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#92015

DATE: February 5, 1992

SUBJECT: Proposed Constitutional Amendment to Exempt Livestock from Property Taxation and Tax Other Tangible Personal Property Based on "Depreciated Value."

REQUESTED BY: Senator Roger Wehrbein
Nebraska State Legislature

WRITTEN BY: Don Stenberg, Attorney General
L. Jay Bartel, Assistant Attorney General

As a follow-up to our response to your prior questions regarding the constitutionality of a proposed amendment to the Nebraska Constitution exempting livestock from property taxation, addressed in Attorney General Opinion No. 92005, January 10, 1992, you have requested our opinion on several additional questions relating to the validity of such an amendment under the equal protection clause of the Fourteenth Amendment to the United States Constitution. Specifically, you ask whether it is permissible under the Fourteenth Amendment for the state to classify all livestock as exempt for property tax purposes, while other tangible personal property is classified as taxable based on its "depreciated value" for federal income tax purposes. In addition, you ask whether the federal equal protection clause bars the state from establishing tangible personal property depreciated for federal income tax purposes as a "class" subject to taxation based on its "value" as reported for federal income tax purposes.

In our prior opinion, we addressed at length the standards applied by the United States Supreme Court in addressing the validity of state tax classifications under the federal equal protection clause. The test for determining whether a distinction is valid under the equal protection clause was summarized by the

Court in Hooper v. Bernalillo County Assessor, 472 U.S. 612, 618 (1985) as follows: "Generally, a law will survive [equal protection clause] scrutiny if the distinction rationally furthers a legitimate state purpose." Thus, where no fundamental right or suspect classification is involved, the test involves a two-part inquiry. First, the state must have a legitimate purpose for the distinction. Second, the distinction must rationally further that purpose.

For the reasons noted in our recent opinion, we do not believe that the establishment of an exemption for all livestock under state law would, necessarily, violate the Fourteenth Amendment guarantee of equal protection, even if other types of tangible personal property remained subject to taxation. It is, of course, true that some breeding livestock is depreciable, (i.e., replacement heifers purchased by a rancher), while other breeding livestock is not (i.e., heifers raised by a rancher), as the depreciation deduction allowed under the Internal Revenue Code applies to livestock acquired for work, breeding, or dairy purposes, unless included in inventory. Treas. Reg. § 1.167(a)-6. For purposes of determining the validity of exempting all livestock under the federal equal protection clause, however, we do not believe this distinction is significant.

In this regard, we note that other states exempt all livestock from property taxation. E.g., Colo. Const. art. 10, § 3; Idaho Code Ann. 63-105(Y) (1989); Utah Code Ann. 59-2-1112 (Cum. Supp. 1991); Wis. Stat. Ann. § 70.111(17) (West 1989). Indeed, in Leonardson v. Moon, 92 Idaho 746, 451 P.2d. 542 (1969), the Supreme Court of Idaho held the exemption of producing property such as production herds of cattle and horses and production flocks of sheep, while other types of productive personal property remained subject to taxation, did not constitute impermissible discrimination prohibited by the Fourteenth Amendment. The exemption of livestock, including breeding livestock, is not irrational, and, based on the reasons outlined in our prior opinion, plainly furthers legitimate state purposes, given the importance of the entire industry to the state.

Of greater significance, however, are the questions you raise concerning the validity of the establishment of tangible personal property as a class subject to taxation based on its "depreciated value" as determined for federal income tax purposes. We have reservations as to whether the state may classify and tax tangible personal property in this manner without running afoul of the equal protection clause of the Fourteenth Amendment.

The equal protection clause "imposes no iron rule of equality, prohibiting the flexibility and variety that are appropriate to reasonable schemes of state taxation." Allied Stores of Ohio, Inc.

v. Bowers, 358 U. S. 522, 526 (1959). In structuring their internal tax structures, "the States have large leeway in making classifications and drawing lines which in their judgment produce reasonable systems of taxation." Lenhausen v. Lake Shore Auto Parts Co., 416 U. S. 356, 359 (1973).

> Equal protection does not require identity of treatment. It only requires that classification rest on real and not feigned differences, that the distinction have some relevance to the purpose for which the classification is made, and that the different treatments be not so disparate, relative to the differences in classification, as to be wholly arbitrary.

Walters v. City of St. Louis, 347 U. S. 231, 237 (1954). "In its discretion [a state] may tax all, or it may tax some, taking care to accord to all in the same class equality of rights." Id. (quoting Southwestern Oil Co. v. State, 217 U. S. 114, 121 (1910) (Emphasis in original). The Clause "applies only to taxation which in fact bears unequally on persons or property of the same class." Allegheny Pittsburgh Coal Co. v. County Comm'n of Webster County, ___ U. S. ___, ___, 109 S. Ct. 633, 637, 102 L.Ed.2d 688, 697 (1989) (quoting Charleston Fed. Savings & Loan Ass'n v. Alderson, 324 U.S. 182, 190 (1945)). "[T]he equal protection clause means that the rights of all persons must rest upon the same rule under similar circumstances. Louisville Gas & Elec. Co. v. Coleman, 277 U.S. 32, 37 (1928).

Judged by these standards, we have doubts as to whether the establishment of a class of "depreciable tangible personal property," subject to property taxation based on its "value" for federal income tax purposes, satisfies the requirements of the equal protection clause of the Federal Constitution. First, it is erroneous to assert that the "adjusted basis" of such property, as determined for income tax purposes under the Internal Revenue Code, as amended, is in any way intended to measure the "value" of property. Indeed, this point was expressly recognized by the Nebraska Supreme Court over 20 years ago in State ex rel. Meyer v. McNeil, 185 Neb. 586, 177 N.W.2d 596 (1970) ["McNeil"].

McNeil involved the issue of whether a legislative act declaring that the values of agricultural income producing machinery and equipment used by any business required to report taxable income under the Internal Revenue Code be used by county assessors for property tax purposes violated Neb Const. art. VIII, § 1. In determining this method of valuing property for tax purposes violated the State Constitution, the court specifically noted the fact that the "value" of such property for income tax purposes bore no relation to the "actual value" determination required to comply with Article VIII, Section 1. In this regard, the court stated:

> [T]he Internal Revenue Code does not purport to determine the value of agricultural income-producing machinery and equipment. Its purpose is to fix an equitable rate of depreciation of personal property used in a trade or business over the estimated useful life of the property rather than have it fall in a single year period. <u>Its purpose is not to fix the actual value of the property at any given time, but to amortize depreciation during its life in determining net annual income</u>. The revenue act therefore does not purport to determine actual value of farm machinery and equipment at any given time and is wholly unrelated to actual value for taxation purposes required by the law of this state.

<u>Id</u>. at 589, 177 N.W.2d at 599 (emphasis added).

We recognize that, under the second scenario presented in your prior request, the Nebraska Constitution would be amended to classify "depreciable tangible personal property" and to allow its taxation based on its "value" as depreciated for federal income tax purposes. This would, of course, address the specific basis for the court's holding in <u>McNeil</u> that the use of a different method of valuation (i.e., depreciated "value" as determined by the Internal Revenue Code) for certain property resulted in a violation of the requirement that all property be taxed uniformly at its "actual value," the standard applied to the taxation of other property. Nevertheless, we must question whether, even if such a classification were established under state law, the use of remaining federal income tax basis as the "value" of tangible personal property for ad valorem tax purposes would constitute an arbitrary or irrational classification prohibited by the federal equal protection clause.

The allowance of a deduction for cost recovery of property used in the production of income is obviously a proper deduction for purposes of determining income tax liability. The theory behind the allowance of a deduction of the cost of such property for income tax purposes is based, in part, on recognition of the fact that it would distort income to have the entire cost of the property deducted in the year of acquisition, when the property has a useful life of more than one year. The depreciation methods required under the Internal Revenue Code are designed to determine taxable income on an annual basis.[1]

While the allowance of a deduction for cost recovery of property used in the production of income is clearly reasonable and rationally related to the determination of income tax liability, it does not necessarily follow that the use of the "adjusted basis" of tangible personal property for federal income tax purposes constitutes a reasonable or rational standard for assessing property for ad valorem taxation, given the lack of any relationship between the "value" of property and remaining federal income tax basis of property as reported under the Internal Revenue Code. Such a classification may, in and of itself, be deemed arbitrary and unreasonable if adopted for ad valorem property tax purposes.

Apart from consideration of whether the establishment of "depreciable tangible personal property" as a separate class of property subject to taxation based on remaining federal income tax basis is permissible under the Fourteenth Amendment, however, an even greater concern is the disparate treatment which adoption of such a standard of taxation would create among properties included within the class. In order to explain the source of such disparities, it is necessary to provide a brief discussion of the various depreciation systems under the Internal Revenue Code applicable to property placed in service during the past twenty years.

Generally, three different federal depreciation systems exist for property placed in service during this period:

(1) A "depreciation deduction" under the "Class Life Asset Depreciation Range (ADR) System" or based on the useful life of property for property placed in service after 1970 and, generally, before 1981;

(2) A "cost recovery" deduction under the Accelerated Cost Recovery System (ACRS) applicable to "recovery property" placed in service after 1980 and before 1987; and

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[1] Moreover, as will be discussed more fully, _infra_, changes to the Internal Revenue Code adopted subsequent to the decision in _McNeil_ (specifically, enactment of the Accelerated Cost Recovery System (ACRS) and the Modified Accelerated Cost Recovery System (MACRS)) have altered the previous useful-life depreciation system to provide for accelerated cost recovery over periods less than the useful lives of many assets. These systems were enacted by Congress as a means to stimulate capital investment and economic growth.

(3) A "cost recovery" deduction under the Modified Accelerated Cost Recovery System (MACRS) applicable to "recovery property" placed in service after 1986.

Under useful-life depreciation, the taxpayer could compute depreciation over the estimated useful life of the property to the taxpayer based on the taxpayer's own facts and circumstances. 3 Stand. Fed. Tax Rep. (CCH) paras. 11,003 and 11,004. Several methods were available to compute the amount of the depreciation allowance, including the straight line method, the sum of the years digits method, the 150 percent declining balance method, and the 200 percent declining balance method. Id. at para. 11037. Under the ADR System, the Internal Revenue Service established ranges for broad industry classes (over 100) of assets from which a depreciation period could be selected for depreciation purposes. Rev. Proc. 72-10, 1972-1 C.B. 721; Rev. Proc. 77-10, 1977-1 C.B. 548; Rev. Proc. 83-35, 1983-1 C.B. 745. The ranges varied from as short as 2.5 to 3.5 years for some assets to as long as 40 to 60 years for other assets. Under the Class Life ADR System, depreciation could be computed under any of the three major methods for which the property qualified, either the straight line, sum of the years digits, or declining balance methods.

The Accelerated Cost Recovery System (ACRS) "is a system for recovering capital costs using accelerated methods over predetermined recovery periods that are generally unrelated to, but shorter than, prior law useful lives." Staff of the Joint Committee on Taxation, 97th Cong., General Explanation of the Economic Recovery Tax Act of 1981, 75-76 (Comm. Print 1981). One of the principal reasons for the enactment of the ACRS System by Congress was to provide accelerated cost recovery over periods that were shorter than the previously existing useful life system, in order to stimulate capital formation and the growth of the economy. Id. at 19.

Under ACRS, the cost of qualifying personal property generally was required to be recovered over periods from three to nineteen years, with most personal property being in a 3-year, 5-year, 10-year, or 15-year recovery period. The allowance generally was based on the 150 percent declining balance method for the early recovery years, then switching to a straight line method. Alternatively, taxpayers could elect to use the straight line method over the ACRS recovery period or over a longer period provided by the law. 3 Stand. Fed. Tax Rep. (CCH) para. 11,258. Taxpayers other than trusts and estates could elect to expense up to $5,000.00 of qualified property placed in service during a year rather than recovering the cost thereof under ACRS. Id. at para. 12,122A.

The Modified Accelerated Cost Recovery System (MACRS) reclassified some assets, provided a more accelerated cost recovery method for some classes, added new classes, and extended the recovery periods for some assets. Recovery generally is made over periods of from 3 to 31.5 years under MACRS. Depending upon the class involved, the recovery methods available for most personal property are 200 percent declining balance, switching to straight line, and 150 percent declining balance, switching to straight line. Straight line recovery is also available, or, in some cases, required. 3 Stand. Fed. Tax Rep. (CCH) para. 11,279. The provision permitting taxpayers other than trusts and estates to treat the cost of qualifying property as an expense was continued, with modifications, including increasing the amount that could be expensed. I.R.C. § 179 (b)(1).

The terminology employed in the Internal Revenue Code reflects that both ACRS and MACRS are "cost recovery systems." I.R.C. § 168. In other words, the systems are not intended to reflect the value of property at any given time. For many assets, the systems are designed to make the recovery before the end of the useful life of the asset. For example, the 7-year property recovery class under MACRS is, by definition, property having a class life under the ADR system of 10 to 15 years. See Rev. Proc. 87-56, 1987-2 C.B. 674, 676.

Each of these systems provide a method of recovering the cost, but not more than the cost, of an asset, either in the year placed in service or over a period of time. The intent of providing an allocation for cost recovery is to more accurately determine the amount of "income" for a given period of time in which the asset is employed in a business. The question is primarily one of timing, with all taxpayers eventually being eligible to recover the same amount, their cost, and taxpayers being taxed by a similar standard, income. In determining the timing of their recovery of costs, taxpayers under the systems have a degree of latitude, although limited, in electing how the systems will be applied to them, and there is a substantial variation in the systems and in the particular results in a particular year (both for that year and cumulatively), depending on several factors, including elections made and the year in which property was first placed in service. Over time, however, each taxpayer is generally treated equally as to the amount to be recovered (i.e., cost), and as to the measure of taxation (i.e., income).

Because of the variations available by choice and those required by the Code, and the variations in the systems themselves as to timing and recovery methods, the use of remaining unrecovered cost as determined for federal income tax purposes as an annual measure for property tax purposes would result in similar property being taxed unequally in a particular year and over the recovery periods of the properties. Taxpayers engaged in identical businesses with identical pieces of personal property could pay substantially different property taxes depending on such factors as whether expensing rather than cost recovery was or is used, the year the item was or is first placed in service by the particular taxpayer, the cost recovery method required or elected as to the property, and the method of acquiring the property. Identical properties could be subjected to grossly different tax burdens.

For illustration, assuming a 2.3 percent annual property tax over a period of eleven years, the property tax imposed over the eleven years on an asset in a "10-year property" class under MACRS, using a mid-year convention, could be between 0 percent or 2.3 percent of the cost of the property if an expense election was taken, but between 8.8 percent and 11.13 percent or higher of the cost if recovered under MACRS; and, for all or most of the eleven year period, one would not be taxed annually at all and the other would be taxed. Moreover, the property being subjected to the higher property tax is the one that, to that time, has provided the least income tax deduction to the taxpayer, or, stated differently, the property that has provided the greatest income deduction to its owner is the one that is subjected to the least amount of property tax.

In sum, the adoption of the remaining federal income tax basis of personal property as reported under the Internal Revenue Code as a basis for property tax purposes would result in identical properties being used for identical purposes in identical businesses by similar types of owners being subjected to substantially different tax burdens. Accordingly, we believe that a serious question exists as to whether the different tax burdens which would be placed on taxpayers owning property within the class of "depreciable tangible personal property," if defined as the remaining basis of tangible personal property for federal income tax purposes, would violate the equal protection clause principle requiring that equality of treatment be accorded to all who are taxed of the same class.

We recognize that at least one state provides a means whereby business personal property may be taxed based on "net book value," which is defined as "the cost less depreciation of the property as shown on the federal income tax return of the taxpayer." Vt. Stat. Ann. tit. 32, § 3618 (1981 and Cum Supp. 1991). Under the Vermont statute, voters of a municipality may elect to tax business personal property and to have such property appraised by either of the following methods, as determined by the taxpayer: (1) Fifty percent of cost during the time the property is not fully depreciated for federal income tax purposes until it is fully depreciated, when it is then appaised at ten percent of cost; or (2) At net book value during the time the property has not been depreciated to ten percent of cost or less for federal income tax purposes, and, thereafter, at ten percent of cost. Apart from certain differences under the Vermont statute which distinguishes this appraisal procedure from the scheme which has been suggested to tax "depreciable tangible personal property" in Nebraska, we note that no question has apparently been raised as to whether the Vermont methodology satisfies federal constitutional requirements.

In the event the Legislature deems it appropriate to provide a means whereby tangible personal property is to be taxed under some standard other than "actual value," permitting its taxation on a "depreciated" basis, we urge that consideration be given to the adoption of a constitutional amendment which would authorize a system which utilizes a schedule (or schedules) which would apply depreciation factors to various types of properties without reliance upon remaining federal income tax basis as the standard for valuing such properties for ad valorem tax purposes. For example, South Carolina has adopted a state constitutional and statutory scheme which permits the definition of "fair market value" of manufacturers machinery and equipment to be determined by reducing the original cost by an annual allowance for depreciation based on a schedule applied to various categories of properties, while providing that original cost cannot be reduced by more than eighty percent. S.C. Const. art. X, § 2; S.C. Code Ann. § 12-37-930 (Law. Coop. Cum. Supp. 1991); <u>see</u> <u>South Carolina Tax Comm'n v. South Carolina Tax Bd. of Review</u>, 278 S.C. 556, 299 S.E.2d 489 (1983) (upholding constitutionality of method for assessing value of manufacturing equipment on this basis). <u>See also</u> <u>South Carolina Tax Comm'n v. South Carolina Tax Bd. of Review</u>, ___ S.C. ____, 407 S.E.2d 627 (1991), <u>cert</u>. <u>denied</u> <u>Collins Music Co. v. South Carolina Tax Comm'n</u>, 60 U.S.L.W. 3478 (Jan. 13, 1992) (sustaining constitutionality of regulation employing a depreciation floor to value merchants' equipment of not less that ten percent of original cost). In our view, adoption of a state constitutional amendment authorizing the enactment of statutory and regulatory provisions utilizing such a "depreciated" value methodology for ad valorem tax purposes would provide a much sounder basis to defend against potential challenges based on due process or equal protection grounds which could be raised if remaining depreciable federal income tax basis where employed as the sole method for assessing the "value" of tangible personal property for tax purposes.[2]

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[2] We do not mean to suggest that the only method of valuation permissible is "actual value," the standard employed to value all property under present Nebraska law. If an appropriate state constitutional amendment were adopted permitting the Legislature to classify and define the values of personal property for tax purposes, use of a standard of value taking into account an allowance for depreciation would not be impermissible. Our concern

In sum, it is our opinion that the federal equal protection clause would not prohibit the classification of all livestock as exempt from property taxation under an appropriate state constitutional amendment. We do, however, have doubts as to whether the establishment of "depreciable tangible personal property" as a class subject to taxation under the state constitution based on its "adjusted basis" as determined for federal income tax purposes, would satisfy the requirements of the federal equal protection clause. We are concerned that the establishment of such a classification may be deemed unreasonable or arbitrary, given the lack of relationship between remaining depreciable federal income tax basis and the "value" of property, and are concerned that property within the same class under state law would be treated unequally under such a method, given the disparate treatment of similarly situated or identical property which would result in the taxation of property if such a standard of valuation were adopted. Finally, we conclude that, while we have reservations as to the validity under the equal protection clause of the Fourteenth Amendment of employing the "adjusted basis" of depreciable tangible personal property as determined under the Internal Revenue Code of 1986, as amended, as a standard of value for property tax purposes, we do not believe that the equal protection clause precludes the state from establishing its own scheme of taxing personal property based on consideration of depreciation factors or allowances which are not based on the remaining depreciable federal income tax basis of property. Such action would, of course, require adoption of an appropriate state constitutional amendment, as well as statutes and regulations implementing such an amendment.[3]

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relates to the establishment of a class of "depreciable tangible personal property" subject to taxation at a standard based on the remaining federal income tax basis of such property as determined under the Internal Revenue Code of 1986, as amended, in view of the requirement imposed by the equal protection clause of the Fourteenth Amendment mandating equality of treatment of property within the same class under state law.

[3] Consistent with the scope of your questions, our conclusions are based solely on consideration of whether the amendments to state law (constitutional or statutory) you have proposed or discussed would satisfy the requirements of the equal protection clause of the Fourteenth Amendment. We caution that any proposed changes in property tax policy must take into account the affect of federal statutes prohibiting discriminatory taxation of the property of certain taxpayers. E.g. 49 U.S.C. § 11503 (railroad common carriers); 49 U.S.C. § 1513 (air carriers); 49 U.S.C. § 11503a (motor carriers).

Very truly yours,

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