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October 2, 2015

VIA EMAIL

Sherrie Kinkle, Tax Administrator II  
California State Board of Equalization  
County-Assessed Properties Division  
Assessment Services Unit, MIC: 64  
Sacramento, CA 94279-0064

Re: Further Revisions to State Assessment Manual

Dear Ms. Kinkle:

This responds to *State Assessment Manual* "rewrites", as proposed by Board counsel, for Matrix Items 61 and 62, as well as "New issue: Text revised to reflect *Elk Hills* language" (Page 13, Line 21). Douglas Mo of Sutherland Asbill & Brennan LLP, joins in these comments.

Matrix Item 61

We take strong exception to Board counsel's *rewrite*. In our view, the proposed rewrite is not consistent with understandings reached at the Board's recent (September 9) Interested Parties meeting. The rewrite distorts *Cardinal Health*, a precedent establishing that an assessor must exclude from assessment properly taxpayer-quantified nontaxable software.

As discussed at the Interested Parties meeting, Matrix Item 61 read, in part, "The issue in this case was whether application software was not subject to property taxation if it came "bundled" or "embedded" with taxable computer hardware." The court held that, if properly quantified by the taxpayer, application software was not subject to property taxation.

Board counsel's rewrite was supposed to clarify that characterization of the court holding. Instead, Board counsel's rewrite flips the holding upside down: "The issue in this case was whether application software was **not** subject to property taxation if it came "**bundled**" or "**embedded**" with taxable computer hardware." Board counsel's rewrite deletes "not" subject to tax, implying that application software is taxable; Board counsel's rewrite also deletes " "bundled"

or “embedded””, the legal centerpiece of *Cardinal Health* (“bundled” is used 43 times in the appellate court decision; “embed(ed)” is used 11 times).

The newly added second sentence in Matrix Item 61 is similarly twisted: “The Court of Appeal held that bundling by itself is not dispositive of whether application software is taxable under Revenue and Taxation Code sections 995 and 995.2, as basic operational programming.”

*Cardinal Health* is important because it clarifies when application software is NOT taxable. Board counsel’s version emphasizes when “software is taxable”.

The newly added third sentence in Matrix Item 61, paraphrasing Property Tax Rule 152(f), is also misleading: “Rather, pursuant to Property Tax Rule 152, subdivision (f), when application software is bundled into the sale or lease price of computer equipment, the burden is on the taxpayer to segregate the value of nontaxable application software from the otherwise taxable value of the computer and basic operational programs.”

There was no common understanding at the Interested Parties meeting that a separate characterization of Property Tax Rule 152(f) would be added to the *Cardinal Health* narrative. However, if language to that effect is included, we recommend directly quoting the court:

Rule 152, subdivision (f) clearly contemplates the possibility that a taxpayer can “identify the nontaxable property and services and 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 contract.” In other words, the sale or lease price is not *necessarily* what is taxable if the taxpayer carries that burden of identification. *Cardinal Health* at p. 229 (emphasis in original).

Board counsel deleted in its entirety a characterization that is accurate and balanced, substituting a description of *Cardinal Health* that is misleading and unbalanced. We urge acceptance of the proposed text:

*Cardinal Health v. County of Orange* (2008) 167 Cal.App.4<sup>th</sup> 219 The issue in this case was whether application software was not subject to property taxation if it came “bundled” or “embedded” with taxable computer hardware. The assessment appeals board and the trial court agreed with the assessor that because the application software was bundled or embedded with taxable computer hardware, the assessor could ignore the taxpayer’s evidence of the value of its nontaxable application software and assess the total amount charged for the software and hardware bundle. The Court of Appeal reversed the decision of the trial court, and held that the fact that the nontaxable application software was bundled or embedded with taxable computer hardware did not excuse the assessor from his duty to make an informed judgment as to

the value of taxable and nontaxable components of the bundled software and hardware.

## Matrix Item 62

During the recent Interested Parties meeting, much of the discussion about Matrix Item 62 focused on the following sentence, to which taxpayer representatives objected:

“With respect to the income approach, the Court distinguished between cases involving intangibles that are necessary for the beneficial and productive use of tangible property such as ERCs, and business enterprise intangibles.”

Board counsel’s substitute language not only repeats, but expands upon the mischaracterization of the *Elk Hills* decision. Board counsel selectively quotes language in the *Elk Hills* decision that suggests the burden of apportioning income rests entirely on the taxpayer, when earlier in the decision the Court states that “case law recognizes that **assessors**, if they are valuing taxable property according to the income produced, may have to apportion income between enterprise activity and the property itself.” *Elk Hills*, at p. 614 (emphasis added). We urge the Board to strike the last two sentences of the substitute language, as indicated below:

“With respect to the income approach, the Court distinguished between two lines of cases. “In the first line of cases, as in this case, courts have upheld income-based assessments that properly assumed the presence of intangible assets necessary to the productive use of taxable property without deducting a value for intangible assets... The second line of cases disapproved assessments that failed to attribute a portion of a business’s income stream to the enterprise activity that was directly attributable to the value of intangible assets and deduct that value prior to assessment.” ~~The Court concluded that “the Board was not required to deduct a value attributable to the ERCs under an income approach” because “[t]here was no credible showing that there is a separate stream of income related to enterprise activity.” Accordingly, the Court determined that the Board correctly “estimated the amount of income the property is expected to yield over its life and determined the present value of that amount.” “~~

“New issue: Text revised to reflect *Elk Hills* language” (Page 13, Line 21)

At the conclusion of the (September 9) Interested Parties meeting, there was no agreement to revise Page 13, Line 21 of the *State Assessment Manual*.

Board counsel’s deletions and additions selectively distort *Elk Hills*. Moreover, Matrix Items 18 and 19 address the exact same point, squarely and succinctly.

We strongly object to this significant and untimely revision, and urge that Board counsel’s “New Issue: Text revised to reflect *Elk Hills* language” not be included in the updated *State Assessment Manual*.

Thank you for considering our comments. We welcome the opportunity to address the subjects presented in this letter before the *State Assessment Manual* is finalized.

Very truly yours,



Peter Michael  
Peter Michaels