

Memorandum**To: PROPERTY TAX COMMITTEE MEMBERS****Date:** May 9, 2014Senator George Runner (Ret.), Chair
Honorable Betty T. Yee
Honorable Michelle Steel
Honorable Jerome E. Horton
Honorable John Chiang**From:** David J. Gau, Deputy Director
Property and Special Taxes Department**Subject:** *May 22, 2014 Property Tax Committee
Discussion on Assessment Issues for Embedded Software*

At the January 16, 2014 Property Tax Committee meeting, the Committee was presented with the *Report on Bundled Nontaxable Software—Embedded Software* which chronicled the findings and observations of the staff of the Board's County-Assessed Properties Division relative to the information obtained on the treatment of application software when it is part of a bundled purchase order. Primarily, the report presented the data supplied by 48 counties that responded to a questionnaire distributed by staff. The report also contained information obtained from the states of Idaho, Nevada, Texas, and Washington discussing their practices involving embedded software. Additionally, the report included data on the treatment of application software by the Board's State-Assessed Properties Division (SAPD).

Following discussions at the January 16 meeting, staff was directed to:

- Disseminate a Letter To Assessors (LTA) discussing the various methodologies submitted to SAPD and discussing the challenges with each of the methodologies and the adjustments that are necessary to make value determinations.

On April 4, 2014, LTA 2014/018, *Evaluating Embedded Software Studies for State-Assessed Property*, was released.

- Solicit more information from other states.

On January 27, 2014, a letter was sent to 45 states¹ soliciting information about their treatment of application software for taxation purposes. Responses from 16 states were received. Attached is an *Addendum to the Report on Bundled Nontaxable Software—Embedded Software* which contains the information received from the original 4 states and the 16 additional states.

¹ Idaho, Nevada, Texas, and Washington were excluded as prior information had been obtained from these states.

- Monitor guidelines from the California Assessors' Association (CAA).

The CAA approved the *Guidelines on Embedded Software (Guidelines)* on April 17, 2014, and the CAA will be forwarding a formal letter to the Board encouraging the Board to help the CAA further disseminate the *Guidelines* to taxpayers and assessors. The *Guidelines* were developed over a six-month period and presents the CAA-adopted recommendation for verifying and measuring application software costs when the property owner contends those cost have been included in the hardware costs.

- Schedule the topic for the May 2014 Property Tax Committee meeting for further discussion.

I request that the *Addendum to the Report on Bundled Nontaxable Software—Embedded Software* be included on the agenda for the May 22, 2014 Property Tax Committee.

Approved:



Ms. Cynthia Bridges
Executive Director

Attachment

cc: Ms. Marcy Jo Mandel
Deputy Controller
Ms. Cynthia Bridge
Executive Director
Mr. Dean Kinnee, Chief
County-Assessed Properties Division
Ms. Joann Richmond
Chief, Board Proceedings Division

Addendum to the

REPORT ON

BUNDLED NONTAXABLE

SOFTWARE

~Embedded Software~

Addendum Presented at the
May 22, 2014
Property Tax Committee Meeting

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

The *Report on Bundled Nontaxable Software—Embedded Software*, compiled by staff of the County-Assessed Properties Division, was presented to the Members of the State Board of Equalization at the January 16, 2014 Property Tax Committee meeting. At the January meeting, staff was directed to solicit further information from other states on the treatment of application software for valuation/assessment purposes.

A letter to other states was sent on January 27, 2014 soliciting information regarding the treatment of embedded software (see Attachment A). The following data is compiled in response to the January 27 inquiry.

ALASKA

The State of Alaska, in general, has been moving away from the assessment of personal property and the issue of operational vs. application software isn't a big issue.

First of all, the State of Alaska does not levy a property tax except for centrally assessed properties which is limited to oil and gas property which is used for exploration, production or transporting of oil and gas. Local municipalities that do levy property taxes have been moving away from personal property assessments. Our state statutes allow municipalities to exempt or partially exempt any or all types of personal property. Of our 19 boroughs that exist in the state, only 15 levy a property tax and of those 15, only 2 tax machinery and equipment (the category under which software would be located) and 5 exempt the first \$20K-\$100K. So from a state perspective, software could be taxed, however, most have chosen to exempt so much of the property that for all intent and purposes, it has been rendered mostly exempt.

State Assessor
State of Alaska

ARIZONA

County Assessors in Arizona are advised to treat bundled computer systems similarly to your State. That is, they may value at total acquisition cost if the taxpayer does not provide a breakdown of costs. Also if the taxpayer reports a generic "software" acquisition, follow up contact should be initiated to determine the correct classification.

A complete discussion of software classification and valuation can be found in our Personal Property Manual, which is available from our website:

<http://www.azdor.gov/Portals/0/Brochure/AZ-Personal-property-Manual.pdf>

Please see pages 2.25 – 2.26 for the guidelines.

Following is the Arizona Revised Statute defining software and its tax treatment in Arizona.

42-19003.01. Computers and equipment; hardware; software; definition

A. Except as provided by subsection C of this section, personal computers and general purpose computers used in a trade or business shall be valued as personal property.

B. Operating system software necessary to enable the operation of personal computers, general purpose computers and peripheral equipment shall be valued as a part of the computer on which it is installed.

C. All other software, other than operating system software, whether it is canned or customized for a specific application by a personal computer or a general purpose computer, shall not be valued as personal property.

D. For the purposes of this section, "operating system software" means the collection of software that directs the computer's low-level operations, controlling and scheduling the execution of application programs and managing the low-level operation of storage, input, output and communication resources.

AZ Department of Revenue

COLORADO

In Colorado, software is defined as intangible personal property and exempted from property taxation under §§ 39-3-118 and 39-22-611, Colorado Revised Statutes (C.R.S.).

The Division of Property Taxation, under the authority of the Property Tax Administrator, publishes additional guidelines (pursuant to § 39-2-109(1)(e), C.R.S.) concerning software taxability and valuation in Assessors' Reference Library, Volume 5, Personal Property Manual (ARL 5). Chapter 7 pages 7.36-7.38 of ARL 5 contain specific guidelines relating to software valuation.

All software (with one exception) is exempt from taxation in Colorado. This exemption would include application software as well as operating systems software, compilers, assemblers, translators, and interpreters. However, software that is an integral part of the hardware and required to make the personal property function as intended for its end-user purpose, is taxable. This would include basic input-output systems (BIOS), Unified Extensible Firmware Interface (UEFI), or other similar systems programs. This appears analogous to your supplied definition of "basic operational software."

The taxpayer should omit any tax exempt software from his or her personal property declaration schedule. In cases where a taxpayer reports a single cost inclusive of otherwise exempt software, the county assessor should work with the taxpayer and/or utilize third-party source information to determine the appropriate deduction. The contributory value of software that has been included in the hardware costs must be valued considering the cost, market, and income approaches to value. In general, we recommend the cost approach as the appropriate approach when valuing software. In some instances, there may be sufficient data for a reliable value indication using the market or income approaches.

Colorado Department of Local Affairs
Division of Property Taxation

FLORIDA

Section 192.001(19), Florida Statutes provides:

"Computer software" means any information, program, or routine, or any set of one or more programs, routines, or collections of information used or intended for use to convey information or to cause one or more computers or pieces of computer-related peripheral equipment, or any combination thereof, to perform a task or set of tasks. Without limiting the generality of the definition provided in this subsection, the term includes operating and applications programs and all related documentation. Computer software does not include embedded software that resides permanently in the internal memory of a computer or computer-related peripheral equipment and that is not removable without terminating the operation of the computer or equipment. Computer software constitutes personal property only to the extent of the value of the unmounted or uninstalled medium on or in which the information, program, or routine is stored or transmitted, and, after installation or mounting by any person, computer software does not increase the value of the computer or computer-related peripheral equipment, or any combination thereof.

The link to this Florida Statute is

http://www.leg.state.fl.us/Statutes/index.cfm?App_mode=Display_Statute&Search_String=&URL=0100-0199/0192/Sections/0192.001.html.

The Florida Department of Revenue does not provide any specific written regulation or procedures for the classification or valuation of software. The county property appraiser is responsible for determining whether the software is application, basic operational, embedded, etc. Also, the county property appraiser determines the taxable and non-taxable elements of a computer equipment sale. You may want to contact them to discuss their treatment of software valuation. A contact list of property appraisers can be found at

<http://dor.myflorida.com/dor/property/appraisers.html>.

Property Tax Oversight
Florida Department of Revenue

HAWAII

Our jurisdiction does not tax personal property and as such we have no relevant information that we are able to provide.

Real Property Assessment Division
County of Honolulu

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.

Property Tax Division
Idaho State Tax Commission

IOWA

Iowa does not apply property tax to personal property like software. See Iowa Code sec. 427A.2 ("Personal property shall not be listed or assessed for taxation and is not subject to the property tax.").

Let me know if you need an explanation of how Iowa sales and use tax applies to software, or if you need any other information.

Tax Policy & Communications Division
Iowa Department of Revenue

KANSAS

First, personal property is not valued at market value. All personal property used in a business to produce income falls in the constitutional subclass of "commercial and industrial machinery and equipment" (CIME) and is valued at retail cost when new (RCWN) depreciated over the economic life if its economic life is seven years or less and no more than seven years. And the appraised value can never be less than 20% of the RCWN.

Second, passed in 2006, any CIME personal property acquired after June 30, 2006, is exempt from property tax.

If we look prior to the 2006 exemption, in KS only tangible personal property is taxable. The KS Supreme Court established in the Tax Protest of Strayer case that application software programs

are intangible property and therefore exempt. Software programs are taxable only if they are basic operational software programs.

Generally, our county appraisers considered the operational software as part of the computer's purchase price (RCWN) unless the business would for some reason break-out the cost of the operational software. KS has a CIME exemption for any RCWN of \$1,500 or less for an item.

It was not always clear what the definition of an "item" was and often businesses would break down the cost to the smallest item possible. Since the exemption of everything (2006) this has not been a problem anymore.

So in summary the court ruled that only operational software was taxable because without it the computer would not function. Application software was considered intangible and not taxable.

Division of Property Valuation
Kansas Department of Revenue

MISSOURI

No Missouri statutes, regulations, or court decisions exist that provide guidance to assessors on assessment of computer software for property tax purposes. The State Tax Commission has never issued a decision, guidelines, or directives on this subject.

Senior Hearing Officer
Missouri State Tax Commission

MONTANA

The Montana Department of Revenue is responsible for the valuations of real, personal, and operating properties in Montana. Montana statutes require the Department to value all property owned, used or leased by a taxpayer in Montana. Montana statutes further require the Department to exempt intangible personal property from its appraisals. Software is one of those intangible items that must be exempted under 12-6-211, MCA. However, the Department only exempts items that are identifiable. Since most basic operational software cannot be separately identified, it is not exempted from our appraisal of a piece of equipment containing software.

Generally speaking the only software exempted under our statutes is custom application software.

If a taxpayer can identify the segregated costs of basic operational software, its exclusion from the appraisal is considered on a case by case basis. The segregated costs must be actual development cost paid for the software only and cannot be based on allocations or other hypothetical analysis.

Centrally Assessed and Industrial Properties
Montana Department of Revenue

NEBRASKA

Nebraska Rev. Stat. § 77-105 defines both tangible personal property and intangible personal property. § 77-1201 subjects all "tangible personal property" in the state to taxation, and requires a listing of all tangible personal property having tax situs in the State of Nebraska.

350 Neb. Admin. Code 20-001.01A(1) specifically provides: "Operational software which is necessary for computer hardware to function is defined as tangible personal property." 350 NAC 20-001.01B(1) provides: "Application software which is not necessary for computer hardware to function is defined as intangible personal property."

In Nebraska, a purchaser of computer hardware which includes the operational software is not required to segregate the cost between the hardware and the software. There is no set procedure to allow the segregation of the costs. As part of the computer equipment this software would be assessed for only 5 years in Nebraska. Application software is considered "intangible personal property" which is excluded from Nebraska's definition of taxable tangible personal property.

Nebraska Department of Revenue

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

NEW YORK

New York state considers software to be personal property, not real property. As such personal property is not taxed by any of its component municipalities throughout the state for ad valorem purposes.

Real Property Analyst Office of Tax Policy Analysis
NYS Department of Taxation & Finance

NORTH CAROLINA

Senate Bill 490 passed the 2013 session of the General Assembly. This bill excludes customized software from property tax by adding the phrase below to G.S. 105-275(40)

The foregoing does not include development of software or any modifications to software, whether done internally by the taxpayer or externally by a third party, to meet the customer's specified needs.

Software that is not capitalized on the accounting records of the owner or is purchased or licensed from a related entity would still be excluded from property tax as it was before S490 passed.

Embedded software is still taxable and defined as: ...computer instructions, known as microcode, that reside permanently in the internal memory of a computer system or other equipment and are not intended to be removed without terminating the operation of the computer system or equipment and removing a computer chip, a circuit, or another mechanical device.

The requirements for software to be taxable are:

It is purchased or licensed from a person who is unrelated to the taxpayer and it is capitalized on the books of the taxpayer in accordance with generally accepted accounting principles, including financial accounting standards issued by the Financial Accounting Standards Board. A person is unrelated to a taxpayer if (i) the taxpayer and the person are not subject to any common ownership, either directly or indirectly, and (ii) neither the taxpayer nor the person has any ownership interest, either directly or indirectly, in the other.

Software that meets the above requirements is now excluded under the new amendment if the software is developed from scratch to meet the specified needs of the taxpayer whether done internally by the taxpayer or externally by a third party.

What about software that is purchased by the taxpayer and then modified for the taxpayer's specified needs? In this case the purchased software is taxable if it meets the requirements of 105-275(40), but the modifications would be excluded. For example, a software package that is purchased or licensed from an unrelated entity for \$100,000 and is capitalized on the taxpayer's books would still be taxable. However, the software cannot be utilized by the owner in its current state, and it must be modified for the owner's use. The owner hires additional full-time employees and also pays outside (unrelated to the owner) consultants to modify and install the software so the owner can use it for their specified needs. The amendment above excludes the additional costs needed to put "the software" in its usable state for the customer's specified needs. In this example, "the software" is taxable and the modifications are excluded from property tax.

This change is effective for tax years which begin on or after July 1, 2014. It does not matter in which year the software was acquired; all customized software is excluded and should not be listed by the owner starting in January 1, 2014.

What about tax years prior to January 1, 2014? If software is deemed to be taxable under the previous statute then it is still taxable for those years.

Local Government Division
North Carolina Department of Revenue

OHIO

Ohio has not imposed a personal property tax since 2009. The purchase of prewritten software is subject to sales tax as the sale of tangible personal property. Ohio Rev. Code 5739.01(B)(1) which states:

"Sale" and "selling" include all of the following transactions for a consideration in any manner, whether absolutely or conditionally, whether for a price or rental, in money or by exchange, and by any means whatsoever:

(1) All transactions by which title or possession, or both, of tangible personal property, is or is to be transferred, or a license to use or consume tangible personal property is or is to be granted;

R.C. 5739.01(YY) defines tangible personal property as follows:

"Tangible personal property" means personal property that can be seen, weighed, measured, felt, or touched, or that is in any other manner perceptible to the senses. For purposes of this chapter and Chapter 5741. of the Revised Code, "tangible personal property" includes motor vehicles, electricity, water, gas, steam, and prewritten computer software.

Ohio also imposes sales and use tax on the services of automatic data processing, i.e., software as a service, computer services and electronic information services. These services are defined in R.C. 5739.01(Y) as follows:

(Y)(1) (a) "Automatic data processing" means processing of others' data, including keypunching or similar data entry services together with verification thereof, or providing access to computer equipment for the purpose of processing data.

(b) "Computer services" means providing services consisting of specifying computer hardware configurations and evaluating technical processing characteristics, computer programming, and training of computer programmers and operators, provided in conjunction with and to support the sale, lease, or operation of taxable computer equipment or systems.

(c) "Electronic information services" means providing access to computer equipment by means of telecommunications equipment for the purpose of either of the following:

(i) Examining or acquiring data stored in or accessible to the computer equipment;

- (ii) Placing data into the computer equipment to be retrieved by designated recipients with access to the computer equipment.

Counsel, Sales & Use Tax Division

OKLAHOMA

Canned software that can be purchased over-the-counter is not classified as intangible and is taxable. *Custom software* designed for a specific program is classified an intangible and is not taxable. A ballot measure passed in June 2012 amended the Oklahoma Constitution:

This measure amends Section 6A of Article 10 of the Oklahoma Constitution. At present that section exempts some intangible personal property from ad valorem property taxation. This measure would exempt all intangible personal property from ad valorem property taxation.

An ad valorem property tax is a tax imposed upon the value of property.

Intangible Personal Property is property whose value is not derived from its physical attributes, but rather from what it represents or evidences.

Intangible Personal Property which is still currently taxed but would not be taxed if the measure is adopted, includes items such as:

- patents, inventions, formulas, designs, and trade secrets;
- licenses, franchise, and contracts;
- custom computer software; and
- trademarks, trade names and brand names.

If adopted, the measure would apply to property taxation starting with the tax year that begins on January 1, 2013.

Personal Property Section
Oklahoma State Tax Department

SOUTH DAKOTA

South Dakota does not have a personal property tax, thus this type of property is not assessed by county assessors. Application software that is bundled with equipment would be subject to sales/use tax on the retail purchase price.

Property and Special Taxes Division
South Dakota Department of Revenue

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

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.

Property Tax Division
Washington State Department of Revenue

WISCONSIN

Computers are exempt from property tax in the State of Wisconsin. Software is included in the computer exemption. We do not attempt to separate the cost of the software from the purchase price of the computer. Application software and system software are treated the same – exempt as part of the computer. The only software that is taxable is custom software. Custom software generally is purchased separately from the computer so the purchase price is easily determined.

Section 70.11 (39) COMPUTERS. If the owner of the property fulfills the requirements under s. 70.35, mainframe computers, minicomputers, personal computers, networked personal computers, servers, terminals, monitors, disk drives, electronic peripheral equipment, tape drives, printers, basic operational programs, systems software, and prewritten software. The exemption under this subsection does not apply to custom software, fax machines, copiers, equipment with embedded computerized components or telephone systems, including equipment that is used to provide telecommunications services, as defined in s. 76.80 (3). For the purposes of s. 79.095, the exemption under this subsection does not apply to property that is otherwise exempt under this chapter.

Wisconsin requires annual reporting of exempt computer equipment. Local municipal assessors receive the value of exempt computer equipment on the Statement of Personal Property (Form PA-003). Municipalities must report the total of all exempt computers to the Department of Revenue on the Exempt Computer Report. Wisconsin requires the value for all exempt computers because the State reimburses the municipality for the lost revenue due to the exemption.

Division of State & Local Finance
Wisconsin Department of Revenue



STATE OF CALIFORNIA

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JOHN CHIANG
State Controller

CYNTHIA BRIDGES
Executive Director

January 27, 2014

[Individually addressed]

Dear Sir or Madam:

In California, *application* software, unlike *basic operational* software, is not valued for property taxation purposes. A basic operational program is defined as a program that is fundamental and necessary to the functioning of a computer.

If a computer or other item of equipment is bundled together with application software and purchased at a single price, lacking documented evidence to the contrary, California County Assessors may value the computer/equipment at its acquisition cost. However, if the taxpayer can supply sales prices, costs, or other information that will enable a county assessor to make an informed judgment concerning the proper value of the taxable and nontaxable components of the sale, then the county assessor must exclude the value of the *application* software from the taxable value of the computer/equipment.

The State Board of Equalization is currently analyzing the taxation issues surrounding computer equipment. A report on California's issues is posted on our website at:

www.boe.ca.gov/proptaxes/pdf/ES_report.pdf

We are hoping that you will be able to provide us with information on how [state name] treats software for taxation purposes. Is application software treated differently than basic operational software? If application software is exempt from taxation, how do you identify the value of this software when it is embedded in a single sale price? We would greatly appreciate any information that you can provide on this issue, including copies of statutes, regulations, or procedures.

Information should be sent to Ms. Sherrie Kinkle at the above address or emailed to sherrie.kinkle@boe.ca.gov. If you have questions regarding this request, Ms. Kinkle may be reached at 1-916-274-3363.

Sincerely,

Dean R. Kinnee, Chief
County-Assessed Properties Division