

# TEI/IPT Silicon Valley Joint State and Local Tax Day

*2013 Property Tax Update*

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# Presenters

**Embedded Software and  
Split Roll Developments  
by  
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**Parcel Taxes, New Laws  
and New Cases  
by  
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# Overview of Our Presentation

- Embedded software
- Split roll
- Parcel taxes
- New laws
- New cases

# Overview of Embedded Software

- What is embedded software?
- Separate the application software from basic operational software
- Examples of equip. with embedded software
- Valuing the embedded software
- Current developments

# What Is Embedded Software?

- Generally the term includes software which is:
  - Sold along with an item of tangible personal property
  - Where the price of the software is not separately stated
  - But excluding “operational software” like basic input output systems (BIOS)
- Thus, embedded software can include almost any type of application software which is sold along with the tangible personal property and which is not priced separately

# Application Software Must Be Separated from Basic Operational Software

- This issue should be an easy one to resolve:
  - See R&TC § 995.2
  - See Rule 152, and especially the examples in such Rule
- However, Assessor Stone is suggesting that it is impossible to separate the application software from basic operational software nowadays
- He is trying to put together a task force of “nerds” who will examine this issue and issue a report on the same

# Examples of Equipment in Which Exempt Software Exists

1. High-technology, digital imaging, and computerized diagnostic medical equipment
2. Other medical equipment
3. Robotic manufacturing devices
4. Network equipment
5. Computers and tablets
6. Servers
7. Phones (cell phones, smartphones and VoIP phones)
8. Bluetooth, Wi-Fi, and GPS equipment
9. Other telecommunications equipment (set-top boxes, cable converters, switchgear, switchboard apparatus, etc.)

# Examples of Equipment in Which Exempt Software Exists (Continued)

9. Printers, copiers, scanning, fax and multi-function machines
10. Transportation equip. (except boats, aircraft and DMV vehicles)
11. Industrial process monitoring and control equipment
12. Analytical, optical, measuring, and controlling instruments
13. Semiconductor manufacturing equipment
14. Security and alarm equipment
15. Cameras, video and motion picture equipment
16. ATMS and cash/credit registers
17. Others?



# Valuing the Embedded Software

- This is a difficult issue
- There are various ways to try to prove the value of the embedded software (see next slide)
- There is lack of uniformity:
  - Between manufacturers and customers (because the former generally have better access to the necessary proof)
  - Between state-assessed and county-assessed taxpayers; and
  - Between the various counties

# Possible Ways to Prove the Value of the Exempt Software

1. “With and without” embedded software method
2. Hardware residual method
3. Secondary (or used) equipment market method
4. Transfer pricing information method
5. Pro rata allocation method, using software R&D costs
6. Others?

# Current Developments Regarding Embedded Software

- State assessees have been getting substantial reductions on their equipment via negotiations with SBE
- Recent SBE survey (see copy attached; done at the request of CalTax) shows that some taxpayers are getting reductions for the value of exempt software in various counties
- But some assessors are resisting to various degrees
- Cases are pending at Assessment Appeals Boards in numerous counties

# Current Developments Regarding Embedded Software (Continued)

- One large computer manufacturer in Santa Clara County excluded the software amounts from the assets being reported in the Form 571-Ls and the Assessor reviewed and accepted this position
- At this point, there are three “classes” of taxpayers:
  - State assessees
  - Manufacturers using their own equipment
  - Customers who buy equipment from manufacturers
- CalTax continues to seek solutions that would improve uniformity, certainty and fairness for taxpayers

# Split Roll

- There are three primary bills to watch at this point:
  - AB 59 (Bonta): permits school districts to impose split-roll parcel taxes retroactively by overturning *George J. Borikas v. Alameda Unified School District*, 214 Cal. App. 4th 135 (1<sup>st</sup> Dist., 2013), which required uniform parcel taxes as between residential and commercial/industrial properties
  - AB 188 (Ammiano): creates a split-roll property tax system by broadening the definition of “change in ownership” for legal entities, resulting in the reassessment of property any time 100% of a legal entity’s interests transfer in a single transaction (even if that transaction takes place in a time period up to three years long)

# Split Roll (Continued)

- AB 561 (Ting) authorizes counties to impose a property transfer tax when a legal entity has a change in control, as defined for property tax purposes
  - The author's reason for expanding the transfer tax to legal entity changes in control are for consistency with the property tax rules
  - However, the new transfer tax may be considered an *ad valorem* tax in excess of the 1% cap under Proposition 13, on legal entities, *i.e.*, a split roll

# Parcel & Special Taxes

- Proposed amendments to Proposition 13 to lower the vote threshold
  - ACA 3 (Campos): lowers voter approval threshold to 55% for parcel taxes, special taxes and bonds for public safety
  - ACA 8 (Blumenfield): lowers voter approval threshold to 55% for funding bonded indebtedness for specified public improvements and public safety buildings
  - SCA 7 (Wolk): lowers voter approval threshold to 55% for parcel taxes, special taxes and bonds for libraries
  - SCA 11 (Hancock): lowers voter approval threshold to 55% for non-earmarked parcel and special taxes

# New Legislation

- Only 2 bills enacted that directly impact property tax assessments
  - AB 551 (Ting): allows cities and counties to create Urban Agriculture Incentive Zones and offer preferential property tax assessment to landowners who restrict urban land to small-scale agricultural use



# New Legislation (Continued)

- SB 825 (Committee on Governance & Finance): omnibus bill that
  - 1. Expands notification requirements associated with the builders' exclusion to residential builders who become ineligible
  - 2. Increases the threshold for combining assessments of parcels in different tax areas from \$25,000 to \$50,000 full cash value
  - 3. Increases the number of days within which the tax collector must notify the assessor of tax defaulted sales from 10 to 30 days

# New Cases

- *Elk Hills Power, LLC v. (Kern County) Board of Equalization*, 57 Cal. 4<sup>th</sup> 593 (Aug. 2013)
  - R&TC §§ 110(d) and (e) are not mutually exclusive
  - Under the replacement cost approach, the Board directly and improperly taxed the power plant's emission reduction credits (ERCs) when it added their replacement cost to the taxable value
  - Under the income approach, only intangible assets that make a direct contribution to the going concern value of the business have a quantifiable fair market value that must be deducted
    - ERCs merely allow the power plant to generate income and therefore, their contribution to the income stream is indirect
    - Board properly concluded that a deduction of the ERCs' fair market value was not warranted

# New Cases (Continued)

- *EHP Glendale, LLC v. County of Los Angeles*, 219 Cal. App. 4<sup>th</sup> 1015 (Sept. 2013)
  - Assessor's expert complied with Rule 8(e) in removing the value of the hotel's intangible assets (Hilton's management and franchise fees, labor costs and marketing expenses) by deducting the related expenses from the projected income stream to be capitalized
  - Rule 8(e) only requires that *sufficient* income be deducted to account for the return on nontaxable operating assets; sufficient income may be zero
  - Court specifically notes that its decision is consistent with *Elk Hills*
  - Prior Court of Appeal decision: *EHP Glendale, LLC v. County of Los Angeles*, 193 Cal. App. 4<sup>th</sup> 262 (2011)

# New Cases (Continued)

- *Western States Petroleum Association v. (Los Angeles County) Board of Equalization*, 57 Cal. 4<sup>th</sup> 401 (Aug. 2013)
  - Rule 474 is consistent with Propositions 8 and 13, R&TC § 51(d)), and the long-standing valuation principle that an appraisal unit is the collection of assets that persons in the marketplace normally buy and sell as a single unit
  - Rule 474 is not subject to Proposition 13's two-thirds vote requirement
  - Rule 474 is procedurally deficient as the Board failed to provide an adequate assessment of economic impact as is required by the Administrative Procedures Act (APA)

# Other New Cases

## ■ Published Cases

- *Benson v. Marin County Assessment Appeals Board*, 219 Cal. App. 4<sup>th</sup> 1445 (Sept. 2013)
- *California State Teachers' Retirement System v. County of Los Angeles*, 216 Cal. App. 4<sup>th</sup> 41 (May 2013)
- *Dreyer's Grand Ice Cream, Inc. v. County of Kern*, 218 Cal. App. 4<sup>th</sup> 828 (July 2013)
- *McWilliams v. City of Long Beach*, 56 Cal. 4<sup>th</sup> 613 (Apr. 2013)
- *Sky River, LLC v. Kern County*, 214 Cal. App. 4<sup>th</sup> 720 (Feb. 2013)
- *Water Replenishment District of Southern California v. City of Cerritos*, 220 Cal. App. 4<sup>th</sup> 1450 (Oct. 2013)

For more information or assistance on any of the above,  
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