Buffalo Law Review

Volume 7 | Number 3 Article 11

4-1-1958

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Supreme Court taking jurisdiction. This would eliminate the risk of juries running wild and at the same time determine fairly the merits of a citizen's claim. As it now stands liability of the city for all practical purposes is *dead,* and the individual claimant is being denied a common law right to bring successful suit against a municipal corporation for its tortious neglect to maintain the streets and sidewalks in a reasonable safe condition for travel.

Anthony J. Colucci, Jr.

VALUATION OF PUBLIC UTILITY PROPERTY FOR TAX PURPOSES: THE NEW YORK SPECIAL FRANCHISE TAX

"What is a cynic? A man who knows the price of everything and the value of nothing."

—Oscar Wilde.

Whether the jaundiced outlook of a habitual cynic is the cause producing the regrettable imbalance noted above, or whether a prolonged struggle to discover a rational relationship between the opposed concepts might be the cause of cynicism, the fact remains that when the ineluctable exigencies of taxation require the expression of *value* in dollars and cents, which are properly the terms of *price,* problems are generated the subtlety of which may well threaten the most equable temperament.

Public utilities share with all other commercial and industrial enterprises many general problems of this character, and such problems, since they are not peculiar to public utilities, are beyond the scope of this paper.

The public utility encounters its own special brand of problem in two areas affected by property valuation: real property taxation and rate-making. This paper will concern itself mainly with the first of these areas, although some adversions to the other will be necessary with respect to the question of the evidentiary merit, in proceedings arising out of contested assessments, of valuations made by the Public Service Commission for rate-making purposes.

One of the distinguishing features of a public utility producing valuation problems peculiar to an enterprise of this kind is its statutory right to use public streets and lands in ways which, without such authority, would constitute trespass. Gas, electric, and water companies are good examples, since they clearly must run pipes and wires through streets and highways in order to serve their characteristic public purpose. In New York, these utilities find their statutory warrant for this right in the Transportation Corporations Law.[1]

Such installations in the public streets are usually costly and normally produce income for their owners. It is not to be supposed that they should escape taxation. But how are they to be valued, and by whom? No special political or economic clairvoyance is needed to anticipate that any anomalies or incongruities generated by the special character of such installations will have been summarily resolved by statute. But before examining the statutory solution, the problem should be stated in detail.

If, applying the traditional classification of property, we deduct from the total property of a public utility that which is "real" (ie., lands owned by the corporation together with improvements thereon), there should be left that which is "personal." This would include, at least while they remained unplaced in the public ways, certain *tangible* properties such as pipes, wires, poles, etc. If, upon being so placed, these are considered (in accordance with the common law doctrine of "fixtures" or any statutory enunciation of it) to be *real* property and therefore taxable as such, the fact that the title to the street or highway land is not in the owner of the fixtures (and may for that matter be either in the municipality or in the fee owner of the abutting property) would present in itself, in the absence of the statutory solution hinted at above, tax problems which, while not insoluble, would at least be more complicated than those presented by more ordinary varieties of real property taxation. Nor are these problems to be avoided by any tax on such tangibles as "personal" property of the fixture-owner. Section 3 of the Tax Law provides:

> Notwithstanding any provision of this chapter or of any other general, special or local law to the contrary, personal property, whether tangible or intangible, shall not be liable to taxation locally for state or local purposes.

Now, also included in the residue of utility property after the deduction of what is normally thought of as "real" property are certain *intangibles,* e.g., good will, contracts, and, most notably, "fanchises"—i.e., rights to use public streets and lands for public service uses. But the Constitution provides: "Intangible personal property shall not be taxed ad valorem."[2] On the other hand, the Tax Law provides: "All real property within the state is taxable unless exempt from taxation by law."[3]

1. *E.g.,* Section 11(1), provides: "A gas corporation . . . shall have power . . . to lay conductors for gas in the streets, highways and public places in each city, village and town in the county or counties named in its certificate of incorporation, with the consent of the municipal authorities . . . and under such reasonable regulations as they may prescribe." Section 11(3) provides similar authority for electric companies, and Section 27 does likewise for telephone companies.
2. N.Y. CONST. art. XVI, §3.
3. N.Y. TAX LAW §3.

An enticing solution now appears to the question of how to make taxable a public utility's tangible and intangible (i.e., franchise) properties in the public ways: simply determine by statute that *both* are "real property." Although this entails the contemplation of "intangible real property" (so far as the franchises are concerned), it is exactly what the legislature did, in the passage of the Special Franchise Law in 1889, at the instigation of Governor Theodore Roosevelt.[4]

The chief provisions of the law are now contained in Section 2, subd. 6, and Sections 44-49 of the Tax Law. Section 2, subd. 6, reads:

> The terms "land," "real estate," and "real property," as used in this chapter, include . . . all telegraph lines, wires, poles and appurtenances; all supports and inclosures for electrical conductors and other appurtenances upon, above and underground; all surface, underground or elevated railroads, including the value of all franchises, rights or permission to construct, maintain or operate the same in, under, above, on or through, streets, highways or public places; all railroad structures, substructures, and superstructures, tracks and the iron thereon; branches, switches and other fixtures permitted or authorized to be made, laid, or placed in, upon, above or under any public or private road, street or ground; all mains, pipes and tanks laid or placed in, upon, above or under any public or private street or place for conducting steam, heat, water, oil, electricity or any property, substance or product capable of transportation or conveyance therein or that is protected thereby, including the value of all franchises, rights, authority, or permission to construct, maintain, or operate in, under, above, upon, or through, any streets, highways or public places, any mains, pipes, tanks, conduits or wires, with their appurtenances, for conducting water, steam, heat, light, power, gas, oil or other substance, or electricity for telegraphic, telephonic or other purposes; . . . A franchise, right, authority or permission specified in this subdivision shall for the purpose of taxation be known as a "special franchise." A special franchise shall be deemed to include the value of the tangible property of a person, copartnership, association or corporation situated in, upon, under or above any street, highway, public place or public waters in connection with the special franchise. The tangible property so included shall be taxed as a part of the special franchise. . . .

Sections 44-49 provide that the valuation of the "special franchise" is to be made by the State Tax Commission, which is directed to certify its assessment to the local tax district in which the franchise is exercised, there to be taxed at the local and state rates applicable to other property. (The statutory functions of the Tax Commission in this area are actually discharged at present by a temporary commission called the State Board of Equalization and Assessment, hereafter

4. N.Y. Sess. Laws 1899, c. 712. *Cf.* 1 BONBRIGHT, VALUATION OF PROPERTY 596 (1937).

referred to as the State Board, which was created by Chapter 346 of the Laws of 1949 and is continued in existence at present by Chapter 189 of the Laws of 1956). This innovation—the provision for state rather than local valuation—provided, as will be seen, the occasion for the first constitutional challenge against the new law.

Section 44 calls for annual (and supplemental, if needed) reports to the Tax Commission "containing information and data upon such matters as it may specify." The forms for these reports, prepared by the commission, have become increasingly searching, until by now they are truly formidable. Also, the Public Service Commission is required by this section to furnish to the Tax Commission:

> the estimates of reproduction cost new, depreciation and present value presented to the Public Service Commission by any utility company in any valuation matter, together with such portions of the testimony and exhibits relating thereto as the state tax commission shall request.

Section 45 provides:

> The tax commission shall annually fix and determine the assessment of each special franchise subject to assessment in each city, town or village. . . .

There is no specification here or elsewhere of any *method* to be used in assessing, that is in *valuing*, the special franchise or either of its components—the tangible element and the intangible.

It should be noted that the Tax Commission is to assess "each" special franchise. As might be guessed, they are numbered in the thousands throughout the state. Each time a railroad crosses a street or highway, a separate "special franchise" is involved,[5] assessable by the Tax Commission (or, as now, by the State Board), and taxable by all local tax districts in which the crossing is situated. The far-flung networks of gas, electric and telephone companies likewise present a multiplicity of "special franchises" existing in each city, town or village in which their properties occupy the public ways. It will be seen then that the problem presented to the Tax Commission is enormous in terms of its sheer size, and imponderable in terms of the necessary apportionment of "value" to artificially fragmented sections of integrated systems. And one needs no statistics to judge the importance of this tax to the utility companies, since of course a great amount of the average utility's total property is installed or operated in the public ways.[6]

5. *Cf.* People v. Gourley, 198 N.Y. 486, 92 N.E. 398 (1910). See also, People v. Hale, 203 N.Y. 312, 96 N.E. 933 (1911).

6. In 1930 the total of equalized assessments on special franchises in New York State was about one billion dollars. In the period 1918-1920, the special (Footnote continued on following page.)

In 1903, in *People ex rel. Metropolitan Street Railways v. Tax Commissioners,*[7] five street railroads and two gas companies challenged the constitutionality of the special franchise tax. The main grounds of their case were: (1) assessment is traditionally a local function, and transferring it to the central state authority is a violation of the home rule provisions of the state constitution; (2) the statute's "failure to indicate any principle or method for ascertaining the value of intangible property included in the special franchise, the failure of the state board to attempt any separate valuation of the intangible property, and its failure to adopt or proceed upon any principle or method of valuing the totality of intangible and tangible property together constituting the special franchise, and necessarily the substitution of speculation and guesswork in place of judgment in making such valuation amounted to such an absence of quasi-judicial action as to constitute the taking of property without due process of law."[8] The Court of Appeals held the statute constitutional. In answer to the first argument, the court stated that the new tax was *sui generis,* that the assessment for it was not a function which local assessors ever did exercise, and that therefore the "home rule" provisions of the constitution were not violated. The court's opinion, by Judge Vann, makes the point that local assessors *could not* do the job entailed by the law:

> The valuation of this new kind of property, intangible, invisible and elusive, but of great value, would be attended with peculiar difficulties, which would require a degree of knowledge and skill not possessed by local assessors, but belonging only to experts who had long and carefully studied the subject of taxation in all its varied aspects. . . . The local assessors dealt with tangible property, which could be seen and was open to the judgment of ordinary men, or with written evidence of debts or contracts, the value of which could be easily computed. It was their habit to measure, weigh and count; to learn the market-value from current sales, to pass upon physical and material property which they were accustomed to own, rent, or use, and with which they were familiar in their daily life. They saw it, knew it, and could judge its value. It was before their eyes and they could act upon it directly.[9]

Judge Vann goes on to introduce the subject of "earning capacity" as a basis for taxation. (It will be recalled that the statute itself gives no indication of what weight is to be attached to the earning capacity of special franchises, nor even any indication that it is to be considered at all.)

(Footnote continued from preceding page.)
franchise tax represented almost one-half of the total tax bill of local traction companies, telephone and telegraph companies, and electric and gas companies. Source: 1 BONBRIGHT, VALUATION OF PROPERTY 597 (1937). These are the latest figures of this character the writer could discover.

7. 174 N.Y. 417, 67 N.E. 69 (1903), *reversing* 79 App. Div. 183, 80 N.Y. Supp. 85 (1903) and 79 App. Div. 643, 80 N.Y. Supp 1145 (1903); *aff'd* 199 U.S. 1, 199 U.S. 48, 199 U.S. 53 (1905).
8. 174 N.Y. 417, 429-30 (Points of Counsel for Respondent).
9. 174 N.Y. 417, 437, 439, 67 N.E. 69, 73, 74.

> Moreover, a special franchise, now confined to one district, may be expansion, through merger, consolidation, leasing and the like, extend into other tax districts. Such an enlargement is open to all, has been the experience of many, and may be the experience of all. The same corporation may have many special franchises, continuous or separate, yet they are all practically one, because they all belong to one system, the earning capacity of which may be ascertained, but not that of each special franchise independent of the others. . . . The combination of all into a single enterprise gives the highest, if not the only value to each. What would a franchise in a town be worth, with no right to enter a city or village? While the strength of the chain is in the links, the value of the links is in the chain. Hence a franchise is not essentially local in character, and may require action, observation and estimate beyond the lines of a single tax distict, or the accustomed jurisdiction of local assessors. An examination of the books of the corporation may be necessary in making the valuation, yet they may not be kept in the municipality of the assessors' residence. A highway may be local, but the title thereto is not, for whether a fee or an easement, it is held in trust for the people at large, represented by the state, which has control of the streets and of the erections therein.[10]

Judge Vann's sentence, "While the strength of the chain is in the links, the value of the links is in the chain," is a captivating tooled expression. But it is either a valid legal analogy or mere sententious counterpoint depending on whether or not in the final process a particular dollar value can rationally be attributed to *each link*, as the statute provides must be done for purposes of local taxation. Anent this problem, Bonbright, an eminent authority on valuation problems, asks:

> If the wire, pipe or track of a utility company extends beyond the limits of a single tax district, by what method shall the tax commission determine the value of the right to use the streets of any one district? It is hardly necessary to point out that, from the standpoint of appraisel theory, these questions are absurd. But they are inevitably raised by a tax which, in its very nature, makes absurd distinctions between tangible and intangible values, and between those intangible values that are created by the use of the streets and those otherwise created.[11]

To state the problem another way, one might ask whether any just apportionment of value can be made among components all of which are *vital* to the operation of the utility. Are not the terms "apportionment" and "vital" mutually exclusive in this context? Is not the word "vital" as incapable of grammatical comparison as is the word "unique"? Is a man's heart worth more than his liver?

It is only a partial answer that vital components may be valued by reference to cost, whether original or replacement. So indeed might the *tangible* element of

10. 174 N.Y. 417, 442, 67 N.E. 69, 75.
11. 1 BONBRIGHT, VALUATION OF PROPERTY 611 (1937).

a special franchise be valued, and so indeed it *must* be, where determination of the *earnings* attributable to the particular franchise cannot be determined. In *People ex rel. Delaware, L. & W. R. Co. v. Clapp*, the Court of Appeals observed that "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, draws into the calculation so many elements that the process becomes too complex and difficult for even an expert,"[12] and the Court rejected such a basis in favor of valuation at depreciated reproduction cost. But there is no such thing as reproduction cost for the *intangible* property known as a franchise. You either have the permission or you have not. There is no substitute.

As noted earlier, the statute avoids any prescription of *method* by which either system-wide valuation or the ultimate apportionment of value to each special franchise is to be determined. Judge Vann, while endorsing the principle of "earning capacity" for purposes of argument with respect to the incapacity of local assessors to meet the challenge of the new tax, avoids, further exploration of this murky area:

> The further contention of the relators, that the act is impracticable and incapable of execution; that the special franchises should have been separately assessed; that the state tax commissioners adopted no rule in making the assessments . . . after due consideration we overrule, without further expression of reasons that already appears.[13]

The case was appealed to the United States Supreme Court. Elihu Root, in his brief for one of the plaintiffs in error, challenges the legitimacy of the method presumably employed by the Tax Commission in this case:

> It cannot be argued that a deduction from the aggregate value of the corporate securities as representing the total value of the corporate property, of the value of the real estate, securities of other companies, equipment and all other tangible property, will give the value of the special franchise. Such a method would be clearly untenable. Even if the market price of securities were a true measure of actual value, the deduction of the value of all the tangible property would leave a remainder which must represent numerous items of intangible property; namely, contracts with customers, patents, good will, and the general franchises of the corporation. There is no method or rule by which this remainder can be apportioned to the different items of intangible property. Any attempt to do so would necessarily be pure guesswork and imagination. And under the laws of this state, general franchises and good will are not taxable for local purposes.[14]

12. 152 N.Y. 490, 494, 46 N.E. 842, 843 (1897).
13. 174 N.Y. 417, 449, 67 N.E. 69, 77.
14. As reported in 50 L. Ed. 86.

The Court discusses this argument in its opinion in a companion case:

> It will not do to say that the valuation of a piece of property is mere guesswork. True, it is often largely a matter of opinion, and mathematical exactness is not always possible. Various elements enter into and affect an opinion respecting the value of a given piece of property, and all that can be required is that the assessing board exercise an honest judgment, based upon the information it possesses, or is able to acquire. That valuation is of the property as a totality, and it is unnecessary in making an assessment to disintegrate the various elements which enter into it and ascribe to each its separate fraction of value. Oftentimes the combination itself is no inconsiderable factor in creating the value. We are of the opinion that the relator was not denied due process of law in the valuation and assessment of its franchise.[15]

It will be noted that this answer appears to admit the argument made by Mr. Root that other intangibles than the franchise value are present in the amount assessed for same, but to discount its significance in spite of the New York constitutional provision which forbids the taxing of intangible personal property. The only way out of this impasse seems to be to construe Section 2, subd. 6 of the Tax Law even more broadly than its own sweeping language would at first reading seem to necessitate, i.e., to deem "real property" not only the tangibles placed in the public ways by the utility company and the rights, authority or permission to do so, which the statute specifically provides for, but also all *other* intangibles which are attendant upon such operations or which are profitable because of them. This is indeed a contortion of traditional property concepts which would seem to be finally mortal to them.

Although the "net earnings rule" is not specified in the statute as a method of evaluating special franchises, and the intangible element of the franchise *right* in particular, it gained early and lasting favor as a judicial test for determining, in certiorari proceedings, whether the assessment of the Tax Commission was fair and just, even when it was not certain that the tax commission itself applied the rule in the first instance.

In *People ex rel. Jamaica Water Supply Co. v. Tax Commissioners*,[16] the water company's special franchise assessment had been fixed by the tax commission at $800,000. In the certiorari proceeding, the Supreme Court at Special Term appointed a referee, who, using the net earnings rule (though it was not stated whether the Tax Commission had used it) found the assessment not excessive. The Appellate Division accepted the net earnings rule as a fair method, but found certain fault with the referee's (and perhaps the Tax Commission's) use of

15. 199 U.S. 48, 52; see note 7 *supra*.
16. 196 N.Y. 39, 89 N.E. 581 (1909), *modifying* 128 App. Div. 13, 112 N.Y. Supp. 392 (3d Dep't 1908).

it, in certain details. The Court of Appeals modified the judgment of the Appellate Division, but still endorsed the net earnings rule, which thereby became an accepted judicial test.

The Court of Appeals stated the rule as follows:

> The net earnings rule contemplates a valuation upon the basis of the net earnings of the corporation which are attributable to its enjoyment of the special franchise. The method is thus applied: (1) Ascertain gross earnings. (2) Deduct operating expenses. (3) Deduct a fair and reasonable return on that portion of the capital of the corporation which is invested in tangible property. The resulting balance gives the earnings attributable to the special franchise. If this balance be capitalized at a fair rate we have the value of the special franchise.[17]

(The court here is using the term "special franchise" to mean only the intangible element—the right or permission itself. The value of this as determined by the above rule is then added to the value of the tangible element and the sum is the value of the total "special franchise" as this term is used in the Tax Law, Section 2, subd. 6.)

The Court also held that there must be an allowance for depreciation in addition to actual outlays for "maintenance" which is an operating expense. Especially significant was the Court's affirmation of the Appellate Division's holding that a 6% return on tangible property rather than the 5% allowed by the referee was proper, as being necessary to attract capital. The Court also held that a 7% capitalization rate was proper "in view of the character of the relator's business."[18]

The problem of tax-equalization as applied to special franchise taxes was also involved in this case. The referee had found that the ration of assessed valuation to the actual or full value of real estate in Queens County in 1907 was 89%. The Appellate Division, in remitting the matter to the tax commission for reconsideration of some points noted above, also ordered that the total value of the special franchise, as found in accord with its opinion, should be reduced by 11% in order to equalize the assessment with the assessed value of other property in the same locality. The Court of Appeals remitted the matter to the Special Term, rather than to the Tax Commission, as at that time the tax commission had no statutory authority to equalize, and this was a purely judicial process which must be conducted in the equity side of a court.

Today, the equalizing is done by the State Board (*vice* the Tax Commission)

17. 196 N.Y. 39, 56, 89 N.E. 581, 586.
18. 196 N.Y. 39, 65, 89 N.E. 581, 589.

pursuant to statutory authorization and directive. Section 45 of the Tax Law provides:

> In determining such (special franchise) assessment, it (the Tax Commission) shall apply the latest state equalization rate except as to any portion of the special franchise property which was assessed for the year 1953, to which it shall apply the 1953 state equalization rate.

The foregoing materials, it is hoped, will serve to indicate the logical and conceptual problems arising out of the Special Franchise Tax. But the question remains: What methods are employed *today* in fixing the values with which we are here concerned? What methods will courts allow? Two difficulties would normally lie in the way of an answer.

First, most cases that have arisen since the law's inception are of the character that "must be limited to their facts," since it is a recurring theme in practically all of them that "it is the fairness of the ultimate result reached by the State Board which controls rather than the *modus operandi* involved in arriving at such result."[19] In view of this broadly equitable approach, while certain polarities may be observed persisting through the cases, it is practically impossible to plot the "isogonic lines" which would marshall the cases significantly for purposes of establishing abstractly what is allowed and what is not.

Second, there is precious little evidence in the cases to indicate what methods of valuation the Tax Commission or the State Board actually employ. It must be remembered that the burden of proof is on the objector to the assessment,[20] and the Tax Commission has on occasion appeared to be willing to rest on the presumption in favor of the fairness of its assessment; this despite such strictures as Judge Willard Bartlett's:

> The elements that enter into (a special franchise's value) may be so numerous and variable that it is utterly impossible for the taxpayer or the court to ascertain whether it has been assessed fairly and justly unless some ground of valuation is set forth more enlightening than a bare declaration that the assessing officers exercised their best judgment. As applied to a special franchise this is tantamount to a refusal to state any ground at all.[21]

But fortunately for the purposes of this paper, there has been reported recently (September, 1957) the opinion in a case decided in Supreme Court,

19. Staten Island Edison Co. v. Moore, 6 Misc.2d 1031, 1044, 164 N.Y.S.2d 772, 795 (Sup. Ct. 1955).
20. People *ex rel.* N.Y. Cent. R. Co v. State Tax Commission, 282 App. Div. 1007, 125 N.Y.S.2d 577 (4th Dep't 1953).
21. People *ex rel.* Buffalo Gas Co. v. State Board of Tax Commissioners, 199 N.Y. 162, 166-67, 92 N.E. 215, 217 (1910).

Albany County, in December, 1955, appeal on which is now pending. The case is *Staten Island Edison Corporation v. Moore*,[22] and it involves practically every important problem that could arise out of special franchise assessment except that of apportionment of value to different tax districts. The exhaustive opinion is by a referee and constitutes the decision, the parties having waived submission of formal findings.

The case involves the assessment for the fiscal year of 1952-53 of the special franchise of an electric company, the plant and all facilities of which were located in the Borough of Richmond, New York City. The following are the significant revelations and holdings:

(1) In determining the value of the intangible element of the Company's special franchise, the tax commission added 5% to the value it determined for the tangible element. The opinion reveals:

> It is undisputed that it has been the practice of the State Board for many years to attach a value to this incorporeal right equal to 5% of the value of the tangible component of the franchise in all cases where the net return of the utility is less than 6%. Concededly, relator's earnings for the year in question showed a net return of only 5.86%[23]

It seems probable that many, if not most of New York utilities are presently taxed in the same fashion on their special franchises, inasmuch as the Public Service Commission, in determining the allowable rate of return on a utility's investment "undoubtedly (places) a heavy reliance on a sort of natural rate in the neighborhood of 6%."[24]

The court held the practice of adding 5% to be arbitrary, and disallowed it on the grounds that when such a company's earnings do not exceed 6% of the cost of its investment, the value of the franchise right is merged into the value of the tangible element of the special franchise, and no additional "separable" value may be ascribed to it. ". . . [T]he measure of the value of the franchise right itself is *excess* earnings capitalized at a fair rate of return."[25] (Emphasis added.)

(2) The accrued depreciation on the tangible component (26.88%) as calculated on rates mandated by the Public Service Commission for purposes of rate-making was accorded an evidentiary value sufficient to make it preferable to the lower figure (15%) allowed by the tax commission, inasmuch as the

22. See *supra*, note 19.
23. 6 Misc.2d 1031, 1045, 164 N.Y.S.2d 772, 787.
24. Somers, *Cost of Money as the Determinant of Public Utility Rates*, 4 Buffalo L. Rev. 289, 309 (1955).
25. 6 Misc.2d 1031, 1048, 164 N.Y.S.2d 772, 789.

presumption in favor of the commission's figure is overcome when the company goes ahead with proof of the fairness of its figure and the commission offers no affirmative proof of the fairness of its own.

(3) "Economic obsolescence" due to progress in the art as well as actual physical deterioration may be included in depreciation.

(4) In valuing the tangible element of the company's special franchise property, the state board actually used "*original* cost depreciated" as the basis for its computation. However, during the trial, the board and the City of New York as intervenor-defendant sought to show that a more proper basis for valuation would be "*reproduction* cost depreciated" and that if this were used, the resulting assessment figure—even if the Public Service Commission depreciation rate were employed—would be much greater than that actually fixed by the board.

The court refused to countenance this turnabout argument, holding that the original basis was eminently fair if properly applied—i.e., if the proper depreciation were allowed and the synthetic 5% for intangible franchise value were disallowed. The court accepted the company's evidence that original cost so applied resulted in a figure *greater* than the value of the special franchise as calculated by the net earnings method, this test being acceptable where no problems of apportionment are present. Reproduction cost, the court declared, is the *maximum* value of taxable property, but not necessarily the proper value to be used where a different figure can be achieved by acceptable means. Furthermore, where rates are fixed by the Public Service Commission on a rate-base arrived at by taking original cost,

> it is utterly unrealistic to suppose that the true or actual valuue of the property of a public utility can be determined on the basis of a formula which, as in the case at bar, produces a valuation upwards of $2,500,000 in excess of that on which this same property is allowed to earn a fair return for its owners. Modern business is not conducted in an economic vacuum where it is completely insulated from those factors which necessarily affect and determine earnings, but in a practical world where values are—and indeed must be—measured by the accepted criteria of the market place.[26]

It is believed that should this case go to the Court of Appeals, as it probably will, the decision therein will become a landmark case in the confused and baffling history of the special franchise tax. The issues are clearly drawn in the referee's decision, and one thing that may at least be partially resolved is the anomaly of two government bodies, the Public Service Commission and the State Board, performing identical functions of valuation and arriving by different

26. 6 Misc.2d 1031, 1060, 164 N.Y.S.2d 772, 801.

methods at radically different results, where their difference in purpose is not sufficient to explain or justify the disparity.

It would seem desirable that if a mechanism must have two pendulums, at least they should operate in phase.

Walter J. Barrett

THE TAX CONSEQUENCES OF THE SALE OF A PATENT

The tax treatment to be accorded the transfer of patents is an area in the field of federal income taxation which has given rise to perplexing problems and persistent litigation. As is the case in any transfer of assets today, the transferor of rights to a patent naturally seeks to avail himself of capital gain benefits. However, in any situation other than the ideal, the transferor of a patent now has many intricate and uncertain problems facing him. The source of much of this difficulty is first, the limited scope of the present statutory scheme which requires those outside its narrow, complicated mandate to seek relief under the law evolved prior to its enactment, and second, because in applying this latter law, one must contend with a questionable ruling of the Commissioner which is contrary both to expressed legislative policy and to the economic realities surrounding the transfer of a patent. The first phase of this comment shall consist of a discussion of the law as it developed prior to the 1954 Code and the second phase shall discuss the 1954 Code in light of recently adopted regulations.

THE LAW PRIOR TO THE 1954 CODE

Prior to the enactment of the 1954 Code, the taxpayer had several serious hurdles to overcome before he could obtain capital gain benefits: (1) Was the patent a capital asset, or a section 117(j) asset, held for more than six months? (2) Was there a sale or exchange? (3) Would the contention of the Commissioner with respect to the mode of payment defeat the sale?

Was the patent a capital asset held for more than six months?

Prior to 1942, in order for a patent to be treated as a capital asset, it could not be depreciable property used in the taxpayer's trade or business, stock in trade or inventorial property, or property held primarily for sale to customers in the ordinary course of the taxpayer's business.[1] In other words, the taxpayer had to show that he was not a professional inventor or, if an investor, that he was not a dealer in inventions. An analysis of the cases deciding this factual question

1. INT. REV. CODE OF 1939, §117(a), 56 STAT. 50 (now INT. REV. CODE OF 1954, §1221).