



# 2017 Cost Property Tax Workshop Oak Brook, Illinois

## California Dreamin' – Handling Property Tax Issues in the Golden State

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# EMBEDDED SOFTWARE



# Polling Question

Have your reported equipment costs for property tax purposes been properly adjusted for application software:

- 1) On your annual business property statement filings;
- 2) During your personal property tax audits;
- 3) Both of the above;
- 4) None of the above.



# Learning Objective

- Awareness of California exemption for application software
- Issues in proving allowable exemption



# Overview

- Embedded or application software exemption—Rev. & Tax. Code sec. 995
- Tax Rule 152;
- *Cardinal Health* decision;
- Examples of equipment with exempt software;
- Ways to prove value of exempt software;
- Recent developments.



# Personal Property – Embedded Software

- Intangible personal property is exempt from property taxes
- California distinguishes between bundled (embedded) software and unbundled software
- Most jurisdictions distinguish between tangible vs. intangible



# Overview of California Property Tax Embedded Software Exemption

- What is embedded software?
- Separate the application software from basic operational software
- Cardinal Health 301, Inc. v. Cnty of Orange, 167 Cal.App. 4th 219 (2008)
- Examples of equip. with embedded software
- Valuing the embedded software
- Tie between software and trade level
- Current developments



# What is Embedded Software?

- R&TC section 995 states that software is generally not taxable unless it is a “basic operational program”
- Section 995.2 defines “basic operational program” to be a computer program that is fundamental and necessary to the functioning of the computer – like basic input output systems (BIOS)
- Excluded from these definitions are “processing programs”, “application programs” and non-basic operational programs
- Computer program is defined to include process designed to enable the user to communicate with or operate a computer or other machinery





# Property Tax Rule 152

- Rule 152 states that:
  - the taxpayer should be required to identify the nontaxable property with “sales prices, costs or other information that will enable the assessor to make an informed judgment” concerning the nontaxable property value
- The main disputes arise with respect to showing the value of the exempt software



# Embedded Software: Cardinal Decision

- The leading case is Cardinal Health 301, Inc. v. County of Orange, 167 Cal. App. 4<sup>th</sup> 219 (6<sup>th</sup> Dist. 2008).
- Cardinal involved computer and medical cabinet equipment.
- Under Property Tax Rule 152(e), in valuing computer equipment that is sold or leased at a single price not segregated between taxable property and non taxable programs, the assessor, lacking any evidence to the contrary, may regard the total amount charged as indicative of the taxable tangible property.
- Under the holding in Cardinal, while all taxable software is bundled, not all bundled software is taxable. Thus, bundling is a necessary condition for taxation, but not a sufficient condition.



# 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 *(cont'd)*

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



# Possible Ways to Prove the Value of the Exempt Software

1. “With and without” embedded software method
2. Software residual methods:
  - a. Calculate new hardware cost and add on margin
  - b. Use secondary market sales of hardware without software to calculate the value of new hardware without software
3. Transfer pricing information method
4. Vendor representation method
5. Pro rata allocation method (e.g., using software R&D costs)
6. Others?



## Relationship Between Trade Level and Embedded Software (for Manufacturers)

- Most equipment manufacturers capitalize and use some of their own equipment
- If so, they must do a trade level adjustment under Rule 10
- Manufacturers should analyze their calculation of such adjustment to see if some embedded software is inadvertently being treated as taxable hardware
- If so, they should correct the error in the Form 571-L or on audit
- Assessors may be more amenable to a value reduction if it is labeled a trade level, instead of an exempt software, adjustment



# Current Developments Regarding Embedded Software

- Cases are pending with Assessor Offices and at Assessment Appeals Boards in numerous counties
- Not much action by SBE or legislature at this point
- The unfairness in treatment of differently situated taxpayers continues:
  - State assesses have still been getting substantial reductions on their equipment via negotiations with SBE staff
  - For locally assessed taxpayers, manufacturers are likelier to get reductions than are entities acquiring equipment from third party manufacturers
  - Results vary by county



# Current Developments Regarding Embedded Software *(cont'd)*

- Assessors are becoming more aggressive in challenging the treatment of hardware and software. For example, we have seen or heard about the following:
  - One assessor issued escape assessments re portions of the capitalized software and/or expensed R&D accounts
  - Another assessor has been rejecting taxpayer proofs that software was separately priced in the invoice
  - A third assessor has been asserting that security cards containing software are fully or mostly taxable
  - Other examples?





# RECENT ASSESSMENT APPEALS BOARD FINDINGS

## American Airlines—Los Angeles County Assessment Appeals Board June 2017 Findings:

- Assessor did not take any deduction for avionic software;
- Assessor contended Applicant did not meet burden of prove pursuant to Rule 152(f);
- Applicant sought 3-4% allowance;
- Applicant relied on Vendor Representation Method and expert testimony based on Software Lines Code Method;



# RECENT ASSESSMENT APPEALS BOARD FINDINGS *(cont'd)*

Board found a 2% reduction for Applicant:

- Both parties agreed software existed;
- Board found law requires recognition;
- Assessor failed to make any attempt to adjust for non-BIOS software;
- Applicant's approaches not detailed enough to support a 3-4% reduction;
- Based on evidence, 2% reduction allowed.



# RECENT ASSESSMENT APPEALS BOARD FINDINGS *(cont'd)*

## American Airlines—San Mateo County Assessment Appeals Board August 2017 Findings:

- Principally same facts as Los Angeles case;
- Assessor contended R&TC section 401.17 provides presumptive FMV of aircraft and governs over R&TC sections 995 et seq;
- Assessor contended no evidence of a computer;
- Assessor contended software programs were operational because equipment unable to operate without per BOE No. 2014/018 Letter to Assessors



# RECENT ASSESSMENT APPEALS BOARD FINDINGS *(cont'd)*

Board found for Assessor—no exempt software:

- Legislative history of R&TC 401.17 does not show FMV to be reduced under R&TC section 995;
- Applicant's vendor representation and lines of code methodologies unreliable;
- Applicant's expert relied on estimates and experience rather than actual costs;
- Did not reach Assessor's defense that double counting would occur if exemption recognized as R&TC 401.17 was a compromise of all issues



## POLLING QUESTION

Who needs to think about the possible beneficial effect of this exemption:

- 1) Buyers of equipment with embedded software
- 2) Taxpayers who use self-manufactured equipment.
- 3) Lessees who are liable for the tax.
- 4) All of the above.

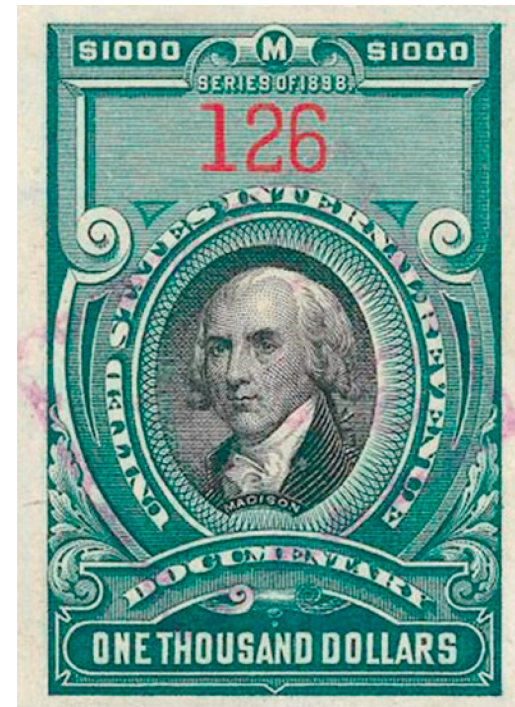


# Embedded Software: Steps Companies Should Consider

- The parties liable for the tax should consider:
  - Claim the exemption in Form 571-Ls.
  - Filing applications for reduced assessment (September 15 or November 30).
  - Filing claims for refund (need to be filed within four years of date of payment of tax) (would appeals also have to have been filed?).
  - Addressing the issue during audit for any open years.



# California Documentary/Real Estate Transfer Tax





# Imposition – R&T 11911

. . . Imposed on each deed, instrument, or writing by which any lands, tenements, or other realty sold within the city shall be granted, assigned, transferred, or otherwise conveyed to, or vested in, the purchaser or purchasers, or any other person or persons, by his or their direction, when the consideration or value of the interest or property conveyed (exclusive of the value of any lien or encumbrance remaining thereon at the time of sale) exceeds one hundred dollars (\$100)





## Brief History of CA Documentary Transfer Tax

### State

- CA's DTT Act signed into law by Gov. Reagan in 1967; eff. Jan. 1, 1968; Replaced Federal Stamp Act

### County

- CA's Counties enact conforming laws

### City

- Cities enact conforming/nonconforming laws:
  - Municipal Law Cities
  - Charter Cities



# Polling Question

Have you ever had a difficult time determining whether documentary transfer tax is applicable to a transaction in California?

- a) Yes, always
- b) Yes, on occasion
- c) No, never
- d) What is documentary transfer tax?



# Counties – General Law and Charter



Can impose a conforming tax.



Cannot impose a different tax or one with more restrictions than state law.



## Municipal Law

366

Bound by state's general law

Can impose a conforming documentary transfer tax

Cannot impose a different tax or one with more restrictions than state law

## Charter Cities

112

Have supreme authority of "municipal affairs" Art. XI, 5(b)

Can impose a transfer tax different from state law, so long as it does not violate the CA Constitution or other relevant authorities



## CRUCIAL DEVELOPMENT:

926 N Ardmore LLC v. County of Los Angeles (2017)

Holding: Revenue and Taxation Code Section 11911 should be interpreted such that “realty sold” includes the change in ownership of a legal entity owning real property. This permits a documentary transfer tax when a transfer of interest in a legal entity results in a “change of ownership” within the meaning of Revenue and Taxation Code section 64, subdivision (c) or (d).



## Post-Ardmore Questions/Conceptual

- How much of the DTT and property tax law should be read together?
- What exclusions are applicable?
- Will counties go after already-closed transactions?
- What is the statute of limitations on those transactions?



# Standard Language re Transfer of Partnership Interest

(a) In the case of any realty held by a partnership or other entity treated as a partnership for federal income tax purposes, no levy shall be imposed pursuant to this Article by reason of any transfer of an interest in a partnership or other entity treated as a partnership for federal income tax purposes or otherwise, if:

(1) Such partnership or other entity treated as a partnership (or another partnership or other entity treated as a partnership) is considered a continuing partnership within the meaning of Section 708 of the Internal Revenue Code of 1986, as amended; and

(2) Such continuing partnership or other entity treated as a partnership continues to hold the realty concerned.

(b) If there is a termination of any partnership or other entity treated as a partnership for federal income tax purposes within the meaning of Section 708 of the Internal Revenue Code of 1986, as amended, for purposes of this Article, such partnership or other entity shall be treated as having executed an instrument whereby there was conveyed, for fair market value, all realty held by such partnership or other entity at the time of such termination.



# DTT v. Property Tax – Issue 1

- For DTT purposes, transfers of an interest in an entity treated as a partnership for federal income tax purposes that holds realty, if (i) the partnership is treated as continuing under IRC 708 and (ii) the continuing partnership continues to hold the realty are excluded from the tax (R&T 11925) – **Potentially Assessable for property tax purposes (R&T 64)**
  - Example 1: In a real estate-owning partnership-type entity not subject to original coowner rules and where we are only concerned about the change in control test, A and B, each 50 percent owners, sell to A, B, C, and D, each 25 percent owners. No change in ownership for property tax purposes, but causes instance of DTT.
  - Example 2: In a real estate-owning partnership-type entity not subject to original coowner rules and where we are only concerned about the change in control test, A and B, each owning 50 percent, enter into a transaction in which A acquires 1% from B. A now controls the entity and that triggers a change in ownership for property tax purposes, but there is a DTT exclusion.





# DTT v. Property Tax – Issue 1

- Example 3A: In a real estate-owning partnership-type entity subject to original coowner rules and where we are concerned with both the change in control test and the original coowner rules, A and B, each 50 percent owners, sell half of their respective interests to C, so that the ownership is A(25), B(25), and C(50). No change in control or original coowner issue for property tax purposes. DTT imposed, however, because of IRC 708 termination.
- Example 3B: 2 years later, A gives 1% to his favorite charity. This would trigger an original coowner change in ownership, but would be excluded under 11925 because there is no partnership termination.



# Different Treatment: Corporations & Partnerships

## Corporation

- Any change in ownership is subject to DTT

## Partnership

- Change in ownership subject to DTT unless no 708 termination?



## DTT v. Property Tax – Issues 2 and 3

- For DTT purposes, no tax applies with respect to any deed, instrument, or writing to a beneficiary or mortgagee, which is taken from the mortgagor or trustor as a result of or in lieu of foreclosure when consideration does not exceed unpaid debt, including interest and cost of foreclosure (R&T 11926) – **This is reassessable for property tax purposes (R&T 60, 62 & Cal Code Regs. 462.120)**
- Transfers by the State of California, or any political subdivision, agency or instrumentality thereof, to certain nonprofit corporations (11929) – **Assessable for property tax purposes, but subject to various exemptions once owned by non-profit.**



# DTT v. Property Tax – Issue 4

- For DTT purposes, no tax is imposed on deeds, instruments, or other writings which purport to grant, assign, transfer, convey, divide, allocate, or vest lands, tenements, or realty, or any interest therein, if by reason of such inter vivos gift or by reason of the death of any person, such lands, tenements, realty, or other interests are transferred outright to, or in trust for the benefit of, any person or entity (R&T 11930) – **Potentially Assessable for property tax purposes.**
  - Example 1: A deeds a property to his wife as an inter vivos gift. No DTT, no property tax (R&T 63).
  - Example 2: B's trust provided property went to her children at her death. No DTT, property tax depends on applicability of P/C excl. (R&T 63.1)
  - Example 3: C makes an inter vivos gift of property to his nephew. No DTT, property tax reassessment (R&T 60, no exclusion).



# DTT v. Property Tax – Issue 4

- Example 4: A gifts an interest in a legal entity to his wife as an inter vivos gift. No DTT, no property tax (R&T 63).
- Example 5: B's trust provided that interests in a legal entity that owns property went to her children at her death. No DTT, yes property tax (R&T 63.1 does not apply to LE interests).
- Example 6: C makes an inter vivos gift of an interest in a legal entity that owns property to his nephew. No DTT, property tax reassessment (R&T 60, no exclusion).



# DTT v. Property Tax – Issue 5

- For DTT purposes, tax is imposed on the creation of a leasehold of greater than 35 years (*Thrifty & McDonalds*). For property tax purposes, that is also a reassessment. (Cal. Code Regs 462.100)
  - Example 1A: A, fee owner, enters into 40 year lease with B. Both DTT and property tax apply.
- When a fee with a greater than 35 year lease on it is sold, there is no property tax reassessment. (Cal Code Regs. 462.100) The DTT consequence is unstated.
  - Example 1B: A then sells the fee. No property tax reassessment. Under case law, answer appears to be no DTT. Counties, however, not in agreement.



# Additional Issues

- Non conforming Cities. What to do?
- Valuation questions. (R&T 11935b)
- Other?



# California Audits & Appeal Opportunities





# Polling Question

What percentage of your California Personal Property Tax Audits result in escaped assessment being issued?

- a) Less than 1/3<sup>rd</sup>
- b) More than 2/3<sup>rd</sup>
- c) Somewhere in between



# Personal Property Tax Audits

- **Mandatory Audit Provisions**

- Prior to January 1, 2009 - The Assessor was required to audit any account with a tangible personal property and fixtures assessment of \$400,000 or greater at least once in each four-year period.
- After January 1, 2009 – The Assessor is required to conduct a “significant number of audits”.
  - A “significant number of audits” means at least 75% of the audit workload the assessor was conducting during the time period of fiscal year 2002-03 to 2005-06.
- Assesseees can be found guilty of a misdemeanor and be required to pay reasonable and ordinary expenses for food, lodging, transportation, and other related items incurred by the assessor's representative if they do not make available their information or records for examination.



# Personal Property Tax Audits

- **Audit Waivers**
  - For an escape assessment to be enrolled after the four-year statute of limitations, a waiver must be signed by the Assessee extending the allowable time period.
- **Cooperative Audits**
  - CA has an intercounty cooperative audit program in which one county will conduct an audit for multiple counties.
  - Coop Auditors do not make value judgments.
- **Audits by Correspondence**
- **Office Audits**



# Personal Property Tax Audits: Best Practices

- Many auditors have lengthy canned information requests
  - Considering your business, what information do they actually need? For example:
    - Chart of accounts
    - General ledger balances
    - Fixed asset listing
    - Work papers reconciling general ledger balances to filed 571-L's
- Can audit findings be a good thing?



# Personal Property Tax Audits

## Other considerations:

- How has the auditor recognized disposals? Have they utilized reverse trending?
  - Example: A retailer, who does not have an itemized fixed asset listing, spent the following on store fixtures:

Acq. Yr.	Cost Spent
2013	2,000,000
2012	50,000
2011	50,000
2010	50,000
2009	50,000
2008	50,000
2007	50,000
2006	5,000,000



# Personal Property Tax Audits

- Many assessors and auditors would value this property as follows:

Acq. Yr.	Cost Spent	Trend Factor	Cost in 2014 \$s (Reproduction Cost New)	Depreciation % (12 Year Life)	Assessed Value
2013	2,000,000	1.00	2,000,000	94%	1,880,000
2012	50,000	1.01	50,500	87%	43,935
2011	50,000	1.04	52,000	80%	41,600
2010	50,000	1.07	53,500	73%	39,055
2009	50,000	1.06	53,000	66%	34,980
2008	50,000	1.09	54,500	59%	32,155
2007	50,000	1.13	56,500	52%	29,380
2006	5,000,000	1.19	5,950,000	45%	2,677,500
<b>Total</b>	<b>7,300,000</b>		<b>8,270,000</b>		<b>4,778,605</b>



# Personal Property Tax Audits

- Reverse Trending – Specifically addressed in the California Assessors Handbook Section 504

Acq. Yr.	Cost Spent	Trend Factor	Cost in 2014 \$s	Cost to Remove	Cost to be Depreciated	Depreciation % (12 Year Life)	Assessed Value
2013	2,000,000	1.00	2,000,000		2,000,000	94%	1,880,000
2012	50,000	1.01	50,500		50,500	87%	43,935
2011	50,000	1.04	52,000		52,000	80%	41,600
2010	50,000	1.07	53,500		53,500	73%	39,055
2009	50,000	1.06	53,000		53,000	66%	34,980
2008	50,000	1.09	54,500		54,500	59%	32,155
2007	50,000	1.13	56,500		56,500	52%	29,380
2006	5,000,000	1.19	5,950,000	2,320,000	3,630,000	45%	1,633,500
<b>Total</b>	<b>7,300,000</b>						<b>3,734,605</b>

*Cost to Remove is the sum of replacement assets (assets bought from 2007-2013) stated in 2014 \$s*



# Polling Question

Have you ever received a Personal Property assessment reduction in California?

- a) Yes, we have filed an appeal and won before an Appraisal Review Board
- b) Yes, we have negotiated a reduction with an assessor informally (e.g. an assessor has agreed to use a faster depreciating life than those recommended by the California State Board of Equalization)
- c) No, we have always accepted our value as assessed
- d) We do not own any Business Fixtures or Personal Property in California





# Appeal Deadlines

- **Counties with a September 15<sup>th</sup> Regular Assessment Roll Appeal Deadline**

- Alameda
- Alpine
- Inyo
- Kings
- Placer
- San Francisco
- San Luis Obispo
- Santa Clara
- Sierra
- Ventura



# Appeal Deadlines

- Counties with a November 30<sup>th</sup> Regular Assessment Roll Appeal Deadline

- Amador
- Butte
- Calaveras
- Colusa
- Contra Costa
- Del Norte
- El Dorado
- Fresno
- Glenn
- Humboldt
- Imperial
- Kern
- Lake
- Lassen
- Los Angeles
- Madera
- Marin
- Mariposa
- Mendocino
- Merced
- Modoc
- Mono
- Monterey
- Napa
- Nevada
- Orange
- Plumas
- Riverside
- Sacramento
- San Benito
- San Bernardino
- San Diego
- San Joaquin
- San Mateo
- Santa Barbara
- Santa Cruz
- Shasta
- Siskiyou
- Solano
- Sonoma
- Stanislaus
- Sutter
- Tehama
- Trinity
- Tulare
- Tuolumne
- Yolo
- Yuba



# Appeal Deadlines

- Escaped Assessment/Roll Change Appeal Deadline:
  - Within 60 days from the mailing date shown on a notice that includes both the enrollment of a change to the assessment currently on the roll as well as the taxpayer's rights to appeal the change enrolled
    - Notice for a Net Value Increase: Notice of Enrolled Escaped Assessment
    - Notice for a Net Value Decrease: Varies by jurisdiction
  - If you file an appeal without the proper notice, it will be deemed invalid and rejected.
- Supplemental Tax Roll Appeal Deadline:
  - Within 60 days from the mailing date shown on the supplemental notice or tax bill



# Appeal Opportunities: Clerical Issues

- Typical return processing pitfalls:
  - Returns are processed relatively quickly (less than 2 months) and clerical errors are common
  - Supporting schedules are often overlooked (ex. Schedule A3 “Other Equipment”)
  - Disposals are often overlooked



## Appeal Opportunities: Valuation Issues

- The Assessor's mass appraisal cost approach uses Reproduction Cost New – how does that compare to Replacement Cost New?
- State BOE mass appraisal depreciable life guidelines are used which may work for an industry but not for an individual Taxpayer's specific circumstances.
- The standard cost approach used by an assessor rarely considers external obsolescence without additional information provided by the Taxpayer.



# Appeal Opportunities: Double Taxation of Structures & Business Fixtures

- Understand your Real Estate Value
  - Does it have a Prop 13 Value or a Prop 8 Value?
  - Income producing property considerations
- If you lease - Not all Leasehold Improvements are Business Fixtures
  - What does your lease say?
    - Is ownership of the improvement defined?
    - What happens to the improvement at lease expiration
  - Actual Rent vs. Market Rent
- Review the Real Estate Property Record Card
- Encourage the Personal Property Assessor to talk to the Real Property Assessor



# Appeal Opportunities: Sales Comparable Approach

- Mass appraisal does not consider the Sales Comparable Approach to Value
  - Note: When using the sales comparable approach, sales tax, freight, discounts, and other costs unique to specific equipment must be added to (or subtracted from) the sales price of equipment where appropriate to arrive at full cash value for property tax purposes
- Assets that are not acquired new (Asset Purchases vs. Stock Purchases)
- Indexed original soft costs such as freight and installation may overstate value using the cost approach
- The sales comparable approach captures external obsolescence
- BOE Guidelines for Substantiating Additional Obsolescence for Personal Property and Fixtures: <http://www.boe.ca.gov/proptaxes/pdf/lta10030.pdf>
  - External obsolescence is typically only considered under appeal



# Appeal Opportunities: Other Considerations

- Appeals must be heard within two years of being filed unless both sides agree to waive this right
- Postponements/Continuances
- Waivers
- Findings of Facts
- Non De Novo appeals





# Appeal Opportunities: Other Considerations

- Why file an appeal?

<b>Cost Benefit Analysis</b>	<b>Assessment</b>	<b>Tax</b>
Year 1 Potential Reduction	500,000	5,750
Year 2 & 3 Carry Forward as you wait for case to be heard	1,000,000	11,500
Personal Property Tax Audit (1-3 Prior Years)	1,000,000	<u>11,500</u>
Total Potential Savings a \$500K Assessment Issue		<u><b>28,750</b></u>

- Long appeal process can work in your favor
  - Multiple year settlements are possible
  - With larger numbers comes increased room for negotiation
  - The benefits of hindsight



## Questions and Comments

- Questions, comments, feedback?