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10 **STATE OF CALIFORNIA**  
11 **BOARD OF EQUALIZATION**

12 In the Matter of the Petition for  
13 Reassessment of the 2010 Unitary Value for:

) **APPEALS DIVISION'S**  
) **HEARING SUMMARY FOR**  
) **ORAL HEARING ON**  
) **PROPERTY TAX PETITION**

14 **Cbeyond Communications, LLC (8049)**

15 Petitioner

)  
) Appeal No.: SAU 10-028  
) Case ID No.: 538673  
)

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17 Representing the Parties:

18 For the Petitioner: Joe Molina  
19 Ryan & Co.

20 For the Respondent: Richard Moon  
21 Tax Counsel IV  
22 Attorney for State-Assessed Properties Division

23 Don Jackson  
24 Principal Property Appraiser  
25 State-Assessed Properties Division

26 Counsel for Appeals Division: Louis A. Ambrose, Tax Counsel IV

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**PROPOSED VALUES**

	Value	Penalty	Total
2010 Board-Adopted Unitary Value	\$19,000,000	\$0	\$19,000,000
Petitioner's Requested Unitary Value	15,077,851	0	15,077,851
SAPD Recommendation	19,000,000	0	19,000,000

**ISSUE**

**Whether petitioner Cbeyond Communications, LLC has shown that its percent good factors are more reliable than those used by respondent State-Assessed Properties Division (SAPD or respondent) in the calculation of the Replacement Cost Less Depreciation (ReplCLD) value indicator.**

**BACKGROUND INFORMATION**

Petitioner provides managed Internet protocol-based communications services to small businesses in the United States. Petitioner's services include local and long-distance voice services, broadband Internet access, mobile voice and data, and other communications and information technology services. Petitioner's 2010 Board-adopted unitary value of \$19,000,000 was determined by placing 100 percent reliance on the ReplCLD value indicator.

**Appeals Division's Recommendation<sup>1</sup>**

The Appeals Division recommends that the Board deny the petition for reassessment because petitioner has not met its burden of proving that its percent good factors more accurately represent the remaining value of petitioner's unitary property and, thus, support petitioner's requested reduction of the 2010 Board-adopted unitary value.

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<sup>1</sup> Unless the Board otherwise holds, the Board shall take official notice of: the property statement filed with the Board, together with any attachments, including without limitation any reports to regulatory agencies such as the U.S. Securities and Exchange Commission and the California Public Utilities Commission, and any annual reports to shareholders; the Appraisal Data Report (ADR) prepared by the State-Assessed Properties Division (SAPD) together with any workpapers; the Notice of Unitary Value; and any correspondence between SAPD and petitioner.

1 **Contentions**

2 **Petitioner's Contentions**

3 Petitioner states that 91 percent of its network is comprised of high-technology  
4 components including computers, soft switches, integrated access devices, routers and software.  
5 Petitioner further states that its fixed asset listing of California property had a value of \$29 million and,  
6 of that amount, about \$27.2 million of all of its assets "represent three (3) year and five (5) year  
7 estimated useful life equipment kept on [petitioner's] books and records." Petitioner provides a table  
8 grouping petitioner's "accounting costs" "by their depreciable accounting lives" which shows the  
9 following: costs of \$149,609 equaling 1 percent of petitioner's property with a life of 2 years, costs of  
10 \$14,959,988 equaling 50 percent of petitioner's property with a life of 3 years, costs of \$12,259,795  
11 equaling 41 percent of petitioner's property with a life of 5 years, and costs of \$2,479,598 equaling 8  
12 percent of petitioner's property with a life of 7 years. (Petition, pp. 1-2.)

13 To properly reflect the depreciation in its unitary property, petitioner has developed  
14 percent good factors for the following three categories of property: (1) Softswitch, (2) Integrated Access  
15 Devices (IADs), and (3) T1 Aggregators, Collocation and Softswitch and describes the functionality of  
16 the components of each of those categories which is the basis for the application of its percent good  
17 factors. With respect to the functionality of the first category, petitioner states that a softswitch connects  
18 voice and data communications over a variety of mediums by means of computer software. As a result,  
19 petitioner states that, "due to the inherent software-intense nature of the softswitch", petitioner's percent  
20 good factor for this category is based 50 percent on the computer valuation schedule and, due to Internet  
21 Protocol (IP) processing, storage, and circuitry the remaining 50 percent is based on a digital switch set  
22 7-year life. (Petition, p.4.)

23 Petitioner states that an IAD "converts multiple types of input signals into a common  
24 communications format" by transmitting "signals of telephony and video data across bandwidth to its  
25 media or communications system." For this category, petitioner states that IADs are considered  
26 computers and related peripheral devices, thus petitioner's percent good factors are based 50 percent on  
27 the computer valuation schedule and 50 percent on the Customer Premise Equipment (CPE) factors. For  
28 the last category, petitioner states that a Cisco IAD is installed and managed at each customer's location

1 which connects to both a customer's existing phone system and local area network. The IP traffic is sent  
2 across petitioner's "private Cisco-based backbone network", the Internet data is sent via petitioner's  
3 "Internet service provider partners" and phone calls are transmitted via the Public Service Telephone  
4 Network. Petitioner states that its representative determined the IP network was comprised of both  
5 routers and gateways (computer equipment) and telecommunications equipment. For that reason,  
6 petitioner states that the router's percent good factors are based 50 percent on the computer valuation  
7 schedule and the remaining 50 percent is based on the factors for Central Office Equipment (COE)  
8 except switch-router. (Petition, pp. 5-7.)

9           Petitioner concludes by stating that the future of the telecommunications industry will  
10 almost certainly be marked by the acquisition of small to medium sized companies pursuing new  
11 markets with new technologies to acquire market share historically held by an incumbent monopoly.  
12 The growth of the new technologies – fixed wireless, fiber optics, cellular, satellite and Internet phone  
13 service – have eroded the historical walls between various telecommunications services. Under the  
14 appraisal principle of substitution, a buyer will pay no more than cost to acquire an equally desirable  
15 substitute and there is an abundance of substitute and alternative providers in this industry. Petitioner  
16 provides a table presenting modified ReplCLD value indicators reducing respondent's ReplCLD value  
17 indicators for the identified categories as follows:

	ReplCLD	Modified ReplCLD
18           Softswitch	\$390,472	\$293,399
19           CPE	\$8,463,415	\$7,167,769
20           COE Except Switch - Routers	\$2,334,686	\$1,795,750

21 (Petition, p.8.)

### 22           **Respondent's Contentions**

23           Respondent contends that petitioner has applied "customized percent good factors" to its  
24 COE, COE Switch (Softswitch), and CPE. Respondent asserts that petitioner's percent good factors are  
25 based on an arbitrary determination that petitioner's COE, Softswitch, and CPE are comprised of 50  
26 percent computer equipment and 50 percent of other equipment components. Respondent argues that  
27 petitioner's determination is arbitrary because, in petitioner's model, the selected network equipment is  
28 broken down and valued by its component parts, and not valued as operational equipment put to its

1 beneficial use as required by the Assessors' Handbook section 501, *Basic Appraisal* (AH 501). In  
2 respondent's view, petitioner's model does not result in a fair market value of the network equipment  
3 because it does not accurately represent the actual equipment that a prospective purchaser would acquire  
4 in the marketplace. (SAPD Analysis, p.2.)

5           Respondent makes the point that petitioner decided to purchase Cisco switches and  
6 routers based on the features that the particular CISCO equipment provides. Respondent emphasizes  
7 that petitioner purchased the entire switch and router, rather than their component parts, to gain the  
8 functionality that they were designed to provide. Respondent adds that petitioner would not have been  
9 able to purchase the component parts because there is no market for them. Thus, respondent contends  
10 that in petitioner's model such equipment would not function or be usable for any other salable function.  
11 Consequently, respondent contends that petitioner's percent good factors are based "on projected uses  
12 that do not conform either to the way in which such equipment operates or to how the market for such  
13 components actually works." (SAPD Analysis, pp. 2-3.)

14           Respondent also notes that petitioner's public SEC filings show that petitioner has  
15 already recorded three years of losses as of year end 2007, 2008, and 2009, for "additional depreciation  
16 and amortization expense" on "equipment resid[ing] at customer locations" in the amounts of  
17 \$1,164,000, \$2,130,000, and \$1,746,000, respectively. Respondent further asserts that the application of  
18 petitioner's California allocation percentage of 10.86 percent to the internal obsolescence adjustment  
19 made for 2009, results in a write-down of approximately \$190,000. However, respondent contends that  
20 petitioner requests a value reduction of its California property by an additional \$4 million dollars despite  
21 the fact that petitioner has already taken a \$1.7 million write-down for all of its property (of which only  
22 10.86 percent is located in California). Thus, respondent contends that petitioner's mathematical  
23 calculations provide no basis as to why additional obsolescence should be recognized. (SAPD Analysis,  
24 p.3.)

25           Finally, respondent contends that petitioner fails to include \$2,001,401 in construction  
26 work in progress (CWIP) that it reported on its 2010 Property Statement. Respondent asserts that  
27 petitioner neither adjusted nor requested an adjustment to CWIP, nor has it provided any evidence as to  
28 why CWIP should not be included in the 2010 unitary value. Therefore, according to respondent, even

1 if petitioner's methodology is correct, petitioner should have requested a unitary value of no less than  
2 \$17,079,252. (SAPD Analysis, p.4.)

### 3 **Petitioner's Reply Brief**

4 In a single-page reply to the SAPD Analysis, petitioner first states that it "submits this  
5 response to the SAPD recommendation to correct its opinion of value to include the CWIP at  
6 \$17,079,252 to reflect the entire system value in California." Petitioner also seeks to "correct  
7 misstatements" in respondent's analysis. First, petitioner states that the derivation of the percent good  
8 factors is based on the Board's methodology which reflects assets as operational equipment. Petitioner  
9 contends that its approach does not value the component parts but rather values computer equipment that  
10 is now being used to provide telephony. Petitioner states that its network has been constructed using  
11 hardware and software configurations from Cisco, including the new Cisco IAD 2400 series smart  
12 integrated access devices, the Cisco 10,000 Edge Services Router, the Cisco Catalyst 6500, the Cisco  
13 7200 series router and a Softswitch CISCO 10200. Petitioner attached to the reply brief documents that  
14 petitioner describes as "White Papers" for this type of equipment. Petitioner points to the White Paper  
15 for the Cisco 7200 Series Router Architecture as "definitive proof" that computer equipment is being  
16 utilized to offer telephone service.

17 Due to the recent convergence of data (voice, video and data) over the same protocol,  
18 petitioner states that IP computer routers are now utilized in the telecommunications industry. For that  
19 reason, petitioner states that it developed factors that best reflect the value of this equipment by using the  
20 valuation factors for computers and blended those with the Board's percent good factors for  
21 telecommunication equipment categories. Petitioner contends that the Board has utilized this same  
22 approach for the wireless industry and states that switching equipment percent good factors show that an  
23 eighty percent weighting was given to the switching category and twenty percent weighting was given to  
24 the computer category.

25 With respect to the write-downs in 2007, 2008, and 2009 for "additional depreciation and  
26 amortization expense" on "equipment resid[ing] at customer locations", petitioner contends that  
27 respondent has incorrectly described that reporting as a write-down of all property for obsolescence.  
28 Petitioner contends that the write-down only includes IADs, which are routers leased to customers, and

1 hence only reflects the CPE and not all the property as respondent contends.

2 **Applicable Law and Appraisal Principles**

3 **Burden of Proof** Assessing officers are presumed to have properly performed their duties. (Evid.  
4 Code, § 664.) The Board has promulgated the Rules for Tax Appeals (RTA) to govern the  
5 administrative and appellate review processes for all of the tax and fee programs administered by the  
6 Board. (Cal. Code Regs., tit. 18, § 5000.) Of relevance here, RTA 5541, subdivision (a) places the  
7 burden of proof upon the taxpayer as to all issues of fact except as otherwise specifically provided by  
8 law. Courts have long presumed that the Board assesses all property correctly, placing on the taxpayer  
9 the burden of proving that an assessment is incorrect. (*Trailer Train Co. v. State Bd. of Equalization*  
10 (1986) 180 Cal.App.3d 565, 584.) Therefore, petitioner bears the burden of showing that the assessment  
11 is illegal. (*ITT World Communications v. Santa Clara* (1980) 101 Cal.App.3d 246.)

12 **ReplCLD Value Indicator** Property Tax Rule 6,<sup>2</sup> subdivision (a) provides, in part: “The reproduction  
13 or replacement cost approach to value . . . is preferred when neither reliable sales data . . . nor reliable  
14 income data are available . . .” In general, the Replacement Cost Less Depreciation (ReplCLD)  
15 valuation methodology is estimated by applying trend factors—price level changes, including the  
16 application of “current prices to the labor and material components of a substitute property capable of  
17 yielding the same services and amenities, with appropriate additions as specified . . .” (Property Tax  
18 Rule 6, subd. (d).) Then, the resulting adjusted cost amount is Replacement Cost New (RCN), which is  
19 “reduced by the amount that such cost is estimated to exceed the current value of the reproducible  
20 property by reason of physical deterioration, misplacement, over- or underimprovement, and other forms  
21 of depreciation or obsolescence. The percentage that the remainder represents of the reproduction or  
22 replacement cost is the property’s percent good.” (Property Tax Rule 6, subd. (e).)

23 **Depreciation and the Replacement Cost Approach** In general, the ReplCLD value indicator  
24 recognizes three types of depreciation: physical deterioration, functional obsolescence, and external, or  
25 economic, obsolescence, through application of the Board’s replacement cost new trend factors and  
26 “percent” good factors. Obsolescence may occur when property is outmoded (functional obsolescence)  
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<sup>2</sup> All Property Tax Rules or Board Rules of Practice reference those numbered sections and subsections of title 18 of the California Code of Regulations.

1 or when some event has substantially diminished the future earning power of the property (economic  
2 obsolescence). (*See* Assessors' Handbook section 501, *Basic Appraisal* (January 2002), pp. 81-83.)  
3 Functional obsolescence is the loss of value in a property caused by the property's loss of capacity to  
4 perform the function for which it was intended. (*Id.* at p. 81.) Economic obsolescence is the diminished  
5 utility of a property due to adverse factors external to the property being appraised and is incurable by  
6 the property owner. (*Id.* at p. 82.)

7 **Percent Good Factors** Percent good factors are the basis for adjusting the ReplCN into an indicator of  
8 fair market value. The factors are complements of physical deterioration and functional obsolescence  
9 and are used to determine the remaining value of a property. The factors used for a given property type  
10 are derived from the expected economic life of that property type which are based on service life studies  
11 which help determine what percent good factors will be applied to a property type. Service life studies  
12 can measure some, but not all, economic obsolescence. Examples of economic obsolescence include:  
13 increased competition, unexpected technological innovation, legal limitations on use, and environmental  
14 factors. The percent good factors, the basis for adjusting the RCN into an indicator of fair market value,  
15 are used to determine the remaining value of a property and are complements of physical deterioration  
16 and functional obsolescence. The factors used for a given property type are based on the expected  
17 economic life of that property type which is based on a service life study that surveys industry  
18 participants who own that type of property. (Unitary Valuation Methods (Revised March 2003) (UVM),  
19 p. 30.)

20 In addition to economic life, there are four other variables that have an effect on percent  
21 good factors. These are: the rate of return, the method of calculation, the survivor curve, and the  
22 presence of an income adjustment factor. In the SAPD, these variables are determined as follows: rate  
23 of return annually established by the Property Tax Department, single-life calculation method, R-3  
24 survivor curve and the use of an income adjustment factor reflecting a 10% decline over average life.  
25 Petitioner has the burden of establishing the existence of any additional or extraordinary obsolescence.  
26 (*See* Property Tax Rule 6, subd. (d) & (e); Cal. Bd. of Equalization, Assessors' Handbook section 502,  
27 *Advanced Appraisal* (December 1998), p. 20-21; UVM, p. 30.)

28 **Construction Work in Progress** Construction in progress is assessable at full cash value on the lien

1 date. Costs incurred as of the lien date represent total costs, including preliminary direct and indirect  
2 costs such as planning and engineering charges. The fair market value should be based on what the  
3 property in its partially-constructed condition would bring in the market place involving a willing buyer  
4 and seller. Assessors' Handbook section 504, *Assessment of Personal Property and Fixtures* (October  
5 2002) (AH 504), p. 115.)

#### 6 **Appeals Division's Analysis and Recommendations**

7 Petitioner has the burden of proving that respondent's methodology does not reflect an  
8 appropriate amount of depreciation for each category of petitioner's unitary property. As stated above,  
9 respondent's methodology applies the percent good factors to types of telecommunications property which  
10 presumably includes the categories of property described by petitioner in its model. While petitioner's  
11 model uses percent good factors for each category based on a 50/50 allocation, petitioner has not presented  
12 any evidence to prove that the allocation properly represents the composition of the equipment in each  
13 category. At the hearing, petitioner should be prepared to present documentation to support its allocation  
14 for each category. Respondent should be prepared to describe the methodology by which it develops its  
15 percent good factors and valuation factors and describe how those factors reflect an appropriate amount of  
16 depreciation for each type of telecommunications property. In particular, respondent should explain the  
17 basis upon which it derived its switching equipment percent good factors, referenced by petitioner, that  
18 give 80 percent weighting to the switching category and 20 percent weighting to the computer category.

19 Petitioner reported write-downs for depreciation of systemwide unitary property in its  
20 Forms 10-K for 2007, 2008 and 2009, of \$1,164,000, \$2,130,000, and \$1,746,000, respectively, which  
21 translates to write-downs of approximately \$126,000, \$231,000, and \$190,000 for petitioner's California  
22 property for each of those years (based on petitioner's allocation of 10.86 percent to California).  
23 Petitioner explains that the write-downs included only IADs, i.e., routers leased to customers, and hence  
24 only reflects depreciation of the systemwide CPE. However, in this appeal, petitioner requests a  
25 reduction of almost \$1.3 million (out of the total \$4 million value reduction requested) for depreciation  
26 of the 10.86 percent of CPE allocated to California. Thus, petitioner's estimated depreciation of almost  
27 \$1.3 million for the California CPE for 2010 appears disproportionately large when compared to the  
28 write-downs of \$126,000, \$231,000, and \$190,000 for the California CPE for the last three years. At the

1 hearing, petitioner should be prepared to explain and justify the substantial disparity in the amount of  
2 depreciation for the California CPE for 2010.

3           In the reply, petitioner appears to agree with respondent that the entire value of the  
4 reported CWIP (\$2,001,401) was improperly omitted from petitioner’s opinion of value. At the hearing,  
5 petitioner should clarify whether that amount should be added to petitioner’s opinion of value of  
6 \$15,077,851 requested in the petition. If petitioner does not agree to that amount, petitioner should be  
7 prepared to explain why the reported CWIP should not be included.

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