industry-wide

capitalization rate and predeterminated weighting of the indicators of value. Cf. Independent School District No. 99, et al v. Commissioner of Taxation, 297 Minn. 378 (1973). Rather, we believe that the capitalization rate and weighting of the indicators should be calculated on an individual basis for each railroad. Thus it is suggested at the very least that the following paragraph, which was in the initial draft of the proposed rules, be added to this section:

> "Due to the diverse nature of the railroads which operate within Minnesota; huge transcontinental roads to short switching roads within the boundaries of one city, railroads earning a generous return on investment to roads mired in bankruptcy, railroads operating as a rather minor segment of conglomerates to roads having no other interests outside of transportation; the Commissioner of Revenue reserves the right to exercise his judgment whenever the circumstances of a valuation estimate dictate the need for it."

13 MCAR §1.0024 Valuation

A. General

Here again, we believe it is desirable that the proposed rules should take into account the extreme diversity of the railroads operating within the State of Minnesota. While this paragraph does provide for variance from the prescribed weighting for railroads which have no stock in debt or are bankrupt (13 MCAR §1.004D. and F., respectively), the paragraph as written does not permit the Commissioner to take the special circumstances into account in determining the weighting to be assigned to the three indicators of value.

B. Cost approach to valuation

The cost approach to valuation is recognized by virtually all valuation experts as the least reliable indicator of market value. This lack of reliability becomes even more pronounced when no allowance is made for depreciation or obsolescence. It is unfortunate that utilization of the cost approach to value has been unreasonably restricted so as to preclude adjustments for depreciation and obsolescence, thus casting grave doubts on the ability of the Commissioner to use cost as a factor in determining market value.

C. Income approach to valuation

As indicated previously, we believe that the utilization of an industry-wide capitalization rate ignores the vast fundamental differences between the railroads operating in Minnesota. It is our belief that the capitalization rate for each railroad should be determined based upon its own facts and circumstances. Further, in view of the rapid changes in the nation's economy, the capitalization rate should be calculated each year for each railroad.

Finally, we believe that the reference in subparagraph 2 to "paying particular attention to embedded debt of railroads" should be deleted. It is accepted by virtually all recognized railroad appraisers that the current cost of debt or money is more realistic in the marketplace than is embedded debt. The assumption that a prospective purchaser would assume embedded debt rather than finance a purchase at current rates is, we believe, too unrealistic to warrant the utilization of embedded debt in ad valorem tax valuation.

E. Unit value computation

Here too, we believe that because of the diverse nature of the railroads operating in the State of Minnesota the Commissioner should not be bound to predetermined weighting of the three indicators of value but rather should be free to exercise judgment and discretion depending upon the particular circumstances of the railroad being valued.

13 MCAR §1.0026 Adjustments for non-formula assessed property or exempt property

This section correctly recognizes that after the Minnesota portion of the unit value of a railroad company is determined, the property which is either exempt from taxation, such as pollution control equipment and personal property, or classified as non-operating property, must be deducted from the Minnesota portion of unit value to the extent that such property has been included in the computation of Minnesota value. However, it is the railroads' position that the use of depreciated cost instead of original cost in determining the amount of the personal property exclusion is incorrect and inconsistent.

The statute provides that if the Commissioner uses original cost as a factor in determining the unit value of operating

property, no depreciation or obsolescence allowance shall be permitted. Proposed §1.0024 B. provides that the Commissioner will use original cost without any allowance for depreciation or obsolescence as a factor in determining unit value of railroads operating in Minnesota, and that the cost indicator of value will bear a weighting of 25 percent. The railroads believe it is inconsistent for the Commissioner to take undepreciated costs into account for purposes of determining value, and then to utilize depreciated costs for the purposes of determining the personal property exclusion. Furthermore, the railroads believe that to utilize depreciated cost figures in determining the amount of the exclusion violates the spirit if not the intent of the statutory language. If the personal property is to be taken into account at original cost without depreciation for purposes of unit value, that same criteria should be applied for purposes of determining the exclusion.

Please do not hesitate to contact me if you have any question about these comments.

Respectfully submitted,

Donald C. Knickerbocker

Donald C. Knickerbocker
Assistant General Counsel
Burlington Northern Inc.

DCK/gtc,1-4

ADMIN 1000

Attachment D

STATE OF MINNESOTA

DEPARTMENT OF REVENUE

Office Memorandum

TO : DOROTHY MC CLUNG
Research Attorney

DATE: FEBRUARY 14, 19

FROM : GERALD D. GARSKI, Manager
State Assessed Properties

PHONE: 5134

SUBJECT: REPLY TO COMMENTS ON PROPOSED TEMPORARY RULES GOVERNING THE VALUATION AND ASSESSMENT OF RAILROADS

On January 21, 1980 the above mentioned rules were published in the State Register. Part of the publication was a request for comments from interested parties. Pursuant to this request, two railroads responded, the Burlington Northern and the Duluth, Winnipeg and Pacific. Their comments are attached.

Since you will be forwarding these comments together with the temporary rules to the Attorney General for his approval, I believe that it is wise for the Department to respond to the comments of the railroads.

In reading the comments of the railroads, it is perhaps wise to keep in mind that most of the positions they advocate are self serving in that the adoption of their suggestions would result in lower valuations, hence lower taxes for the railroads.

The Burlington Northern appears to take issue with three major points: 1) the lack of flexibility or discretion allowed the Commissioner by the rules, 2) the use of the cost approach to valuation, and 3) the use of depreciated cost when computing the personal property exclusion.

The Department is aware of the fact that the proposed rules do not allow the Commissioner much flexibility or discretion. The rules were written under the premise of treating all members of a class of taxpayers alike. If the Commissioner is to "exercise his judgment" in each and every instance, there appears to be little need to write rules and regulations since each valuation will be treated as unique. The Department believes that this is not the purpose behind the rule making procedure; hence we have proposed a rigid, structured format.

The Burlington Northern feels that the Department is in error in using the cost approach to value when estimating the value of railroad operating property. It is interesting to note that they also quote the Independent School District No. 99, et al v. Commissioner of Taxation case in their flexibility argument. Had they read the case further, they would have noted that in this case the Court advocated the use of as many indicators of value as were pertinent. The Department believes that cost is a viable indicator of value. The fact that no depreciation or obsolescence is allowed on this cost is not a Department policy but is mandated by statute.

The final point made by the Burlington Northern concerns the use of depreciated cost when calculating the personal property exclusion

from the unit value. The Department does not believe it is inconsistent to use this depreciated cost basis as the railroad claim. Bear in mind that two totally different concepts are being discussed here; one is valuation and the other the differentiation between real and personal property. We have chosen to use a depreciated cost basis for this differentiation because of the very logical reason that real property (land, buildings, structures) has a different useful life, hence different depreciation practices as opposed to personal property (freight cars, roadway machines). Normally items of personal property are depreciated much more rapidly at a higher rate than items of real property. It would be unreasonable to compare land, which never depreciates, with a freight car which is fully depreciated in a few years.

The Duluth, Winnipeg and Pacific Railway is of the opinion that the regulations do not fulfill the requirements of either the Minnesota Railroad Tax Reform Act or the Federal Railroad Revitalization and Regulatory Reform Act. They base their opinion on three major points: 1) the lack of flexibility allowed by the rules, 2) the capitalization rate used is improper and 3) the taxing of personal property.

We have already addressed the inflexibility issue and need not comment on it further.

The DW & P makes an argument against using any type of study period to arrive at an average when calculating the capitalization rate to be used in the income indicator of value. The Department is well aware of the fact that averages, by their very nature, may not produce the ultimate in accuracy; however, they do provide for a high degree of stability. This is the very reason we do not provide for the capitalization of only one year's income in the rules, but use a five year average. So, while it is true that we are not using a cap rate which reflects the most current economic trends, neither are we applying the cap rate to the most current income. The cap rate must always be compared or matched to the income being capitalized. The Department believes that we are following this precept of appraisal theory in the proposed rules.

The final point raised by the DW & P is their opinion that the rules may provide for the taxing of some items of personal property. It is extremely difficult when using the unit value method to differentiate between the value of real and personal property. The unit value method presupposes that the value of any one piece of property is interdependent upon all other parts of the unit. A good example of this is that of a chain. Certainly a long chain has more use and hence more value than each individual link. Separating the value link by link is not logical or practical. No other taxpayer whose property is valued using the unit value method has the value split between real and personal property; however, we are required to do so in the case of the railroad

industry. We have approached this very difficult problem with an open mind and have resolved it in what we think is a fair and equitable manner.

The DW & P has said that in addition to the listed personal property accounts of coal and ore wharves, communication equipment, roadway machines, shop machines, power plant machines and equipment, it believes that ties, rail, other track material, ballast, signals and interlockers should also be excluded as personal property. The listed accounts presently reduce each railroad's taxable value by approximately 50%. To increase this deduction to include ties, rails, etc. would in effect leave only land and buildings as taxable property. The Department believes that if this occurs, the unit value method is no longer practical to use for valuing railroad property and the valuation of these lands and buildings should be done on a local basis by the local assessor using whatever methods are in use to value other land and buildings within that taxing district.

After considering carefully the comments of the railroads, I would recommend that we apply to the Attorney General for approval of the proposed rules without modification.

GDG:vh

ADMIN 1000 (Rev. 1/78)
SF-00006-01

STATE OF MINNESOTA

DEPARTMENT ATTORNEY GENERAL

Office Memorandum

TO : DOROTHY A. McCLUNG
Research Attorney
Department of Revenue

DATE: March 3, 1980

FROM : JERRY S. ANDERSON
Special Assistant
Attorney General

PHONE: 296-1288

SUBJECT: Temporary Rules Governing Assessment of Railroad Property

As we discussed, the rules in the above-captioned matter have not been approved by this office for the following reasons.

1. In § 1.0023 A., the statement that "[m]uch of the data used in the evaluation, allocation and apportionment process will be drawn from reports submitted to the Department" suggests that some data will be obtained from unstated sources. Minn. Stat. § 15.0412, Subd. 3 (1978), however, requires an agency to establish by rule "every agency statement of general applicability and future effect." (Emphasis added.) Clearly, all of the data that will be used in the subject determination are "agency statement[s] of general applicability and future effect" and must be established by rule, but the way that the rule is phrased presently permits the agency to require or consider data in an ad hoc fashion. While the rule need not set forth explicitly all possible information or reports that might be considered, to the extent possible the rule should state the other types of data that might be considered and the instances or purposes under which such data will be required.

2. The use of the word "may" in § 1.0023 B. permits the Commissioner to grant or to deny applications for extension and to consider unstated criteria in that decision. Similar to the above discussion, a rule must provide for predictability and nondiscriminatory action by stating explicitly the criteria on which such a decision will be based. Apparently, however, what is intended is that all applications for extension will be approved; therefore, the "may" should be changed to "shall."

Upon consideration of the issues raised in this memorandum, and any subsequent action taken by the Department on these rules, three (3) copies of the rules as amended and the new Order Adopting said rules may be resubmitted to this office. Please contact me if you have any questions regarding this matter.

JSA/bw
Encl.
cc: Duane Harves
Susan Robertson