

**REPORT ON
BUNDLED NONTAXABLE
SOFTWARE**

~Embedded Software~

**Presented at the
January 16, 2014
Property Tax Committee Meeting**

**Compiled by
State Board of Equalization
Property and Special Taxes Department
County-Assessed Properties Division**

Preface

In 2011, *embedded software* was a topic of discussion at the State Board of Equalization's (Board) annual meeting with California County Assessors. At that meeting, the Board directed staff to explore with interested parties possible means of segregating the value of application software from the equipment in which it resides.

Subsequently, at the Board's January 2013 meeting, staff was further directed to gather information about the treatment of embedded software not only by assessors, but also by the Board's State-Assessed Properties Division (SAPD). Those efforts involved:

1. Querying assessors and SAPD about any adjustments made for embedded software;
2. Asking for copies of documentation used to make such adjustments; and
3. Requesting from assessors information about the number of assessment appeals filed that involved embedded software, as well as copies of evidence presented by the applicants during such appeals.

In addition to the above efforts, staff queried members of the Multistate Personal Property Association¹ soliciting information as to how their states treat the valuation or assessment of various types of software.

The following report represents the findings and observations of the staff of the Board's County-Assessed Properties Division relative to the information obtained regarding the treatment of application software when it is part of a bundled purchase order—that is, embedded software.

¹ The Multi-State Personal Property Association has been in existence since 1998. The purpose of the group is to help better understand the personal property programs in other states. The Association is comprised of the states of Arizona, California, Colorado, Idaho, Montana, Nevada, New Mexico, Oregon, Texas, Utah, Washington, and Wyoming.

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Bundled Nontaxable Software

The assessment of bundled nontaxable software, commonly called *embedded software*, has increasingly become more difficult for California county assessors. Where a computer or other item of equipment is bundled together with application software (exempt from taxation) for purchase at a single price, Property Tax Rule² 152 allows a county assessor, lacking evidence to the contrary, to simply value the taxable tangible property at its acquisition cost. Thus, the rule provides a de facto rebuttable presumption that the purchase price of equipment that includes embedded software is the value of that equipment for property tax purposes.

However, the rule specifically allows a taxpayer to rebut this presumption by providing information on sales prices, costs, or other information that will enable the assessor to make an informed judgment concerning the property value to be ascribed to taxable and nontaxable components of the purchase contract.

Legislation

In 1972, the California Legislature enacted Revenue and Taxation Code³ section 995 on the subject of storage media for computer programs. When enacting section 995 in 1972, the Legislature stated:

It is the intent of the Legislature that storage media, except basic operational programs, for computer programs shall be valued as if it had no computer program placed on it except any basic operational programs. The Legislature recognizes that it is not in the public interest to value storage media for computer programs except as provided above. Basic operational programs, like law books or other standard reference books, have value which is measurable, but any other programs, like an attorney's brief, an engineer's calculations, or business records would be highly speculative.

It is the intent of the Legislature that only those basic operational programs which are presently being assessed and taxed in the various counties continue to be assessed and taxed during the effective period of this act. The value of other computer programs is not now subject to property tax, was not intended to be subject to property tax and shall not be subject to property tax, either directly or indirectly or through the inclusion of the value of such computer programs in evaluating related storage media for computer programs. Taxation of these expressions of creativity would be detrimental to research and an expansion of business activity within the state.

In 1973, section 995.2 was added to define *basic operational program*. Section 995.2 provides:

The term "basic operational program," as used in Section 995, means a computer program that is fundamental and necessary to the functioning of a computer. A

² All references to Property Tax Rules or Rules is to Title 18, California Code of Regulations.

³ All statutory references are to the Revenue and Taxation Code unless otherwise specified.

basic operational program is that part of an operating system including supervisors, monitors, executives, and control or master programs that consist of the control program elements of that system. . . .

Regulation

On September 14, 1972, the Board adopted Property Tax Rule 152, *Computer Program Storage Media*, to further clarify the provisions of section 995. The rule was amended on February 21, 1974 to include the provisions of section 995.2. In 1996, the Board amended Rule 152 in order to clarify the term *basic operational program* used in sections 995 and 995.2. Subdivision (d) of Rule 152 defines *basic operational program*:

The term "basic operational program" refers to a "control program," as defined in section 995.2 of the Revenue and Taxation Code, that is included in the sale or lease price of the computer equipment. A program is included in the sale or lease price of computer equipment if (i) the equipment and the program are sold or leased at a single price, or (ii) the purchase or lease documents set forth separate prices for the equipment and the program, but the program may not be accepted or rejected at the option of the customer.

On July 28, 1999, the Second District Court of Appeal filed their opinion in the case of *Hahn v. State Board of Equalization*, 73 Cal.App.4th 985. Their opinion affirmed the trial court's judgment that upheld the 1996 amendments to the rule.

Assessment Issues

In 1972, the Legislature enacted Revenue and Taxation Code section 995, which essentially provides that all computer software except basic operational programs is exempt from property taxation. A basic operational program is defined in section 995.2 as a computer program that is "fundamental and necessary to the functioning of a computer." Property Tax Rule 152 clarifies that "basic operational programs" include, on a personal computer, the basic input output system, or BIOS,⁴ but does not include operating systems such as Windows. It follows that the myriad of other application programs that might be found on a personal computer are also not taxable.

The 1972 Legislature could not have envisioned the progress of computer technology over the succeeding decades. Thus, today, computer software does not reside only in the stand-alone multi-purpose machines we use every day at home and in business. Increasingly, software is also *embedded* in all sorts of machinery and equipment. This latter form of software, which serves to control processes via computer chips that were once performed mechanically or manually, is called *embedded software*.

As one familiar example, whereas automobiles once came with carburetor systems that mechanically controlled the fuel and air mixture burned by the engine, those mechanical systems have been replaced by computer-controlled fuel injection systems. Analogous computer-driven systems are pervasive in modern equipment of all kinds, including that used in medicine, airlines, manufacturing, shipping, food service, agriculture, and countless other industries.

Where a computer or other item of equipment is bundled together with application software for purchase at a single price, Rule 152 allows the county assessor, lacking evidence to the contrary, to simply value the taxable tangible property at its acquisition cost. Thus, the rule provides a rebuttable presumption that the purchase price of equipment that includes embedded software is the value of that equipment for property tax purposes.

Under the rule, this presumption may be rebutted more or less easily depending on the facts. Specifically, if the taxpayer can "supply sale prices, costs or other information that will enable the assessor to make an informed judgment concerning the proper value to be ascribed to taxable and nontaxable components of the [purchase] contract,"⁵ then the county assessor must exclude the value of the nontaxable software from the value of the equipment. Thus, the rule burdens the taxpayer with the job of providing the county assessor with data to make an informed judgment about the value of any nontaxable software, but leaves to the county assessor (and, frequently, an assessment appeals board) the decision as to whether such information is sufficient to reliably value that software.

⁴ Even BIOS software is exempt unless it is "bundled" with the computer at purchase; *Cardinal Health 301, Inc. v. County of Orange* (2008) 167 Cal.App.4th 219.

⁵ Rule 152, subdivision (f).

One issue involved in segregating the value of embedded software from the equipment whose functioning depends on it was resolved in the case of *Cardinal Health 301, Inc. v. County of Orange*.⁶ There, the court found the county assessor wrong in assessing certain medical equipment at its total cost, including the cost of embedded software, solely on the grounds that the software was bundled into the sale or lease price of computer equipment. The court found that since Cardinal had provided the county assessor with data that would enable an informed judgment as to the value of the nontaxable software, the trial court's ruling (which upheld the assessment appeals board affirmation of the county assessor's position) must be reversed. The case was remanded for further proceedings on the issue of separately valuing the nontaxable software.⁷

The *Cardinal Health* decision clarified that mere bundling of otherwise nontaxable software is not dispositive of whether the value of that software is severable from the value of the equipment whose functioning depends on it. Still, the decision left unaddressed several issues that continue to impact the assessment of such equipment.

First, while taxpayers are theoretically in a better position than assessors to have knowledge of the value of nontaxable application software embedded in their own equipment, in practice taxpayers may not have the necessary information. The cost of the equipment *including* the software is what is relevant to the buyer or lessor; segregating the value into components is relevant only for tax purposes. Thus, while it is clear under *Cardinal Health* that taxpayers *may* provide the county assessor with information that would enable an informed judgment as to the value of nontaxable application software, as a practical matter most taxpayers will find doing so to be a decidedly uncertain problem. Therefore, those efforts will often have to be resolved by assessment appeals boards, who may be just as uncertain as taxpayers.

Second, while the *Cardinal* court resolved a narrow issue of interpretation concerning the 1972 statute and the clarifying Board rule, the court did not consider the unimaginable (in 1972) progress in computer technology over the past four decades. Specifically, the statute as enacted contemplated only stand-alone computers and associated software.

The Legislature in 1972 could not have envisioned that software would later be written specifically to enable the functioning of certain machinery and equipment, or that, conversely, certain machinery and equipment would later be designed specifically to accommodate developable software. Thus, a question remains about whether the language of those early statutes adequately addresses the inescapable entwinement between modern machinery and equipment and the software embedded within it.

In the 2011 legislative session, a bill was introduced that was designed to inject some clarity into the problem of valuing equipment with embedded software. Assembly Bill 832, which was not

⁶ (2008) 167 Cal.App.4th 219.

⁷ Upon remand, the county assessor and the taxpayer stipulated to a value and the appeal was settled.

enacted, would have required taxpayers to prove the value of any nontaxable application software under a very high legal standard—clear and convincing evidence.

Chronology of Events

The following is a chronology of some of the events that have occurred regarding the issue of embedded software.

- September 20, 2011 – Gina Rodriguez of CalTax appeared before the Board at the Taxpayers' Bill of Rights hearing to request the Board provide guidance to assessors and industry regarding the claiming of embedded software for exemption from property taxation.
- October 19, 2011 – A panel discussion was held at the annual Board/Assessors meeting. The result of the discussion was that staff was directed to begin an interested parties process to explore the process of determining percentages regarding embedded software. The taxation issues were referred to both the Board's Business Taxes Committee and the Property Tax Committee as a joint effort.
- December 1, 2011 – The Board's County-Assessed Properties Division (CAPD) staff met with CalTax and several CalTax members to discuss the software issues. The result of the meeting was that CalTax members agreed to determine what data might be available to conduct a study on a specific equipment category. Both CAPD and CalTax members committed to attempt to collect information on what had previously been accepted by counties as evidence of application software when a tax exemption was requested where part of a bundled sale.
- January 6, 2012 – Board staff met with representatives from Ernst & Young regarding comments Jason Chao of Ernst & Young made at the October 19, 2011 Board/Assessors meeting regarding methods to value embedded software. The result of the meeting was Board staff requesting a concrete example of the methodologies Ernst & Young alluded to during the meeting.
- April 18, 2012 – Board staff attended a meeting of the California Assessors' Association (CAA) Ad Hoc Committee on Embedded Software.
- May 10, 2012 – Board staff had a follow-up meeting with CalTax and the CalTax members who had participated in the December 1, 2011 meeting. The result of the second meeting was that Board staff committed to approach the CAA regarding possible formation of a working group consisting of Board staff, industry, and the CAA to explore the possibility of developing guidelines delineating standards of evidence for claiming application software when part of a bundled sale.

The CalTax representatives acknowledged that they had not been successful in identifying any concrete data that might be used in a study to document embedded software.

- June 8, 2012 – Board staff attended a meeting of the CAA Ad-Hoc Committee on Embedded Software in San Jose. At the conclusion of the meeting, the Committee agreed to make a recommendation at the CAA's August meeting that the CAA participate in a

working group, headed by Board staff, to set guidelines for the standard of evidence that would be required to document application software when part of a bundled sale.

- July 9, 2012 – Senator George Runner (Ret.), Chair of the Board's Property Tax Committee, sent a letter to Honorable Tom J. Bordonaro, Jr., President of the CAA, expressing support for the formation of a working group to study the issue of embedded software, with the ultimate goal of developing standardized guidelines.
- September 20, 2012 – Honorable Tom J. Bordonaro, Jr., President of the CAA, sent a letter to Honorable Jerome Horton, Chair of the Board, and Senator George Runner (Ret.), Chair of the Board's Property Tax Committee, requesting the Board formally convene a working group to develop guidelines for the evidence that will be required prior to a review of any request for embedded software value reduction. The CAA recommended that:

". . . the working group be comprised of BOE staff, Assessors' staff knowledgeable about the issue, cost accountants from the Institute of Certified Cost and Management Accountants, software engineers, and members of academia with knowledge of software technology, and any other expertise that will assist the working group in formulating acceptable guidelines. These individuals may also include representatives from industry provided they possess the relevant technological or cost accounting expertise. . . ."

- October 12, 2012 – Ms. Teresa Casazza, President of CalTax, sent a letter to Honorable Jerome Horton, Chair of the Board, and Senator George Runner (Ret.), Chair of the Board's Property Tax Committee, indicating that a Board working group would be a means to commence the process to develop an approach for embedded software valuation that would be cost-effective for both taxpayers and local assessors. CalTax recommended that:

". . . the working group, at a minimum, include tax accountants, tax directors, engineers, technology developers, property tax attorneys, CalTax representatives, and others to help provide specific knowledge of certain processes and functions. We also believe that representatives from equipment vendors and manufacturers, along with cost evaluation consultants, would be helpful in the process. . . ."

- October 31, 2012 – Honorable Jerome Horton, Chair of the Board, sent a letter to Honorable Tom J. Bordonaro, Jr., President of the CAA, acknowledging receipt of Mr. Bordonaro's letter regarding the formation of a working group to study embedded software issues.
- November 15, 2012 – At the annual Board/Assessors meeting held in Sacramento, CAPD staff provided an update on staff's efforts regarding embedded software since the discussion at the prior year's meeting between the Board and counties, and outlined potential efforts going forward.

- December 19, 2012 – During a meeting of the Board, Board staff was requested to provide an update on the issue of embedded software at the January 2013 Board meeting.
- January 14, 2013 – Honorable Lawrence E. Stone, Chair of the CAA Ad-Hoc Committee on Embedded Software, sent a letter to Honorable Jerome Horton, Chair of the Board, and Senator George Runner (Ret.), Chair of the Board's Property Tax Committee, indicating that:

" . . . After extensive review, including consultation with an experienced Silicon Valley software engineer specializing in embedded systems, the CAA Ad-Hoc Committee on Embedded Software has concluded that the creation of a BOE working group would neither be productive nor a prudent use of public resources. . . ."

- January 15, 2013 – During a meeting of the Board, staff was directed, with respect to the development of current practices regarding the valuation of embedded software, to look at what the counties are doing on the local level, including the processes and considerations used to determine the decisions that were made; and, what can be borrowed from the State-Assessed Properties Division's process and conclusions.
- January 17, 2013 – Senator George Runner (Ret.), Chair of the Board's Property Tax Committee, sent a letter to Honorable Larry Stone, Chair of the CAA Ad-Hoc Committee on Embedded Software, acknowledging receipt of Mr. Stone's January 14, 2013 letter. Mr. Runner indicated:

" . . . After discussion at the Board hearing on January 15th, it was decided that a formal working group will not be convened at this time. Instead, the BOE County-Assessed Properties Division will reach out to county assessors to learn their various approaches to treatment of embedded software. In order to accomplish this goal, the Division may call individual counties, send out surveys, and consult with software engineers and industry representatives. . . ."

- January 24, 2013 – Ms. Teresa Casazza, President of CalTax, sent a letter to Honorable Jerome Horton, Chair of the Board, and Senator George Runner (Ret.), Chair of the Board's Property Tax Committee, indicating that:

" . . . We believe that ascertaining the scope of varying existing local tax treatment of embedded software, and examining approaches currently utilized for state-assessed properties, as identified in your letter, will be very useful in a collaborative effort to address embedded software valuation concerns. We believe that it would be equally productive to convene a working group, whether formal or informal, of industry representatives, academia (as recommended by the California Assessors' Association), and other experts to examine the data collected and, guided by the BOE's objectives stated in your October 31st letter (to the California Assessors' Association President, Tom Bordonaro), potentially make recommendations to you and the other Board members. . . ."

- February 19, 2013 – Honorable James Rooney, President of the CAA, sent a letter to Honorable Jerome Horton, Chair of the Board, stating that the:

". . . CAA will support a legislative solution during the 2013-14 legislative session and will encourage the convening of interested parties to discuss a legislative solution. This activity could be undertaken concurrent with the CalTax proposal."
- February 28, 2013 – Honorable James Rooney, President of the CAA, sent a letter to Honorable Jerome Horton, Chair of the Board, providing further clarification of his February 19, 2013 letter. Mr. Rooney indicated:

". . . When the CAA proposed that a working group be created, we were cautiously optimistic about the prospect for success. It became clear, however, by January 2013, that the progress and direction of the proposed working group were insufficient toward reaching a reliable conclusion, as the project, both in scope and the membership of the working group, was significantly modified from our original proposal. The courts also reached a similar conclusion on two separate occasions. More recently, the Orange County Court of Appeals urged the state legislature to intervene and update the 40-year-old code which the Court concluded had no applicability in today's high-technology environment. The CAA tends to concur with Senator Runner that, absent legislative intervention, we may be pursuing an outcome for which there may 'not be an answerable problem.'"
- March 19, 2013 – David Gau, Deputy Director, Property and Special Taxes Department, attended a CalTax meeting and provided the members with an update on the efforts to analyze the embedded software issues.
- April 9, 2013 – County Assessors Only letter, CAO 2013/010, distributed a questionnaire to counties requesting data regarding the assessment of bundled nontaxable software. Counties were asked to respond by May 20, 2013.
- August 13, 2013 – CAPD staff presented at the CAA Conference at Squaw Valley a preliminary summary of the data that had been received in the bundled nontaxable software questionnaires from 42 counties. [Subsequent to the Squaw Valley Conference, six additional counties responded to the questionnaire for a total of 48.]
- October 22, 2013 – At the annual Board/Assessors meeting, a panel discussed the various assessment issues for embedded software. The panel consisted of Honorable Larry Stone, Santa Clara County Assessor; Ms. Therese Twomey, Fiscal Policy Director of CalTax; and Mr. Lawrence Hoenig, Tax Partner with the law firm of Pillsbury Winthrop Shaw Pittman LLP.
- December 10, 2013 – Honorable Larry Stone, Santa Clara County Assessor, sent a letter to Senator George Runner (Ret.), Chair of the Property Tax Committee, stating that:

". . . Despite extensive efforts, my office has not received any study including source documentation that we could use to justify an assessment reduction. In

fact, in three separate assessment appeals with major Silicon Valley corporations, each of our three assessment appeals boards ruled that the taxpayers failed to provide any 'credible' evidence to satisfy their burden of proof. It is for these reasons that I am skeptical of studies in which industry is unwilling or unable to provide proper evidence.

". . . I would appreciate your assistance in making each of these studies [referenced in question nine of the BOE survey] available to assessors. In order for assessors to improve uniformity, it is critical that we receive all available information so that we can independently review and adjust assessed values where appropriate.

- December 20, 2013 – Senator George Runner (Ret.), Chair of the Board's Property Tax Committee, sent a letter to Honorable Larry Stone, Santa Clara County Assessor, acknowledging the December 10, 2013 request to make embedded software studies available to the county. Senator Runner referred the request to the Board's State-Assessed Properties Division.

Treatment of Application Software by the Board's State-Assessed Properties Division

The Board's State-Assessed Properties Division (SAPD) is responsible for administering the assessment program of California state assessees. The California Constitution requires the Board to annually assess property, except franchises, owned or used by regulated railway, telegraph or telephone companies, car companies operating on railways in California, and companies transmitting or selling gas or electricity. It also requires the Board to annually assess pipelines, flumes, canals, ditches, and aqueducts lying within two or more counties. Inherently, application software is widespread in equipment owned by state assessees, and the segregation and assessment of it is as problematic for Board staff as it is for county assessors.

SAPD provides the following information to state assessees regarding exempt software:

"Pursuant to Revenue and Taxation Code section 995, storage media for computer programs, such as hard drives, shall be valued for property tax purposes as if there were no computer programs on such media other than basic operational programs. In other words, computer programs other than basic operational programs are not subject to property tax. Revenue and Taxation Code section 995.2 defines the term 'basic operational program.' All software programs not considered 'basic operational programs' may be referred to as 'exempt software programs' or 'nontaxable programs.' It is the assessee's responsibility to identify and remove all exempt software program costs from taxable accounts and report these costs separately to the BOE on the Schedule B and Summary Control portions of the Property Statement.

"All reported costs of exempt software programs are subject to audit. In support of an assessee's claimed software exemption, Property Tax Rule 152(f) states, 'A person claiming that a single-price sale or lease includes charges for nontaxable programs and services should be required to identify the nontaxable property and services and supply sales prices, costs or other information that will enable the assessor to make an informed judgment concerning the proper value to be ascribed to taxable and nontaxable components of the contract.' Other information can include, but is not limited to, a detailed study from the manufacturer of the equipment. Property Tax Rule 152(e) also states, in part, 'the assessor, lacking evidence to the contrary, may regard the total amount charged as indicative of the value of taxable tangible property.'"

When a state assessee claims exempt software on the Property Statement, SAPD staff evaluates the reasonableness of the amount claimed in relation to the types and amounts of an assessee's property. If the amount is considered reasonable, it is allowed and then subject to substantiation on audit if the amount is considered material to the assessee. Generally, substantiation is either in the form of purchase invoices which separately state software costs or software studies.

Over the past two years, a number of studies have been provided by state assessees in an effort to substantiate the amount of exempt software claimed on Property Statements. Relative to these studies, SAPD staff has found:

- Many studies are not acceptable and provide inconclusive data.
- No studies have been unconditionally accepted as submitted. Well-documented studies have provided a "starting point" for analysis by SAPD staff and interaction with the state assesses to provide further data needed by SAPD staff to make a final value determination.
- There are many different methodologies employed by assesses and their consultants in the studies. Some methodologies may be appropriate for one industry and inappropriate for another.
- All methodologies employed are still only as reliable as the data used in them. Substantiation of data used in the studies is critical.
- An acceptable study must be fact-driven for the specific assessee's subject equipment, and will provide little or no applicable data for any other state-assessee's property.
- An acceptable study will be for a specific lien date and must be evaluated annually to determine applicability to subsequent lien dates. Rapidly changing technology may require frequent updates to the study.

Treatment of Application Software in Other States

In an effort to discover answers to some of the assessment issues for exempt application software, the Board's Property and Special Taxes Department sent inquiries to representatives of the Multistate Personal Property Association. We asked the representatives:

1. Can you provide us with some information on how your state treats software for purposes of property taxation?
2. Is application software treated differently than basic operational software?
3. If application software is exempt from taxation, how do you identify the value of this software?

We received responses from four states.

Idaho

In Idaho only custom software or custom computer programs would be exempt. Custom Computer Programs are defined as follows in Idaho Code 63-3616(b):

(ii) As used in this subsection, the term "custom computer program" means any computer software (as defined in this subsection) which is written or prepared exclusively for a customer and includes those services represented by separately stated charges for the modification of existing prewritten programs when the modifications are written or prepared exclusively for a customer. The term does not include a "canned" or prewritten program which is held or existing for general or repeated sale, lease or license, even if the program was initially developed on a custom basis or for in-house use. Modification to an existing prewritten program to meet the customer's needs is custom computer programming only to the extent of the modification, and only to the extent that the actual amount charged for the modification is separately stated on invoices, statements, and other billing documents supplied to the purchaser.

Otherwise all *other* software is taxable.

Idaho State Tax Commission, Property Tax Division

Nevada

In Nevada application software is taxable, even if the taxpayer can separate the application software costs from the equipment component costs. Application software has the same depreciable life as the underlying equipment (i.e. MRI application software has the same 5-year depreciable life as the MRI machine itself).

Clark County Nevada

Texas

In Texas we exempt application software when specifically listed as software on the detailed asset listing. Operational software is not exempt. The Rendition statement requests historical costs for computer assets, so often the full cost of computer and some application software would be included, such as Microsoft Office. During appeals, a closer look at the assets would exclude these application software.

Travis Central Appraisal District

Washington State

In Washington, we have rule WAC 458-12-251 which provides a good overview/explanation on how software is handled for assessment purposes.

For the valuation of canned software:

(11)(a) In the first year in which it will be subject to assessment, canned software shall be listed and valued at one hundred percent of acquisition cost as defined in section (10)(a), above, regardless of whether the software has been expensed or capitalized on the accounting records of the business.

(b) In the second year in which it will be subject to assessment, canned software shall be listed at one hundred percent of acquisition cost and valued at fifty percent of its acquisition cost.

(c) After the second year in which canned software has been subject to assessment, it shall be valued at zero.

(d) Upgrades to canned software shall be listed and valued at the acquisition cost of the upgrade package under subsections (11)(a) and (b), above, and not at the value of what the complete software package would cost as a new item.

For the valuation of customized canned software:

(12) In the case where a person purchases canned software and subsequently has that canned software customized or modified in-house, by outside developers, or both, only the canned portion of such computer software shall be taxable and it shall be valued as described in subsection (11).

For the valuation of embedded software:

(13) Because embedded software is part of the computer system, machinery, or other equipment, it has no separate acquisition cost and shall not be separately valued apart from the computer system, machinery, or other equipment in which it is housed.

Questionnaire Summary and Observations

Summary

The following summarizes statistics from the counties' responses to the Bundled Nontaxable Software Questionnaire. See Appendix A for a more detailed summary of responses.

48 COUNTIES RESPONDED TO THE QUESTIONNAIRE.

- Of the 48 counties, **20 counties** made adjustments to exempt application software included in a bundled purchase.
 - Of the 20 counties making adjustments, only 10 counties submitted documentation for analysis with their responses to the questionnaire. It appears that most, if not all, of the adjustments were for the medical industry, e.g., as a result of the *Cardinal Health* decision.
- Of the 48 counties, **28 counties** indicated they have made no adjustments to remove bundled nontaxable software from the cost of machinery and equipment in their counties.
 - Of the 28 counties, 18 counties indicated that they have had no requests to exempt application software included in a bundled purchase.
 - Of the 28 counties, 10 counties indicated that they had requests to exempt application software which had been included in a bundled purchase, but that the taxpayers did not provide sufficient evidence to meet the burden of proof under Rule 152(f) to provide the assessors with sufficient data to make value determinations.
 - Of the 10 counties that indicated that they had requests to exempt application software but that the taxpayers did not provide sufficient evidence, 4 counties provided documentation with their questionnaires.
- The vast majority of counties reported that when taxpayers submitted data in support of their requests to exempt application software that the data was insufficient and did not provide the assessor with enough information to make a determination regarding any value attributable to the application software.
 - Frequently, data submissions included a memo or letter from the taxpayer with only an estimate of a percentage of a purchase price that should be attributable to exempt software, with no data to support the estimated percentage.
 - Some reports/studies submitted by taxpayers, while lengthy, did not supply sufficient detailed costs associated with application software, and did not meet the

burden of proof required under Rule 152(f) to enable the assessors to make value determinations.

- Of the 14 counties that submitted documentation with their questionnaires, in only 3 instances did the documentation constitute a "study," often submitted by multiple counties. None of the studies were without flaws. An assessor must have:
 - A list of properties to which the percentage advocated in the study was applied. When a software percentage is identified in a study or vendor analysis/statement, it is still of critical importance to determine what accounts and to what costs it will be applied. In most instances, an account for a particular type of property will include many types of costs, some of which may have software and some will not (e.g., delivery charges). Also of concern is the software percentage for different vintage years of the subject equipment.
 - Copies of timely invoices for all properties to which the percentage advocated in the study was applied. Since invoices are only applicable to the specific vendor for the specific property purchased and the costs can vary for many reasons (e.g., volume discounts), specific documentation for each property type must be made available for the assessor to make a valid value determination.
- Assessors were able to make adjustments for application software included in bundled purchases when the taxpayers provided either purchase invoices that arrayed the costs associated with the application software or reports that provided the necessary cost breakdowns.
 - Invoices were provided by the taxpayers either at the time the request to exempt the software was made or upon audit by the assessors.
- To date, only one case involving the exemption of application software in a bundled purchase has moved past the appeals board to court.

Observations

The following are observations made by staff of the Board's County-Assessed Properties Division after analysis of the responses to the Bundled Nontaxable Software Questionnaire and the data received from other states.

- There appears to be two schools of thought regarding accepting evidence for application software in a bundled purchase.
 - The first wants to draw a bright line and require detailed invoices or some other hard evidence/data showing the exact cost of any application software associated with equipment/machinery. This methodology is easy to define but time-consuming to administer.

- The second is where a county assessor recognizes that there is application software associated with a certain piece of equipment/machinery and the assessor works with the taxpayer to get to a comfort level whereby the assessor can justify making an adjustment. This methodology is difficult to define and time-consuming to administer.
- Perhaps more information should be provided to taxpayers regarding the definition of possible exempt software and the data necessary to substantiate the requested exemption.
 - Currently, the *Business Property Statement*⁸ contains only the following text in the instructions for the form:

"Do not include application software costs in accordance with section 995.2 of the California Revenue and Taxation Code."
 - The *Business Property Statement* does not include a box/space for the taxpayer to indicate how much is "not being reported" to accommodate application software.
 - Often, the first time that the assessor knows if or how much the taxpayer "did not report" to accommodate application software is when the assessor conducts an audit of the taxpayer's records. If there is a lack of information to support the taxpayer's claim, the taxpayer may be confronted with an escaped assessment.
- Most of the appeals seemed to be focused on medical devices and television provider equipment and those taxpayers' assertions regarding a percentage exemption for the applicable application software. Following is a compilation of the appeals reported by counties in questionnaires:

2007-05: 53 appeals filed as reported by 12 counties
 2008-09: 141 appeals filed as reported by 13 counties
 2009-10: 105 appeals filed as reported by 11 counties
 2010-11: 236 appeals filed as reported by 12 counties
 2011-12: 192 appeals filed as reported by 15 counties
 2012-13: 285 appeals filed as reported by 15 counties

While the number of appeals increased dramatically, the filings represent multiple appeals filed by the same taxpayer on the same issues. For example, for 2012-13, one county reported 110 appeals were filed with 108 of those appeals filed by only two taxpayers. Another county reported 73 appeals with 71 of those appeals filed by only two taxpayers.

- Analysis of the data obtained from the states of Idaho, Nevada, or Washington indicate that their methods of assessing application software promote uniformity and consistency, and make administration straightforward and simplify mass assessment.
- Obtaining the necessary documented data for assessors to make value determinations regarding application software may be difficult at best for some taxpayers and impossible

⁸ Form BOE-571-L.

for other taxpayers. Manufacturers of the products that contain application software consider their data confidential and of a proprietary nature. They are extremely reluctant to provide the breakdown cost information, even to the taxpayers who purchased their products. Lacking this type of data, it is difficult and sometimes impossible for an assessor to exclude an amount from a purchase price for application software—and equally impossible to conduct a study to develop guidance for a particular product.

- A final staff observation mirrors that of the Orange County Court of Appeals where the Court suggested that the Legislature might be urged to intervene and update the 40-year-old code to be more applicable to today's high-technology environment. When section 995 was enacted in 1972, the testimony involved with this original legislation used terms such as blank punch cards, tapes, disks, or drums on which the programs are stored—technology which has long ago been superseded. Increasingly, software is *embedded* in all sorts of machinery and equipment, and the outdated statute makes it extremely difficult for assessors to employ the mass appraisal methods used to value equipment and machinery.

Appendix A: Compilation of Responses to Questionnaire

In April 2013, the Board disseminated a questionnaire to all California county assessors regarding the assessment of bundled nontaxable software in their respective counties. The questions were designed to elicit information as to whether there were problems statewide on the assessment of application software, and, if so, whether the problems were confined to any particular industry(ies).

The following are the questions contained in the April 2013 questionnaire and the responses to the questions provided by 48 of the 58 county assessors.

1. Have adjustments been made to remove bundled nontaxable software from the cost of machinery and equipment in your county?

Yes. If yes, please provide responses to questions 2 through 9.

20 Counties

No. If no, please provide responses to questions 8 and 9.

28 Counties

2. How did you become aware that an adjustment was necessary?

Taxpayer Notified the Assessor before Business Property Statement was filed

2 Counties

Business Property Statement

6 Counties

Property Tax Audit

12 Counties

Assessment Appeal Filed

14 Counties

Other (Please Explain)

Comment: Audit was "sold" to another county who supplied information provided by the agent.

Comment: Agents bring up issue; hard to separate the value reduction to software only when agent is requesting reduction.

3. What type of documentation was used to support the adjustment (mark all that apply)?

Study conducted or data collected by your office.

3 Counties

Study or data provided by a taxpayer.

6 Counties

Invoice

9 Counties

Manufacturer or vendor provided a breakdown in costs concerning one or more of the following: hardware, basic operational software, operational software, and/or application software.

9 Counties

Other (Please Explain)

Comment: Accepted data received by another county from the agent.

Comment: Industry study for Set Top Boxes

Comment: Letters from vendors were rejected by assessor but accepted by AAB

Comment: Questionable cost breakdown provided

Comment: Vendor provided a % of software to hardware letter

Comment: Spreadsheet summary of company quote

Comment: Stipulation by taxpayer; assessor conducted field inspection

Comment: Received volumes of cost data but it did not support adjustments

Comment: Consulted with other counties

4. How was the adjustment calculated (mark all that apply)?

Percentage of the total cost of the equipment? If this adjustment was used, please describe the equipment and identify the percentage used.

Comment: taxpayer asked for 45% to 50%; taxpayer accepted county offered 10%

Comment: MRI machine - 30%

Comment: 15%-30% for medical equipment, plus warranty and training costs of 5%

Comment: 20% estimate full cash value reduction was agreed and included 16% nonassessable software, 4% estimate warranty and training costs

Comment: Up to 30% adjustment

Comment: High-tech medical including MRI units – 35%

Cost on invoice?

6 Counties

Cost based on breakdown provided by manufacturer or vendor?

6 Counties

Other (Please Describe)

Comment: Tax agent prepared worksheet for adjustments

Comment: MRI machine 30% rejected by assessor but accepted by AAB

Comment: Cost/breakdown provided by manufacturer; average % applied

Comment: Internet information provided by taxpayer

Comment: Tried to verify amount through manufacturer; applied reduced trade level to account for software

Comment: Estimated %; 20% to 30% depending on make, model, and year

Comment: Negotiated settlement; unable to separate % adjustment for bundled software versus trade level

5. Please complete the following table with respect to the number of assessment appeals filed in your county due to bundled nontaxable software.

Year	2012-13	2011-12	2010-11	2009-10	2008-09	2007-08
Appeals Filed	3	2	20	20	1	1
	8	27	1	1	20	4
	33	20	1	32	1	3
	5	1	121	9	54	1
	73	76	21	22+	1	13
	20+	14	42+	2	13	2
	6	1	11	7	20+	8
	110	20+	4	2	10	3
	1	8	5	1	3	1
	5	15	1	1	1	1
	5	7	1	8	1	9
	1	1	8		5	7
	1	1			11	
	8	9				
	6	6				
	285	192	236	105	141	53

OUTCOME/STATUS OF APPEALS

Year	2012-13	2011-12	2010-11	2009-10	2008-09	2007-08
Pending/Unresolved	3 8 33 5 73 20+ 6 110 1 5 5 1 8 6	2 25 22 14 1 20+ 8 15 7 6	16 21 11 2 5	9 2 5 2	1 10 3	1 7 3
	284	120	55	18	14	11
Withdrawn	* 1	2 1 16 1	1 15 7 5	8 5	7	3 2
	1	20	28	13	7	5
* No show						
Stipulated		20 38 1	20 1 85 2 1	20 1 12 2 2 1	1 20 1 54 13 1	1 13 1
		59	109	38	90	15
Hearings Before the Appeals Board		9	4 31 8	12 14 2 8	14 5 11	1 9 7
		9	43	28	30	17

OUTCOME OF HEARINGS BEFORE THE APPEALS BOARD

Year	2012-13	2011-12	2010-11	2009-10	2008-09	2007-08
Assessments Reduced	1	1	4 30 1	12 13 1	1 13 1	1 4 13 1
	1	1	35	26	15	19
Assessments Upheld		9	1 8	8	5	9
		9	9	8	5	9
Assessments Increased			3 1	14	14	1
			4	14	14	1

6. Use the following table to identify the type of industry where adjustments were made to remove bundled nontaxable software (BNTS) from the cost of machinery and equipment. If available, include adjustment information, year of adjustment, and source used to identify the necessary adjustment.

No	Industry	Total Assessed Value	Adjustment to Remove BNTS	Net Assessed Value	Year ₁	Source ₂
1	Medical	\$3.4 million	<50K		A	2
2	Leased Health Care	\$557,370	Table Provided	\$198,152	E	4
3	Leased Health Care	\$339,340	Table Provided	\$120,666	F	4
4	MRI		\$166,192		A	1
5	MRI		\$213,676		B	1
6	MRI		\$206,520		C	3
7	MRI		\$247,087		D	3
8	MRI		\$510,993		E	3
9	MRI		\$955,911		F	5
10	Small Adjmts to PCs					
11	Medical/Hospital				A	
12	Medical/Hospital	\$8,600,334	\$2,688,091	\$5,912,243	B	4
13	Medical/Hospital	\$47,139,538	\$14,126,516	\$33,013,022	C	3,4,5
14	Medical/Hospital	\$46,540,370	\$13,699,072	\$32,841,298	D	3,4,5,6
15	Medical/Hospital	\$29,127,780	\$9,971,290	\$19,156,490	E	4,5,6
16	Medical/Hospital	\$23,541,947	\$8,213,630	\$15,328,317	F	4
17	Medical/Hospital	\$4,186,139	\$1,106,984	\$3,079,155	G	4
18	Medical					
19	Medical Equipment	\$3,376,709	\$885,125	\$2,491,584	E	4
20	Medical Equipment	\$18,497,551	\$6,121,706	\$12,375,845	F	4
21	Medical (MRI/CT)		20% – 30%		B/C	4,1

No	Industry	Total Assessed Value	Adjustment to Remove BNTS	Net Assessed Value	Year ₁	Source ₂
22	Medical (dialysis)	\$2.3 million estimate	30%		E	5,1
23	Medical (dialysis)	\$1.7 million estimate	20%		D	5,1
24	Medical (dialysis)		0%		C	5,1
25	Medical	\$942,858	\$188,572	\$754,286	B	3
26	High Tech Medical	\$185,000	\$47,000	\$138,000	C	2
27	Medical-Cardinal					
28	Dialysis	\$2,110,189			H	
29	Dialysis	\$2,202,910			G	
30	Dialysis	\$2,211,102			F	
31	Dialysis	\$3,488,190			E	
32	Dialysis	\$2,658,992			D	
33	Dialysis	\$7,181,474			C	
34	Dialysis	\$6,378,544			B	
35	Dialysis	\$3,764,160			A	
36	Theater Proj Equip	\$197,552	\$36,520	\$161,032	A	1
37	Healthcare		Net-value excl	\$2,190,806	A	1
38	Healthcare		\$2,073,376	\$2,273,220	B	1
39	Healthcare		\$1,453,253	\$3,095,289	C	1
40	Healthcare		\$1,202,004	\$3,003,969	D	2
41	Healthcare		\$1,141,689	\$2,940,040	E	2
42	Healthcare		\$1,231,474	\$1,682,201	F	2
43	Medical/Healthcare	\$1,231,538	\$566,535	\$665,003	F	4
44	Medical/Healthcare	\$1,451,340	\$739,444	\$711,896	E	4
45	Medical/Healthcare	\$3,798,468	\$1,003,033	\$2,795,435	A	2
46	Medical/Healthcare	\$4,671,892	\$1,220,252	\$3,451,640	B	2
47	Medical/Healthcare	\$5,308,480	\$1,358,869	\$3,949,611	C	2
48	Medical/Healthcare	\$6,095,013	\$1,534,297	\$4,560,716	D	2

¹ Use the following codes to identify the roll year: **A** for 2012-2013; **B** for 2011-2012; **C** for 2010-2011; **D** for 2009-2010; **E** for 2008-09; and **F** for 2007-08.

² Use the following codes to identify the source: **1** for Business Property Statement; **2** for Property Tax Audit; **3** for Assessment Appeals Withdrawn; **4** for Assessment Appeals Stipulated; **5** for Assessment Appeals Hearings with Board Reduced Values; and **6** for all Other (if "other," please complete the following table).

Source: Other

No.	Description of "Other" Source
12	BPP resulting from prior year appeal – prior to audit
14	BPP resulting from prior year appeal – prior to audit
21	The value and adjustment estimated; software not isolated issue just a part of appeal. AAB did not separate value as to issues such as software.

7. Please indicate the number of cases concerning appeals of assessments in which the valuation of bundled nontaxable software, embedded software, Revenue and Taxation Code sections 995 or 995.2, or Property Tax Rule 152 have been an issue since January 1, 2007.

No appeals have been filed with the appeals board.

5 Counties

Number of decisions that have been reached by the appeals board.

5 Counties – 56 decisions

Number of taxpayers who have filed for a refund. Please provide copies of each filing. For each appeal, please provide the evidence presented by the taxpayer and assessor.

5 Counties – 9 refund filings

Number of settlements that have been reached after the filing of a claim for refund.

6 Counties – 61 settlements

Number of cases that have been filed by the county or taxpayers in Superior Court challenging the valuation decision by an appeals board. Please provide copies of the complaint, answer, and evidence presented by the taxpayer and/or assessor and any decision by the Superior Court.

1 County – 1 filing

Number of appeals of any decision of the Superior Court. Please provide copies of all documents filed with the court of appeal.

1 County – 1 court decision

Other (Please Explain

Comment: 47 appeals by same taxpayer. AAB ruled insufficient evidence presented by taxpayer

Comment: 35 appeals but not enough evidence provided

Comment: 2 appeals filed, but both withdrawn

Comment: number of cases stipulated or settled before going to AAB: 2009=5, 2010=14, 2011=13, 2012=0

Comment: 51 appeals filed; none have been heard, stipulated, or resolved

Comment: 5 appeals filed; postponed awaiting actions across the state

Comment: 27 appeals filed since 2007; none have been heard yet.

8. When conducting audits, have you found that taxpayers reported less than full cost of equipment due to bundled nontaxable software?

No

33 Counties

Yes

12 Counties

If yes, how many instances were discovered in the last four years?

8 Counties – 21 discoveries

If yes, did they have evidence to substantiate their adjustment? Yes No

No

5 Counties

Yes

3 Counties

9. Have you received information/evidence from taxpayers requesting that bundled nontaxable software be excluded from an assessment that you did not accept?

No

23 Counties

Yes

22 Counties

If yes, please identify the taxpayer's documentation submitted as support for an adjustment and provide us with a copy of the information.

Study or data provided by a taxpayer.

6 Counties

Invoice

2 Counties

Manufacturer or vendor provided a breakdown in costs concerning one or more of the following: hardware, basic operational software, and application software, and/or application software.

3 Counties

Other (Please Explain)

Comment: Letters, memos, emails from agent with models of medical equipment

Comment: One 1997 appeal; appeal ultimately dropped

Comment: Letters from vendors; undocumented opinions of tax agents

Comment: General opinion of taxpayer

Comment: Letters/invoices from taxpayer with breakdown by % for make/model

Comment: Quotes from vendor

Comment: % with no supporting evidence

Comment: Documentation prepared by agent with no verification

Comment: Memos and emails from agent claiming a % of software

Comment: Letters from vendors; taxpayer spreadsheets with no support

Comment: Memos and letters from manufacturer with no support to back up estimate

Comment: Memo from manufacturer stating 30% of cost is software

Comment: Requests for deductions made on BPS and in appeal filings

Comment: Not accepted any claim for software because companies have not met Rule 152(f) requirements to supply acceptable information

Comment: Letter/email estimating % of software