SCAP-17-0000816

IN THE SUPREME COURT OF THE STATE OF HAWAIʻI

In the Matter of the Appeal of KAHEAWA WIND POWER, LLC, Appellee / Taxpayer-Appellant.	Case Nos. TX 14-1-0266 and consolidated case TX 16-1-0272, TX 14-1-0267 and consolidated case TX 16-1-0273, and 1 TX 16-1-0275, 1 TX 15-1-0238, 1 TX 16-1-0328 (Other Civil Action) Consolidated Case Nos. CAAP 17-0000816, CAAP 17-0000817, CAAP-17-0000818, CAAP-17-0000819, CAAP-17-0000820 Tax Appeal Court, State of Hawaiʻi Judge: Hon. Gary W.B. Chang

AMICUS CURIAE BRIEF OF TAX FOUNDATION OF HAWAIʻI IN SUPPORT OF APPELLEES

CERTIFICATE OF SERVICE

THOMAS YAMACHIKA 3504
TAX FOUNDATION OF HAWAIʻI
126 Queen Street, Suite 304
Honolulu, Hawaiʻi 96813
Telephone: (808) 536-4587
Facsimile: (808) 536-4588
E-mail: tom@tfhawaii.org

Counsel for *Amicus Curiae*

Table of Contents

Table of Authorities

AMICUS CURIAE BRIEF OF TAX FOUNDATION OF HAWAIʻI IN SUPPORT OF APPELLEES

Pursuant to this Court's Order Granting Motion for Leave to File *Amicus Curiae* Brief in Support of Appellants, and Rule 28(g) of the Hawaiʻi Rules of Appellate Procedure, the Tax Foundation of Hawaiʻi ("Foundation") submits this brief in support of Appellees, respectfully urging this Court to affirm the judgment of the Hawaiʻi Tax Appeal Court.

I. IDENTITY AND INTEREST OF *AMICUS CURIAE*

The Foundation is a non-partisan, non-political IRC § 501(c)(3) organization whose mission is to educate taxpayers and lawmakers on taxation and public finance. We educate and encourage the efficient and effective use of public funds (our tax dollars) to operate government and deliver public services. To do that, we track changes in tax law and how taxpayer dollars are used. Our work is published and distributed as widely as possible and free of charge. A well-informed public (and this includes lawmakers) that understands the impact of our tax system can more effectively participate in pressing for greater government efficiency and accountability.

Over the years, the Foundation has also functioned as a taxpayer watchdog organization, on many occasions scrutinizing and then calling out the government's legislative proposals to make its own job easier at the expense of taxpayer rights and protections. This case, to the Foundation, presents an example of a county government seeking to expand its own taxing power by legislative fiat, to the detriment of taxpayer rights and protections.

II. STATEMENT OF FACTS

This brief relies on, and incorporates by reference, the facts referenced in the briefs of both parties.

This case is about wind turbines mounted on high ground in Maui. The County assessed real property tax on the value of the turbines, contending that they are improvements to land. The Tax Appeal Court and the Intermediate Court of Appeals concluded that the turbines were machinery that was not taxable under Maui's real property tax. *Kaheawa Wind Power, LLC v. County of Maui,* 135 Haw. 202, 347 P.3d 632 (Ct. App. 2014), *cert. denied,* No. SCWC-12-0000728 (Haw. Feb. 19, 2015). The Maui county government then amended its ordinance defining real property for tax purposes, Maui County Code § 3.48.005, to include wind turbines explicitly. Maui Ord. 4013 (2013). The turbines were assessed again, and the principal dispute this time is whether the Maui county government had the right to do that. The Hawaii Tax Appeal Court held that it did not, and Maui County brought the matter here by way of appeal.

III. ARGUMENT

A. THE CONSTITUTIONAL CONVENTION OF 1978 EFFECTED A *TRANSFER* TO THE COUNTIES OF THE REAL PROPERTY TAX AUTHORITY THE STATE WAS THEN EXERCISING; THAT AUTHORITY WAS UNDERSTOOD USING THE COMMON DEFINITION OF REAL PROPERTY THEN IN USE.

We will show in this section that the constitutional provisions that resulted in the counties' acquisition of taxing power over real property were structured not as a grant of power over a fluid subject, but as a transfer from the state to the counties of the real property tax that the state was then administering. In 1981, when the transfer took effect, all four counties and the

State had a common definition of real property for tax purposes, leading to a very clear understanding of the taxing power transferred. That common definition marks an upper bound on the counties' taxing power because the counties can wield only the power that was given to them, either by the legislature or the electorate. It follows that Maui County's expansion of the property tax definition to tax something outside the 1981 common definition of real property was beyond the County's power and cannot be given legal effect.

Haw. Const. Article VIII, section 3 states, "The taxing power shall be reserved to the State, except so much thereof as may be delegated by the legislature to the political subdivisions, and except that all functions, powers and duties relating to the taxation of real property shall be exercised exclusively by the counties, with the exception of the county of Kalawao."

The counties' power to tax real property, however, did not always exist. Prior to the 1978 State Constitutional Convention, the State possessed and exercised the power to tax real property. HRS chapter 246 (now repealed). That Convention proposed amending the State Constitution to transfer this power to the counties, and proposed additional revisions to ensure an orderly transition of the power to tax real property. *County of Kaua'i ex rel. Nakazawa v. Baptiste,* 115 Haw. 15, 165 P.3d 916 (2007) ; *State ex rel. Anzai v. City & County of Honolulu,* 99 Haw. 508, 57 P.3d 433 (2002). Specifically, according to Haw. Const. Article XVIII, section 6:

> The amendment to Section 3 of Article VIII shall take effect on the first day of July after two full calendar years have elapsed following the ratification of such amendment [November 7, 1978]; provided that for a period of eleven years following such ratification, the policies and methods

> of assessing real property taxes shall be uniform throughout the State and shall be established by agreement of a majority of the political subdivisions. Each political subdivision shall enact such uniform policies and methods of assessment by ordinance before the effective date of this amendment [July 1, 1981], and in the event the political subdivisions fail to enact such ordinances, the uniform policies and methods of assessment shall be established by general law. Any amendments to the uniform policies and methods of assessment established by the political subdivisions may only be made by agreement of a majority of the political subdivisions and enactment thereof by ordinance in each political subdivision.
>
> Real property tax exemptions and dedications of land for specific use for assessment at its value in such use as provided by law and in effect upon ratification of the amendment to Section 3 of Article VIII [November 7, 1978] shall be enacted by ordinance and shall not be eliminated or diminished for a period of eleven years following such ratification; provided that increases in such exemptions, or the additions of new and further exemptions or dedications of lands, may be established or granted only by agreement of a majority of the political subdivisions, and such increases or additions shall be enacted by ordinance in each political subdivision.

The Legislature enacted HRS chapter 246A (now repealed) to implement this transition. The various counties each adopted a property tax ordinance, all of which were virtually identical to HRS chapter 246 (now repealed), the former State real property tax code. It was no accident that Maui County Code § 3.48.005, as originally adopted, contained a definition of real property that was identical with the definition of real property in HRS § 246-1 as it then existed. Maui Ord. 1076, sec. 3, § 6-1.1 (1980); Maui Ord. 987, sec. 3, § 6-1.2 (1979). The same was true for the other counties. Rev. Ord. of Honolulu § 8-1.2 (1980); Hawaiʻi County Code § 19-2 (1980); Kauaʻi County Code § 5A-1.1 (1981).

In construing a constitutional provision, it is entirely proper for the Court to consider the context in which it was enacted and the relationship of the provision at issue to others adopted in the same ballot measure. *County of*

Kaua'i ex rel. Nakazawa v. Baptiste, 115 Haw. 15, 43, 165 P.3d 916, 944 (2007). Here, the electorate transferred an existing tax on real property from the state to the counties, with the restriction that the tax would apply to the same things, exempt the same things, and work the same way for a decade. Certainly, the counties were to be given control of the tax after the transition period expired; but the tax was to apply to real property, and real property only. At the time of transfer in 1981, "real property" had a well understood meaning, namely that stated in HRS § 246-1 and in ***all*** of the county ordinances at the time (referred to hereinafter as the "1981 Common Definition"). The 1981 Common Definition represented the subject of the taxing authority transferred. There is no evidence indicating that the electorate or the 1978 Constitutional Convention intended to transfer the power to tax anything else. For those reasons, the 1981 Common Definition necessarily represents an upper bound on the Counties' taxing powers. In other words, the Counties are free to revise the definition of real property, if they wish, to constrict the definition and tax fewer things. But they can't go the other way and expand their own taxing authority beyond the 1981 Common Definition because "if no provision of the Hawai'i Constitution or the HRS empowers the [county] to enact and enforce the ordinance, the ordinance is invalid." *State v. Medeiros,* 89 Haw. 361, 365, 973 P.2d 736, 740 (1999). The courts have determined in *Kaheawa Wind Power, LLC v. County of Maui,* 135 Haw. 202, 347 P.3d 632 (Ct. App. 2014), *cert. denied,* No. SCWC-12-0000728 (Haw. Feb. 19, 2015), that the turbines at issue here were not real property under the 1981 Common Definition. The Maui County ordinance declaring that the turbines are now taxable real property is thus beyond the power of the County to enact.

Such a result would also reflect this Court's precedent. *Cartwright v. Widemann,* 9 Haw. 685, 690–91 (1892), held that machinery in an iron works, although bolted to the floor, constituted chattel and not realty. The current version of Maui County Code § 3.48.005, however, would render such machinery taxable realty because use of that machinery arguably increases the value to or is necessary to the utility of the land, buildings, structures, fences, and improvements. In other words, the same arguments now made by the County of Maui supporting taxability of wind turbines could be turned with nearly equal force against the machinery or other tangible objects used in an iron works or any other business establishment. The judgment below needs to be affirmed to respect the vitality of this Court's precedent in *Cartwright* and to prevent the outward creep of asserted real property taxing authority to tangible chattels.

B. STATE AND FEDERAL INCOME TAX LAW DEFINE REAL PROPERTY CONSISTENTLY WITH THE 1981 COMMON DEFINITION OF REAL PROPERTY.

In its papers, the County of Maui devotes considerable time to assailing the Intermediate Court of Appeals' decision in *Kaheawa Wind Power,* asserting that this Court can use its supervisory power to "correct" the decision (even though the issue preclusion doctrine, *see, e.g., Eastern Savings Bank, FSB v. Esteban,* 129 Haw. 154, 158, 296 P.3d 1062, 1066 (2013), should prevent a second litigation of that issue). This section will show that the 1981 Common Definition is consistent with concepts in the income tax laws, such that allowing a county to upend the definition of real property would create a risk of discontinuity and confusion.

Kaheawa Wind Power, LLC v. County of Maui, 135 Haw. 202, 347 P.3d 632 (Ct. App. 2014), *cert. denied,* No. SCWC-12-0000728 (Haw. Feb. 19, 2015), interpreted the term "real property" under the 1981 Common Definition. That definition of real property contains two elements: first, that real property includes "fixtures … whose use thereof is necessary to the utility of such land," which we will call the Fixtures Necessary to Land Test, and second, real property also includes structures "whose removal therefrom cannot be accomplished without substantial damage," which we will call the Not Removable Test. The court held that the turbines failed both tests, and as such did not fall within the definition of real property.

Section 38 of the Internal Revenue Code of 1954 (now repealed) allowed a credit against Federal income tax for qualified investment in "section 38 property." The current Hawaii Capital Goods Excise Tax Credit in HRS § 235-110.7 is based on the same rules. Section 48(a)(1) of the Code then provided that "section 38 property" meant tangible personal property or other tangible property (not including buildings and their structural components) if such other property is used as an integral part of certain specified activities (including processing and manufacturing). Section 1.48-1(c) of the Treasury Regulations provides that tangible personal property excludes "land and improvements thereto, such as buildings or other inherently permanent structures (including items that are structural components). In other words, the Code and

Regulations create two tests, a "structural component" test that is similar to the Fixtures Necessary to Land Test, and an "inherently permanent structure" test that mirrors the Not Removable Test.

In 1970, the Internal Revenue Service ruled on an electrical distribution system that transmitted energy from the local power company to a factory building to satisfy electrical power needs for lighting the building, power various types of machinery within the building, and satisfy the general electrical energy needs of the building. The electrical distribution system did not include electrical connections between the operating machinery and the main electrical system of the building that are necessary to, and are used directly with, a specific item of machinery or equipment or between specific items of individual machinery or equipment. The Service ruled that the electrical distribution system was a permanent building component servicing the overall electrical needs of the building and, as such, was a structural component relating generally to the overall operation of the building and thus did not qualify as section 38 property. Rev. Rul. 70-160, 1970-1 C.B. 7. In other words, the Service ruled that an electrical distribution system servicing the overall needs of a building was a "structural component" under the investment tax credit rules, indicating that such a system would pass the Fixtures Necessary to Land Test.

In *Scott Paper Co. v. Commissioner,* 74 T.C. 137 (1980), the U.S. Tax Court had before it an electrical distribution system for a paper factory facility covering some 700 acres. The distribution system accepted power from 13.8 kV lines from the utility and essentially acted as a substation, distributing the power to the various machinery on the paper facility and stepping down the power to more usable 480 volt or 2.3 kV lines. The court agreed with the taxpayer that these primary electric facilities were not inherently permanent structures. 74 T.C. at 170-72.

The court next addressed whether the system was a "structural component" of a building, and was faced with Treasury Regulations § 1.48-1(e)(2), which said:

> (2) The term "structural components" includes such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefor such as paneling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; stairs, escalators, and elevators, including all components thereof; sprinkler systems; fire escapes; and other components relating to the operation or maintenance of a building.

(Emphasis added.) Although electric wiring and lighting fixtures are specifically mentioned in the regulation, the court held that such items are structural components only if they are "relating to the operation or maintenance of a building," as the regulation also specifies. The court held that the electrical system before it, to the extent that it was used to meet the demand of process machinery, was not used in the overall operation or maintenance of a building. *Scott Paper,* 74 T.C. at 184. The court held that the part of the primary electrical system used to deliver power for general building services was a structural component, but the rest of the system was not a structural component and could qualify for the investment tax credit. *Id.* at 186.

Although the approach employed in *Scott Paper Co.* was contrary to *A.C. Monk & Co. v. United States,* 686 F.2d 1058 (4th Cir. 1982), the Courts of Appeals preferred the *Scott Paper Co.* approach, and the Service ultimately acquiesced in it. *Morrison, Inc. v. Commissioner,* 891 F.2d 857 (11th Cir. 1990), aff'g T.C. Memo. 1986-129; *Illinois Cereal Mills, Inc. v. Commissioner,* T.C. Memo. 1983-469, *aff'd,* 789 F.2d 1234 (7th Cir.), *cert. denied,* 479 U.S. 995 (1986); AOD 1991-19, *acquiescing in Illinois Cereal Mills,* T.C. Memo. 1983-469.

It also has been held that the "inherently permanent structure" and "structural component" concepts apply to the familiar federal income tax concept of depreciation, which also is used for state income tax. *Hospital Corp. of America v. Commissioner,* 109 T.C. 21 (1997), held that, to the extent a disputed property item would have qualified as tangible personal property for the federal investment tax credit, that property also will qualify as tangible personal property for purposes of the tax depreciation systems known as ACRS and MACRS. Because tangible personal property such as machinery is written off much more quickly than improvements to real estate, taxpayers often argue that an object is machinery while the Service contends that it is an improvement to realty. Such was the case in *Hospital Corp. of America,* where the dispute was over primary and secondary electrical distribution systems in a hospital. Following *Scott Paper Co.,* the Tax Court held that the systems, to the extent that they delivered power for something other than general building services, were tangible personal property described in IRC § 1245 rather than real property described in IRC § 1250. 109 T.C. at 61-64. In AOD 1999-8, the Service acquiesced in that part of the decision applying IRC § 38 investment tax credit standards to depreciation cases but noted that individual cases would turn on their particular facts.

The *Kaheawa Wind Power* decision is fully consistent with *Scott Paper Co.* and *Hospital Corp. of America.* The turbines are bolted to concrete pads but are removable, failing the Inherent Permanency Test and failing to be an inherently permanent structure for income tax purposes. The power produced by the turbines is not retained to power any structures that happen to be on the property, but rather is sent into the Maui Electric grid to power thousands of homes and businesses with renewable energy, thus failing the Fixtures Necessary to Land Test and failing to be a structural component for income tax purposes. A holding that the turbines are real property for property tax purposes while they are clearly not real property for income tax purposes will create a discontinuity between income tax and property tax, with the resulting potential for taxpayer confusion.

IV. CONCLUSION

For these reasons, the Foundation supports the judgment below, and urges this Court to affirm it.

DATED: Honolulu, Hawaiʻi, November 19, 2018.

Thomas Yamachika

THOMAS YAMACHIKA
Counsel for *Amicus Curiae*

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true and correct copy of the foregoing document will be served on counsel of record indicated below through JEFS upon the filing hereof:

<u>Counsel for Appellant County of Maui:</u>	
Patrick Wong, Esq.	Pat.Wong@co.maui.hi.us
Brian A. Bilberry, Esq.	Brian.Bilberry@co.maui.hi.us
<u>Counsel for Appellee Kaheawa Wind Power, LLC:</u>	
Ronald I. Heller, Esq.	RHeller@torkildson.com
<u>Counsel for Appellee Auwahi Wind Energy LLC:</u>	
Vito Galati, Esq.	VGalati@cades.com
Christopher T. Goodin, Esq.	CGoodin@cades.com

DATED: Honolulu, Hawaiʻi, November 19, 2018.

Thomas Yamachika

THOMAS YAMACHIKA
Counsel for *Amicus Curiae*