the application of these rules will substantially lower the valuation of industrial facilities as compared to the cost to construct new facilities.

Pennsylvania case law interpreting these assessment rules has evolved slowly. However, beginning in 1999, a substantial amount of assessment litigation arose with respect to electric generation facilities which became subject to local taxation as a result of the deregulation of the generation of electricity in Pennsylvania. From among those cases, three decisions (the “Allegheny Energy trilogy”) emerged from the Commonwealth Court that have clarified the rules.1 Importantly, from the vantage point of industrial taxpayers, the decisions have underscored the requirement that obsolescence be applied based on the market demand for industrial real estate generally, rather than the “value-in-use” of the premises for specific applications and due to clarifications regarding the scope of exclusions from taxation provided for machinery, equipment and other site improvements used in industrial activities.

BACKGROUND
Pennsylvania’s real estate tax assessment statutes exclude from taxation all machinery, equipment and structures used in manufacturing, mining, agricultural or industrial processes, except for machinery, equipment and structures used primarily for storage or to shelter machinery and equipment. The statutes also require that, when using the cost method of valuation, a reduction must be made to account for depreciation and obsolescence. In a typical tax assessment case, the application of these rules resulted in real estate valuations of the premises ranging from $7 million to $8 million, whereas the taxing authorities had advocated values in excess of $100 million.

This Alert summarizes the circumstances in which assessment reductions are made to account for 1) obsolescence, 2) the exclusion of machinery and equipment, and 3) the minimal contributory value of certain site improvements such as drainage and paving. This Alert also summarizes the assessment appeal process in Pennsylvania.

**ASSESSMENT REDUCTION OPPORTUNITIES**

*Market Value Reduction Based on Obsolescence in the General Industrial Market*

In *Allegheny Energy I*, the taxpayer contended that the fair market value of the premises determined by the cost approach should be based on the replacement cost of general industrial space similar in size to the structures comprising the power plant. The trial court agreed and rejected valuations offered by the taxing authorities that took into consideration the market for power plants as assembled units or the market for electricity. The trial court regarded the taxing authorities’ approach as an impermissible reliance on the value-in-use to the owner rather than consideration of the market value of the premises in the general industrial real estate market. In the initial proceedings, however, the trial court declined to apply any functional or economic obsolescence to the premises, reasoning that the power plant was fully functioning for its intended purpose (to generate electricity) and would likely do so for the foreseeable future.

On appeal, the Commonwealth Court in *Allegheny Energy I* agreed that the general industrial approach to valuation was correct, noting that “the value of the property for a specific use and the value of that use to the current owner are not relevant in determining fair market value.” *Allegheny Energy I*, 788 A.2d at 1092. However, the Commonwealth Court found error in the trial court’s refusal to apply any functional or economic obsolescence to the premises, reasoning that the power plant was fully functioning for its intended purpose (to generate electricity) and would likely do so for the foreseeable future.

On remand, the Commonwealth Court in *Allegheny Energy I* agreed that the trial court did not err when it adopted Mr. Goertel’s obsolescence determination because it considered the site as one in general industrial use. The Commonwealth Court’s pronouncement that obsolescence must be accounted for and that, in determining that obsolescence, the relevant reference is to general industrial property rather than to the utility of the property for a specific industrial use.

The Taxpayers’ expert defined obsolescence, functional and economic, in terms of efficiency and economic demand. In calculating obsolescence, he considered the number of buildings, because of their locations on the site, their lack of heating or electricity, and the fact that many of them are ideally suited to the needs of the power plant and otherwise have little economic value. Certainly, the value of the improvements should be reduced to reflect functional obsolescence, in terms of the loss in value cause by overcapacity and inadequacy, and to reflect economic obsolescence, the loss in value attributable to the lack of economic demand.

*Id.* at 1093.

On remand, the trial court applied approximately 35% obsolescence, and on subsequent appeal the Commonwealth Court affirmed, citing to its earlier holdings in *Allegheny Energy I*. See *Allegheny Energy II*, 837 A.2d at 670-671.3

In *Allegheny Energy III*, the Commonwealth Court noted: “The trial court did not err when it adopted Mr. Goertel’s obsolescence determination because it considered the site as one in general industrial use." The Commonwealth Court’s pronouncement that obsolescence must be accounted for and that, in determining that obsolescence, the relevant reference is to general industrial property rather than to the utility of the property for a specific industrial use.

---

2 Obsolescence is a form of depreciation. Depreciation can result from three causes - physical deterioration, functional obsolescence, and external or economic obsolescence - operating individually or in combination. See [The Appraisal of Real Estate](http://example.com), American Institute of Real Estate Appraisers (11th ed. 1996) at 365.

3 The Commonwealth Court affirmed a similar obsolescence factor of 35% in *Allegheny Energy III*, 869 A.2d at 34.
application, highlights the critical point that it is the real estate and not the business enterprise that is being taxed. In the context of industrial property, the amount of obsolescence that may be applied is often substantial, as illustrated by the 35% obsolescence applied in these cases, in addition to a reduction of approximately 35% for physical deterioration.

**Machinery and Equipment Exclusion**

The Pennsylvania assessment statutes exclude machinery and equipment used in a manufacturing, mining, agricultural or other industrial process from real estate taxation, except for property used primarily for storage or to provide shelter and protection for machinery and equipment. For example, Section 201(a) of the Fourth to Eighth Class County Assessment Law provides:

Machinery, tools, appliances and other equipment contained in any mill, mine, manufactory or industrial establishment **shall not be considered or included** as a part of the real estate in determining the value of such mill, mine, manufactory or industrial establishment.

72 P.S. § 5453.201(a) (emphasis added). The machinery and equipment provision of local tax assessment law prescribes a reasonably classified and constitutional exclusion. Thus, its application presents a problem of selective imposition of tax and, consequently, is subject to the principle of strict construction of tax statutes with all reasonable doubts resolved in favor of the taxpayer. See *BFC Hardwoods, Inc. v. Board of Assessment Appeals of Crawford County*, 565 Pa. 65, 72, 771 A.2d 759, 763 (2001).

Under a substantial line of Pennsylvania Supreme Court precedent, the machinery and equipment exclusion from local tax assessment has been held to be applicable to all improvements to real estate, whether attached to the land or otherwise, which (1) are used directly in manufacturing, mining, agriculture or other industrial activities; (2) are necessary and integral parts of the manufacturing, mining, agricultural or other industrial process; and (3) are used solely for effectuating that purpose. See *BFC Hardwoods, Inc. v. Board of Assessment Appeals of Crawford County*, 565 Pa. 65, 771 A.2d 759 (2001); *Jones & Laughlin Tax Assessment Case*, 405 Pa. 421, 175 A.2d 856 (1961). On the other hand, “improvements which benefit the land generally,” and “structures, which are not necessary and integral parts of the manufacturing process,” are not within the exclusion. See *Jones & Laughlin*, 405 Pa. at 431-32, 175 A.2d at 861. “A structure used for storage, for example, is part of the realty and subject to real estate taxation.” *Id.* at 432, 175 A.2d at 861-862.

In *Allegheny Energy II*, the Commonwealth Court applied this line of precedent in the context of a coal-fired electric generating station. It affirmed in all respects the trial court’s exclusion of substantial portions of the Hatfield’s Ferry Power Station based on the foregoing precedent. *Id.*

In *Allegheny Energy II*, the taxing authorities seized on the “used solely for” phrase in the third prong of the test and contended that substantial improvements, including smokestacks, water intake facilities and cooling towers that were used in the industrial process of generating electricity, were nonetheless taxable because they might be adapted to other industrial uses by a different occupant of the premises. For example, the smokestacks, the taxing authorities contended, could be used by other industries to exhaust fumes, the water intake facility could be used to serve a municipal waste system or agricultural irrigation, and the cooling towers could be used by chemical plants with large thermal requirements. The court rejected these contentions, stating: “…the test is whether the machinery and equipment is integral to and necessary for and used solely for the generation of electricity and not whether the improvements can somehow be adapted in the future for a different user.” *Allegheny Energy II*, 837 A.2d at 669. In reaching that conclusion, the court relied on the decision of the Pennsylvania Supreme Court in *BFC Hardwoods, Inc. v. Board of Assessment Appeals of Crawford County*, 565 Pa. 65, 771 A.2d 759 (2001) which held that structures that served as kilns were exempt in their entirety because they were integral to the industrial process of drying lumber notwithstanding the resemblance of the kilns to a building.

In *Allegheny Energy III*, the court extended the analysis and held that the power plant control room and substantial improvements that supported water heaters and pumps (“heater bay”) were likewise
excluded because they were integral to the industrial process. *Allegheny Energy III*, 869 A.2d 34.

These cases counsel that structures and other improvements that might, initially, be thought of as taxable realty are, in actuality, excluded from taxation when they are integral to an industrial process. Removing such items from the list of taxable improvements may substantially reduce the assessment on the premises. Obviously, the determination of which structures and site improvements are taxable and which are properly excluded requires a thoughtful evaluation of the relationship of those items to the industrial or manufacturing process being performed by the taxpayer.

**Minimal Contributory Value of Site Improvements**

In *Allegheny Energy III*, the court excluded the drainage site improvements from assessment because they were part of the industrial process. The court also affirmed the trial court’s determination not to ascribe value to an array of other site improvements such as gravel parking lots. It adopted the view of Mr. Goertel, the appraiser who testified on behalf of the taxpayer, stating:

> Mr. Goertel testified that the drainage system has no application except to the use of the site as a power plant and therefore adds no value to the plant. Mr. Goertel did not list the gravel parking lots as site improvements, his report stated that improvements including the access roads, interior cartways, and parking lots have been designed and implemented for the purpose of serving the parcel’s present use, and he testified generally that such elements are not reflected in the market, stating, “The market tends to eliminate all of those features from a property when it is being bought and sold.”

*Allegheny Energy III*, 869 A.2d at 34-35 (citations omitted). In so doing, the court was essentially providing legal recognition of a reality of industrial site development. That is, site improvements that may be costly in developing a site are often not reflected in the market value of that site in the hands of an industrial owner.4 As noted in the context of the application of the machinery and equipment exclusion, an appropriate recognition of the distinction between costs expended to provide utility to a site and the impact of those costs on the ultimate market value of the premises is important to avoid excessive tax assessment.

**HOW TO SEEK AN ASSESSMENT REDUCTION**

A taxpayer may seek a reduction in an assessment by timely filing an appeal in response to an assessment change notice. These notices are received whenever the county assessor makes a change of assessment, usually as a result of a countywide revaluation of property and sometimes as a result of a change in the improvements to the property. In addition, a taxpayer also may appeal an assessment in any given year, provided that the appeal is timely filed before the filing deadline established for the county in which the real estate is located. Deadlines vary among the counties in Pennsylvania. For example, assessment appeals in counties of the Fourth to Eighth class must be filed by September 1st of the year preceding the year in which the appeal would be effective (i.e., appeal by September 1, 2005 for tax year 2006). An appeal is heard in the first instance before an administrative board, typically called a board of assessment appeals. If the taxpayer is not satisfied with the disposition by the board of assessment appeals, a further appeal may be made to the Court of Common Pleas. The proceedings before the Court of Common Pleas are *de novo*, meaning that a new record is made and the court makes a determination that is independent of the prior board of assessment decision. Further review, limited in scope, also is available from the Commonwealth Court and, by permission, from the Pennsylvania Supreme Court.

**THE ROLE OF LEGAL COUNSEL IN ASSESSMENT APPEALS**

In considering whether to appeal a real estate tax assessment, it is important to have a clear understanding of the governing law. Property tax

---

4 Although not expressly stated by the Commonwealth Court, it also may have regarded the drainage improvements as excluded machinery and equipment since the drainage was a requirement of the environmental regulations of the industrial process. The Court’s reference to the industrial process suggests this conclusion in the broader context of the case.
assessment appeals, especially for commercial and industrial properties, can result in substantial valuation adjustments. The assistance of experienced legal counsel often is critical to the effective pursuit of settlement negotiations or litigation of the appeals. Attorneys experienced with assessment appeals can assist taxpayers to retain qualified professional appraisers to consider the appropriate valuation methodologies and applicable exemptions, exclusions or other reductions, including exclusions for machinery and equipment and appropriate reductions for depreciation and obsolescence.

Naturally, the list of realty tax assessment reduction topics discussed in this Alert is by no means exhaustive. Rather, it is intended to highlight some of the principles addressed in the recent appellate opinions focused on the proper valuation methods to be applied to large industrial and commercial facilities. It is often said that each piece of real estate is unique. Consequently, the prosecution of any real estate tax assessment appeal must be based on an evaluation of the unique characteristics of the premises.

Carleton O. Strouss
cstrouss@klng.com
717.231.4503

Christopher R. Nestor
cnestor@klng.com
717.231.4812

Allegheny Energy was represented by Kirkpatrick & Lockhart Nicholson Graham LLP. If you have questions about this topic or would like more information on Kirkpatrick & Lockhart Nicholson Graham LLP, please contact one of our lawyers listed below:

**Harrisburg**

Jacqueline Jackson-DeGarcia 717.231.5877 jjacksondegarcia@klng.com

Christopher R. Nestor 717.231.4812 cnestor@klng.com

Raymond R. Pepe 717.231.5988 rpepe@klng.com

Carleton O. Strouss 717.231.4503 cstrouss@klng.com

**Pittsburgh**

Evan A. Bloch 412.355.6234 ebloch@klng.com

Robert L. Byer 412.355.6200 rbyer@klng.com

David R. Cohen 412.355.8682 dcohen@klng.com