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Value Of Emission Reduction Credits Could Be Included In The Assessment Of Power Plant For Property Tax Purposes

In *Elk Hills Power, LLC v. Board of Equalization*, (--- Cal.Rptr.3d ----, Cal.App. 4 Dist., May 10, 2011), a court of appeal considered whether the California State Board of Equalization (Board) properly assessed the value of an electric power plant for taxation purposes where it included emission reduction credits in its unitary tax determination. The court of appeal held that the Board properly took into account the value of the emission reduction credits (ERCs) because the valuable ERCs were necessary to the ongoing productive use of the property, they were properly considered under section 110, subdivision (e). The court found that the assessor is allowed to assume the presence of the ERCs that are necessary to operate the taxable property productively, and to value the fair market value of the property accordingly.

Facts

Elk Hills Power, LLC, ("Elk Hills") built a power plant in Kern County, California, in the early 2000s. Elk Hills needed to comply with the emission regulations of the San Joaquin Air Pollution Control District ("District") so it purchased approximately \$10 million worth of ERCs and used the ERCs to obtain the necessary certifications and permits for the plant, which was completed in 2003, to begin operations. Elk Hills began filing tax returns in 2004 that included Form 529-I and initially reported the costs of the ERCs as \$10,701,575.

The Board utilized the replacement cost approach for analyzing valuation of the power plant from 2004 through 2008. However, from 2006 through 2008, the Board also used "an income approach utilizing a 'capitalized earning ability' or CEA factor (the income approach)." The Board accorded the income approach less weight than the replacement cost approach. In reaching its valuation conclusions, the Board's assessor's worksheets listed a 'site-specific adjustment' for each year that referred to the ERCs as part of the calculation of replacement

Update:

Please see our Legal Alert on the California Supreme Court opinion in this case, "[California Supreme Court Update: Air Quality Emissions Reduction Credits May Be Considered in Assessing Unit Value of Power Plant, But the Fair Market Value of Credits Themselves Must Be Excluded from Assessment and Direct Taxation](#)", September 10, 2013.

cost estimates.

Elk Hills filed a complaint for tax refunds challenging the unitary assessed values for 2004 through 2008 alleging they "were excessive because the Board had assessed the intangible ERCs in an illegal manner." The Board asserted that "under either valuation method, the ERCs were necessary to the beneficial and productive use of the plant, requiring that the unit valuation assumed there was value they contributed or added, such that no separate assessments of intangibles were made." The Board claimed the ERCs were necessary for the use of the property as a power plant and they could not be removed from the assessment. The trial court granted summary judgment in favor of the Board.

Decision

The court of appeal affirmed the decision of the trial court. The Board's unitary taxation determinations properly assessed the power plant *as a going concern*. The court found that the Board's worksheets that contained site-determinations adjustments for the ERCs do not demonstrate the Board impermissibly assessed and taxed the value of the ERCs as a single or separate asset, even though the tax forms filed by Elk Hills listed a value for the assets. The Board properly took into account the value added by the ERCs, as contributing to the value and earnings of the property as a

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whole.

The Revenue and Taxation Code section 110 provides guidelines and definitions to be used for determining the full market value or full cash value of assessed property, including the treatment of intangible rights relating to the uses and purposes to which the property is adapted and for which it is capable of being used, and relating to the enforceable restrictions upon those uses and purposes. The court held, Under section 110, subdivision (e), the power plant was correctly assessed and valued by assuming the presence of intangible assets or rights necessary to put the taxable property to beneficial or productive use, because without the presence of the deployed ERCs, the power plant cannot operate and function as intended, to make energy and money.

Elk Hills argued that pursuant to section 110, subdivision (d), ERCs cannot be included in the plants value because they are intangible. Section 110, subdivision (d)(1), provides, The value of intangible assets and rights relating to the going concern value of a business using taxable property shall not enhance or be reflected in the value of the taxable property. Subdivision (d)(2) provides, If the principle of unit valuation is used to value properties that are operated as a unit and the unit includes intangible assets and rights, *then the fair market value of the taxable property contained within the unit shall be determined by removing from the value of the unit the fair market value of the intangible assets and rights contained within the unit.* (Emphasis added.) Elk Hills asserted section 110, subdivision (d)(2) should be used to remove the value of the ERCs from the value of the power plant. The court rejected this argument.

The court found instead that section 110, subdivision (e) applies to the assessment of the power plant. Subdivision (e) provides, Taxable property may be assessed and valued by assuming the presence of intangible assets or rights *necessary to put the taxable property to beneficial or productive use.* (Emphasis added.) The court found that whether for unitary or other property taxation, section 110, subdivision (e) must govern in those cases where it is critical for the assessor to consider

how the taxable property is put to beneficial or productive use, and when such beneficial or productive use requires the presence of intangible assets or rights as necessary. When such a situation arises, the appraiser for the assessor may assume their presence in valuing the property. In valuing Elk Hills power plant this would mean taking into account the value added to the plant by the existence of the applied ERCs, when assessing the plant as a going concern, i.e., while it is producing power and emitting pollutants as allowed by the ERCs.

When valuing a utility property as a going concern, the Board is required to appraise it at its full value when put to its beneficial and productive use. There are certain intangibles such as permits, licenses, and zoning, that are not real property and may not be taxed as such, but nevertheless affect the real property's value, for example by enabling its profitable use, they may properly contribute to an assessment of fair market value. These intangibles should be considered by an assessor insofar as they contributed to the property's beneficial use, and in doing so, the assessor may impute an amount of income derivable by reason of the intangible right to do business.

Elk Hills purchased the ERCs at issue to build its power plant to comply with the Districts emission requirements. The ERCs are not transferable while the power plant is operating. The court found that because the valuable ERCs were necessary to the ongoing productive use of the property, they were properly considered here, under section 110, subdivision (e). Pursuant to subdivision (e), the assessor is allowed to assume the presence of the ERCs that are necessary to operate the taxable property productively, and to value the fair market value of the property accordingly.

Questions

If you have any questions concerning the content of this Legal Alert, please contact the following from our office, or the attorney with whom you normally consult.

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