



October 12, 2012

Honorable Jerome Horton
Chair, State Board of Equalization

Honorable George Runner, Senator
Chair, State Board of Equalization Property Tax Committee

Dear Chairman Horton and Senator Runner,

It is our understanding that the California Assessors' Association (CAA) requests that the Board of Equalization (BOE) convene a working group to address taxpayer and assessor concerns regarding valuation of embedded software.

As you may know, the California Taxpayers Association reached agreement with the CAA last December wherein the CAA would no longer pursue hostile legislation (AB 832 – Ammiano), but would work with our organization and the BOE to develop an approach for embedded software valuation that would be cost-effective for both taxpayers and local assessors. We agree that a BOE working group would be a means to commence this process. To facilitate this, we recommend that the group work toward the following general objectives:

- Equalize Tax Treatment Statewide
- Maintain Competitive Neutrality
- Ensure Cost Effectiveness
- Promote Long-term Application

Equalize Tax Treatment

California Revenue & Taxation Code §995 generally exempts from property tax application all software that is embedded within business property, except basic operational programs. In order to receive an exemption, a taxpayer typically must provide to the local assessor proof of the existence of embedded software, and documentation pertaining to the value of that software. However, because the law does not specify how a taxpayer claiming the exemption would validate the existence or value such application software, this poses significant challenges for the taxpayer.

First, the most expedient type of proof would be a purchase invoice identifying the embedded software, along with its purchase price. Unfortunately, most invoices do not separately identify such information, and the taxpayer is forced to develop some other documentation alternative that is satisfactory to the assessor. Otherwise, the assessor may tax the embedded software due to a de facto rebuttable presumption that the full purchase price of equipment is the value of the

equipment for tax purposes. In other words, taxpayers are allowed an exemption only if they can document/quantify the value of the embedded software in a way that is acceptable to the assessors.

For some taxpayers, an exemption has been granted only at the expense of costly studies, some of which have to be renewed every few years due to the increasing prevalence of embedded software. Other taxpayers may forgo the tax exemption altogether, either because they do not have the financial means to procure a study, or the cost of doing so may outweigh the value of the exemption. Although this may not be the case in all counties, clearly there is a need to ensure that taxpayers, regardless of their financial status, have equal opportunities for tax exemptions.

Second, the absence of statutory guidance pertaining to proof has led to inconsistent documentation requirements from one county to the next. As a result, two taxpayers with identical equipment located in different counties oftentimes are subjected to different information requests, and in the end, may receive different tax treatment for identical properties. The same situation also may apply in instances where the same taxpayer has operations in multiple counties. Not only is this varied approach confusing for taxpayers in general, it can be costly for taxpayers operating in multiple counties.

Therefore, we believe it is paramount that the working group develop an approach that strives toward equal tax treatment of identical/similar property and that can/will be applied statewide. To achieve equity and uniformity in application of the law, the working group could consider, among other things:

- Compiling a list of business property that contains embedded software, similar to Property Tax Rule 124, to ensure that properties are consistently identified as those eligible for the embedded software exemption.
- Reviewing embedded software guidelines and valuation approaches currently in place for state-assessed properties, and where applicable, consider mirroring them for local-assessed properties. This could mitigate disparities in tax treatment between similar properties where one is assessed by the state and the other is locally assessed.
- Surveying counties for the various approaches currently used for documenting embedded software and consider adopting a best-practices model that is taxpayer friendly.

Competitively Neutral

One of the fundamental principles behind good tax policy is that taxpayers in similar tax situations ought to receive similar tax treatment. However, in the case of embedded software, tax exemptions vary from county to county, depending on the local assessor's requirements, and in some instances, whether the taxpayer is able to procure a costly study.

We have some suggestions that could be considered in this area.

Cost Effectiveness

The current methods for valuation of embedded software tend to be cumbersome and costly for both taxpayers and assessors. Taxpayers may expend significant resources to develop documentation, because embedded software cost information may not be available. Local assessors, too, may spend staff resources to review and understand complex cost modeling approaches. Even more resources are expended by both parties if the case goes to the Assessment Appeals Board or to a trial court.

A common objective for both taxpayers and local assessors is to reduce their respective administrative costs. We would be happy to share some thoughts regarding an approach.

Long-term Application

To provide predictability and stability in the tax system, the working group ought to strive toward an approach that can be applied for the long term. Toward that end, providing a rebuttable presumption for both taxpayers and assessors would help extend the longevity of the process by allowing for future modifications to reflect embedded software changes. In addition, rather than having these guidelines published in a Letter to Assessors (LTA), publication as an Appendix to the Assessors' Handbook Section 504, *Assessment of Personal Property and Fixtures*, would ensure that any future changes to the approach would benefit from stakeholder input.

In order to achieve the stated objectives, we believe it necessary to have a diverse representation from industry groups. We recommend 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.

Thank you for the opportunity to share these initial thoughts with you, and I look forward to discussing any suggestions you may have. We hope to assist with addressing this important administrative issue.

Sincerely,

A handwritten signature in black ink that reads "TERESA CASAZZA". The letters are slightly slanted and connected in a cursive-like style.

Teresa Casazza
President
California Taxpayers Association