LCB File No. R085-98

PROPOSED REGULATION OF THE DEPARTMENT OF TAXATION

EXPLANATION–Matter in ***italics*** is new, matter in brackets [ ] is to be omitted.

AUTHORITY: NRS 361.320 AND NRS 360.090.

Section 1. Nevada Administrative Code Chapter 361 is hereby amended to read as follows:

361.421 Cost approach indicator of value. The cost approach consists of:

1. Determining the gross book cost ***for financial reporting purposes*** of all ***taxable*** operating property including, but not limited to, all property relating to rail transportation, utility plant in service, plant held for future use, contributed plant, nuclear fuel, construction work in progress, experimental plant, acquisition adjustments, materials and supplies, plant and other property leased from others and common plant.

2. Deducting from the gross book cost the accrued book depreciation ***recorded for financial reporting purposes*** **[**as permitted by regulatory agency requirements**]** which ***may*** include**[**s**]** physical, functional and economic obsolescence. Additional obsolescence ***shall*** **[**may**]** be **[**calculated and**]** deducted when **[**considered applicable**]** ***adequately quantified***.

(Added to NAC by Tax Comm'n, eff. 9-30-88)

361.____ Cost approach indicator of value: Optional cost information.

1. The taxpayer may present and the Department shall consider, in addition to the information required by NAC 361.421, one or more of the following alternative cost indicators of value:

(a) A calculation of the reproduction cost new less depreciation for all taxable operating property of the collective unit being assessed performed in accordance with generally accepted appraisal methodology.

(b) A calculation of the replacement cost new less depreciation for all taxable operating property of the collective unit being assessed performed in accordance with generally accepted appraisal methodology.

(c) Any other relevant and verifiable information, such as rate base for regulatory purposes.

361.423 Income approach indicator of value: Formula for determination.

1. The capitalized income approach consists of deducting from the ***normalized and annualized*** gross operating income any direct and indirect ***normalized and annualized gross***

operating expenses specifically related to the ***normalized and annualized gross*** operating income including any annual***ized*** book depreciation. Deferred **[**federal**]** income taxes will be treated as an operating expense. **[**Reported**]** ***Normalized and annualized*** rental expense on operating property leased from others, less imputed depreciation, ***income taxes and other applicable expenses*** will be disallowed as an operating expense.

2. The resulting adjusted net operating income will be capitalized (converted to value) using an appropriate capitalization rate for the industry ***group***. The capitalization rate for the typical company will be used for the firms being appraised in each industry ***group***. The ***market*** **[**statistical median**]** capitalization rate will be derived from calculations made for selected companies in each industry ***group***.

3. The operating income to be capitalized into taxable value will be ***normalized and annualized based on the*** most recent year's adjusted net operating income. When the most recent year's net operating income is not a reasonable representation of a company's net operating income, such as, where a company's net operating income tends to be cyclical, a 3- or 5-year average of adjusted net operating incomes ***will be normalized and annualized*** and may be used.

4. Construction work in progress is not a factor in applying the income approach to value.

5. Any normalization or annualization adjustments to a company's net operating income must be based on known, measurable, and experienced changes in a company's operation or taxable property as of the current years reporting date.

(Added to NAC by Tax Comm'n, eff. 9-30-88)

361.425 Income approach indicator of value: Capitalization rate. The capitalization rate will be established from a selected number of firms to derive the rate for the typical company in each industry ***group*** when the information is available:

1. The band-of-investment method will be used in the compilation of the capitalization rate.

2. The band-of-investment method represents the cost of the money needed by the typical company in each industry ***group*** to acquire its operating plant and carry on its operations. It is composed of two factors:

(a) The capitalization ratios of the typical company; and
(b) The cost of the items which comprise the total capital structure of the typical company.

3. A "typical company" means a theoretical company which is representative of **[**a group of**]** ***the*** firms within an industry ***group***. The selected firms in the industry ***group*** will be ***highly comparable*** **[**similar**]** in amount of revenues, bond ratings, nature of operations and regulatory environment. Certain nonutility conglomerates which have utility operations in Nevada will be studied in the light of other similar conglomerates. Conglomerates will not be grouped with

nonconglomerates where possible. The development of the typical company will reflect input by the companies ***within the industry group,*** which are centrally assessed.

4. The items which comprise the total capital structure of the typical company are those **[**reported book**]** amounts ***as recorded for financial reporting purposes which represent*** **[**reflected under the credit side of the balance sheet indicating**]** the sources of the money or capital funds made available to acquire the **[**properties reflected under the debit or asset side of the balance sheet**]** ***taxable operating property of the industry group*****.** For the purposes of this subsection, "capital funds" means money obtained from:

(a) Creditors through notes or bonds;
(b) Stockholders through stocks, paid-in capital and undistributed retained earnings; and
(c) Similar financial capital accounts, except, not from the Federal Government through deferred federal income taxes.

[Each item will be given consideration.**]** The capital structure of the typical company will be derived through the use of a statistical median from the selected sample of firm calculations.

5. ***In addition to the capital structure of the typical company derived pursuant to paragraph 4, the taxpayer may present and the Department shall consider the total capital structure of the typical company based upon common equity, preferred equity, and long term debt percentages as developed from market information for comparable companies in the industry. The capital structure of the typical company will be derived from the use of market information from the selected sample of firm calculations.***

6. The annual high-low ***monthly*** average yield ***to maturity*** compiled by Moody's Investors Service (Public Utility and Transportation) or another accepted service, approved by the executive director of the department, will be used for the assignment of a cost to the long-term bonded indebtedness component of the capital structure.

[6**]**. ***7.*** The assignment of cost to preferred stock will be determined in a manner consistent with subsection 5.

[7**]**. ***8.*** The assignment of cost to that portion of the capital structure which represents equity for the typical company in each industry will be determined in the following manner:

[(a) For each selected firm, the common stock value is the average of the annual high and low market price quotation during the year multiplied by the yearly average number of shares outstanding.
(b) For each selected firm, the income before extraordinary items (available to common equity shareholders) is divided by the calculated market value of the common stock.
(c) The equity rate of the typical company is the statistical median of the equity rates for the entire group of the firms selected as the sample of the industry.
(d)**]**

(a) The department will develop an equity rate for each industry group based on one or more of the following models:

(1) Discounted cash flow method

(2) Capital Asset-Pricing Model

(3) Risk Premium analysis

(b) The department will also consider the results of cost of equity studies provided by members of the industry groups based on the same models as those listed above.

(c) When considered applicable, the cost of equity capital established for the industry may be determined by using additional models***, such as direct capitalization,*** accepted in the appraisal and financial communities and approved by the executive director of the department.

[8.**]** ***9.*** The capitalization rate of the typical company for the industry will be calculated by using a weighted method (band-of-investment) which is the capital structure percentage times the component rate percentage. The weighted values are then totaled and rounded to four decimal places to get the capitalization rate.

361.427 Market or stock and debt approach indicator of value.

1. The market or stock and debt approach proposes a value for the entire firm ***but is generally recognized as a less applicable methodology for determining the value of taxable property.***

2. The stock and debt indicator is determined by multiplying either the average monthly, quarterly or annual high and low market price quotations when available, for all of the securities which are actively traded in the market place, including common stock, preferred stock and long-term debt, by the number of share outstanding at the end of the year. Computations of the present worth of income flows may be made to determine values for securities, which are not actively traded.

3. The value of the stock of a holding company is apportioned among its operating companies according to the ratio of:

(a) Each operating company's property to the aggregate property of all of the operating companies, valued at historical cost and weighted at one-third; and

(b) Each operating company's net income before income taxes to the aggregate net income of all of the operating companies, weighted at two-thirds.

4. To this amount will be added items such as customer advances for construction which are nontaxable for federal income tax purposes, current liabilities less dividends declared, the present worth of leased property over the period of the lease together with any other items conforming to the theory that if a person were to purchase all the stock and assume all the outstanding liabilities of a company, he would have acquired all the assets which appear on the asset side of the balance sheet and, therefore, own the company.

5. From this amount will be deducted the market value of all **[**nonassessable assets**]** **exempt or nonoperating property** including, but not limited to, cash, accounts receivable, notes receivable, miscellaneous investments, temporary investments, nonoperating properties and other current and accrued assets and properties not subject to the ad valorem property tax imposed by NRS 361.315 and 361.320.
(Added to NAC by Tax Comm'n, eff. 9-30-88)