THE VALUATION OF PROPERTY

A Treatise on the Appraisal of Property for Different Legal Purposes

VOLUME II

BY

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Another Book on Valuation
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VALUATION
UNDER THE LAW OF EMINENT DOMAIN

A Complete Coverage of the Law of Valuation under Eminent Domain Based on an Analysis of the Reported Court Decisions and Commission Cases and on a General Study of All Types of Valuation of Property by the Courts.

Two Volumes — Second Edition

By LEWIS ORGEL
Registrar of the City of New York

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CHAPTER XIX

TAX VALUATIONS UNDER THE UNIT RULE: HISTORICAL DEVELOPMENT*

Most of the public-utility and capital-stock taxes treated in the preceding chapter are distinguished from the ordinary property taxes in basing their assessments on the value of a business enterprise rather than on the value of specific tangible properties. From the standpoint of appraisal theory, this procedure has many advantages; for by appraising a business as an economic unit, it avoids the necessity of making arbitrary distinctions between the value of a going concern and the values of the various assets.

But, in avoiding this difficulty, these "going-concern" assessments run squarely into another. Most of them are levied by the individual states, and even the state assessments are sometimes apportioned among the various local taxing districts. As a result, the state or locality frequently faces the necessity of assessing, not an entire enterprise, but merely that portion of the enterprise which is deemed to be represented by the property or business located within the taxing jurisdiction. The problem is especially serious with respect to corporations with functionally or physically integrated properties located partly within and partly without the state boundary lines. Here the Federal courts are alert to protect the taxpayer against an assessment of extrastate property.

The attempt by legislatures, assessors, and courts to solve this problem while retaining the enterprise as the unit of valuation, has resulted in the development of the so-called "unit rule." Under this rule, in its more thoroughgoing form, the entire enterprise is first valued as a unit, some "fair share" of this value (perhaps after the deduction of certain asset values deemed inappropriate for allocation) being attributed to the particular state or district that is imposing the tax.[1]

* Based on material prepared by Elizabeth Sanford and Benjamin Goldring.

[1] The term "unit rule" is often used in its broadest sense, to denote any assessment, measured by capital value (or by annual income) under which the value of (or income from) property located within a specific geographical area is taken to be equal to a certain share of the value of (or income from) a larger aggregate of property, of which the former property is an integral part. When used in this broad sense, the unit rule does not necessarily require a valuation of an entire

The resulting figure is presumed to measure the "true value" of that portion of the corporate property which comes under the assessor's taxing power.

The first step in this procedure of assessment—the determination of the value of the entire enterprise—has already been discussed in the previous chapter. Here the principles of valuation are the same as those that are applied to an enterprise located entirely within a single taxing district and subject to a tax on an unallocated, unitary value. But the second step—the allocation of a share of this value to the particular taxing jurisdiction—has so far received only incidental attention and remains to be treated in this chapter and in the one immediately following.

An explanation is in order as to our reasons for devoting two chapters to such a highly special aspect of legal valuation. More strikingly than any other line of cases, these unit-rule assessments present one of the most important but least understood problems of appraisal theory—the problem of the relationship between the value of an organic whole and the values of the parts. Indeed, it would be only a slight exaggeration to state that mastery of this relationship, in all of its ramifications, would mean mastery of the whole theory of valuation, while confusion as to the relationship means confusion as to the whole theory.

As this treatise is devoted to problems of valuation, attention will be given only to those cases in which the unit rule is applied under an ad valorem tax. It should be noted, however, that a similar rule, called by the same name, is also frequently employed under a corporate net-income or gross-earnings tax. Here a share of the earnings of a business, located partly within and partly without the taxing jurisdiction, is allocated to the jurisdiction by formulas similar to, or identical with, those that are applied under a property tax. Many of the legal precedents on allocation under the one type of tax are applicable to allocation under the other type.

I. Early Application of the Unit Rule to Railroad Assessments.

In ad valorem taxation as distinct from income taxation, assessments under the unit rule have been largely confined to public-utility

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business enterprise. In railroad assessments, for example, it is sometimes applied merely to rolling stock. The value of the total rolling stock of an interstate railroad may be assumed to equal depreciated replacement cost; and the value of that part of the rolling stock which is employed within the taxing state may be estimated at a share of this total value measured, perhaps, by the ratio between all-track mileage within the state to all-track mileage of the entire railroad system.

properties—especially to railroad, telegraph, long-distance telephone, pipe line, and express properties.[2] The decided majority of legal precedents as to allocation formulas have therefore been established in utility-assessment cases. The earliest of these cases were concerned with railroads; and even today railroad taxation furnishes the richest legal material on valuation under the unit rule. We therefore begin our discussion with the early railroad tax litigation.

Forerunners of the Rule in Early Local Assessments.

Although most of the leading cases involving the unit rule have been concerned with the allocation of interstate property values to specific states, the origin of the rule may be found in the early local assessment of railroads, most of which were still short lines running through several taxing districts without crossing state borders. In valuing their particular segment of a railroad track, the local assessors had the choice of two possible procedures. On the one hand, they might appraise the segment without reference to the remainder of the property, by so-called "physical valuations" based largely on estimates of original cost or replacement cost. On the other hand, they might first estimate the value of the entire railroad business as a going concern, and might then attribute to the track and other property within their jurisdiction a share of this unitary value based on relative mileage or some other allocation formula.

Probably more often than not, the assessors followed the former procedure, without attempting to derive the value of the part from the value of the whole. But sometimes they resorted to the latter procedure, first valuing the whole railroad business by a stock-and-bond method or by a capitalization of reported earnings, and then imputing to their section of the line a portion of this value based on a mileage ratio. In some states they were allowed no choice in the matter.[3] As a result of a tax levy challenged by the railroad, the courts would at times upset an assessment based on the one method in favor of a reduced assessment based on the other.

Perhaps the most important early litigation of this nature was that in New York, which we have already discussed in the preceding chap-

[2] Aside from public-utility taxes, the chief use made of the unit rule, under taxes measured by property values, has been in connection with the state "capital-stock" or "franchise" taxes, where an allocation formula has been used to determine what portion of the "corporate excess" of an interstate business is subject to taxation by a given state. The case law on allocation formulas under these taxes is surprisingly meager except with respect to public-utility companies.

[3] See statute sustained in Louisville & New Albany R.R. v. State ex rel. McCarty, 25 Ind. 177 (1865).

ter.[4] Here the courts wavered between a position favoring a "physical valuation" without reference to the value of the entire railroad, and a position favoring a prorated valuation derived from an enterprise value estimated by a capitalization of earnings. Had they adhered consistently to the latter position, their action would have compelled the state to develop some form of a unit rule of assessment. But the insuperable practical difficulties of local assessment under a unit rule finally led the Court of Appeals, in the *Lackawanna* case,[5] to sanction replacement cost as the usual measure of the value of railroad real property. We quote from its opinion:[6]

> An assessment of the portion of the real estate of a railroad which is within the town . . . of the assessors, upon the basis of the income or profits of the whole system of which it is a part, must necessarily include the use of franchises and personal property which are otherwise assessed. . . .
>
> The principle of assessing a few miles of railroad in a town according to the relations which it is supposed to bear to the whole of a vast and intricate system, or to the income or earning power of the entire system, draws into the calculation so many elements that the process becomes too complex and difficult for even an expert. It is no disparagement of the capacity and intelligence of the average assessor to say that it would present to him a problem incapable of accurate solution and a rule of action in the performance of his official duty impossible in practice. . . .
>
> Where the real estate alone is to be valued without reference to the personal property or franchises, this method [*i.e.*, cost of reproduction] will secure the nearest approach to justice, and it can be applied with something like substantial accuracy.

The court might have added, as did a Tennessee court,[7] that local assessments under a unit rule would necessitate an extremely wasteful multiplication of effort on the part of the various assessors.

In the early local assessment cases, the difficulty of valuing a part of a whole did not present itself with respect to the rolling stock or to the intangible value of intrastate railroads, as these were assessed, if at all, only in the local district in which the railroad corporation had its principal office. But later legislation, discussed in subsequent sections,

[4] *Supra* pp. 522–524.

[5] People ex rel. Delaware, Lackawanna & Western R.R. v. Clapp, 152 N.Y. 490, 46 N.E. 842 (1897). See also People ex rel. Western Union Telegraph Co. v. Dolan, 126 N.Y. 166, 27 N.E. 269 (1896).

[6] 152 N.Y. 490 at 495–497, 46 N.E. 842 at 844–845. See *supra* pp. 524–526 for further discussion of this case.

[7] Franklin County v. Nashville, Chattanooga & St. Louis R.R., 80 Tenn. 521 at 539 (1883).

undertook to allot an appropriate share of rolling-stock and going-concern values to each of the districts through which the railroad ran.[8]

Central State Assessment with Local Apportionment.

So serious are the practical difficulties of applying the unit rule to separate railroad assessments by small political subdivisions, that the rule itself could hardly have developed under this procedure. Only when local assessment was superseded by centralized state assessment, did the unit rule secure statutory sanction and firm judicial support. The advantages of state valuation over local valuation are too obvious for comment at this late date. Indeed, a Kentucky court went so far as to state that, even in the absence of statute,

> . . . the law treats a railroad and all its appurtenances as one entire thing. . . . In that consolidated character it must be taxed for State revenue, and cannot be a fit subject for local taxation by the separate counties through which it runs.[9]

Aside from administrative convenience, a strong impetus to the statutory adoption of central assessment was given by the changing popular attitude toward railroads from one of friendliness and liberality to one of hostility. The sixties and the early seventies began the era of the consolidation of the short lines into large, interstate systems. These combinations opened up opportunities for large profits, combined with stock watering and other forms of financial chicanery. The disastrous panic of 1873 served only to increase public resentment, especially in the western farming states, in which the farmers blamed their depressed market prices of grains on allegedly exorbitant freight rates. There resulted the Granger movement and the first attempts at state and Federal railroad regulation.

In the field of taxation, this popular feeling took the form of a demand for assessments which would reach those large "intangible values," called franchise value or good will, which could not be effectively taxed by local assessors. Hence, statutes were passed which set up state boards of assessment and which directed these boards to include the entire values of the railroads as distinct from, or in addition to, the so-called "cost values" of the physical assets.

[8] An early New York statute to this effect was repealed a year later: L. 1857, C. 536, Sec. 1, repealed by L. 1858, C. 110. At present, rights of way (not in public streets) and other real property are assessable locally in New York, personal property is not taxed, and the State levies several privilege taxes upon railroads.

[9] *Applegate v. Ernst*, 66 Ky. 648 (1868). See also *Cincinnati, New Orleans & Texas Pacific R.R. v. Commonwealth*, 81 Ky. 492 at 503 (1883).