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Property Tax Update

All of us at
Property Tax Assistance
Co. Inc.
Would like to wish you
and your families
A Blessed and
Prosperous
New Year.

PTA PROPERTY TAX UPDATE

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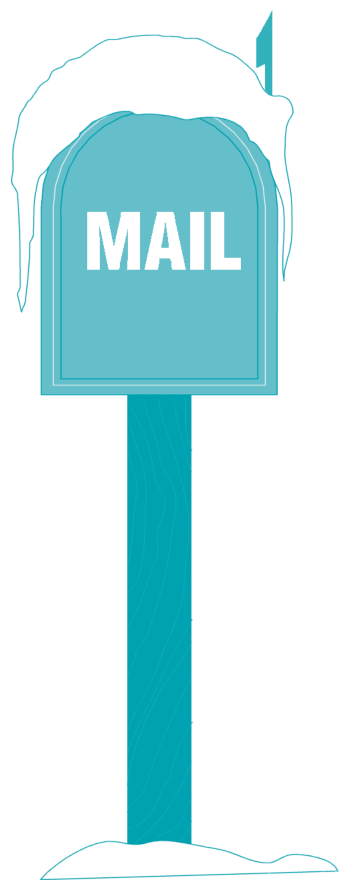
Cardinal Health 301, Inc. v. County of Orange

Chris Larsen, Tax Consultant

In a case which could affect thousands of California taxpayers, the California Court of Appeal, in Cardinal Health 301, Inc. v. County of Orange, recently addressed the issue of whether the value of nontaxable application software could be taxed on the basis of it being bundled with taxable computer equipment. The case involved several Pyxis MedStation 2000 units (computerized medicine dispensing systems), which are leased to hospitals by Cardinal Health, Inc. These "MedStations" have a built-in computer which, once programmed, dispenses appropriate medications to be administered to patients. Ninety percent of the value of each unit consists of proprietary computer software systems. The Orange County Assessor's Office issued escape assessments for the tax years 2000 through 2003, after performing an audit of the company's personal property. The escape assessments were based on the leased value of the MedStation units.



Cardinal Health presented information to both the Assessor and the appeals board that would have allowed the Assessor to segregate the value of the nontaxable software application and the taxable MedStation equipment. However, the board found that such information was irrelevant and determined that the company's software "is not sold or leased separately from the MedStation equipment, and is not priced separately for sale or lease, and does not have any use outside of the MedStation itself. The software is therefore 'embedded' or 'bundled' in the various MedStation units."

The case was eventually brought before the California Court of Appeal. Cardinal Health's primary argument was that the software included with their MedStation units was nontaxable, and the cost should be segregated from the value of the equipment. Revenue and Taxation Code section 995 states that storage media for computer programs shall be valued "as if there were no computer program on such media except basic operational programs. Otherwise, computer programs shall not be valued for purpose of property taxation." Based on this, in order to properly determine if the software in question is taxable, one must establish whether the software meets the criteria of a "basic operational" program.

Code section 995.2 explains that only the lowest level of software, that which is essential to the operation of the computer (typically referred to as the BIOS), is considered 'basic operational' software, and should be taxed. All non-BIOS software, including operating systems and applications should be nontaxable. Cardinal Health's position was that the proprietary software systems included in the price of MedStation units was not necessary to the functioning of the internal computer and could not be classified as a "basic operational" program, and was therefore nontaxable. ***Continued***

Business Property Audits

Linda Offringa, Director Tax Compliance

For those of us who file personal property taxes with a full value over $400,000 in California, you know that every four years you can depend on being audited by the Assessor's office. However, according to Assembly Bill 550 (Ch. 297, Stats of 2008), the term "mandatory" is being amended starting January 1, 2009.

Prior to AB 550, the Revenue and Taxation Code §469 stated that… "the assessor shall audit the books and records of that profession, trade, or business at least once every four years." This provision has been amended to state that the Assessor is now required to conduct a "significant" number of audits. Simply stated, the term "significant" implies that the Assessor will perform 75% of former mandatory audits. These audits still apply to taxpayers that have a full value of $400,000 or more. The allocation of audits is further divided between those businesses that have the largest assessments in the county and those who fall below. The details of this division and the entire text of Assembly bill 550 can be viewed at http://www.leginfo.ca.gov/pub/07-08/bill/asm/ab_0501-0550/ab_550_bill_20080925_chaptered.pdf

According to SBE Letters to the Assessor No.2008-059, "Therefore, it is the intent of the Legislature in enacting this act to provide assessors with discretion in selecting which business taxpayers to audit, thereby adding an element of unpredictability to the audit process and ultimately advancing the policy goals of the audit process, and furthering the constitutional requirement of equal and uniform assessment."

The implementation of this change is to relieve the counties of the burden of performing audits on 100% of those businesses who have a full value over $400,000. The unpredictability of the allocation is designed to keep taxpayers honest. Although the thought of not being audited sounds promising, keep in mind that these audits are also your opportunity to take a second look at your assessed values. This change in the audit rules makes it even more important to review how the Assessor is valuing your assets each year. Taxpayers should be encouraged to file returns in duplicate and request a copy of the Assessors calculated values in accordance with Revenue and Taxation Code §443.1. The calculated values will verify if the Assessor has picked up your reported costs correctly and let you know what trend table they are placing on your equipment. Errors in processing can easily be corrected with a phone call. Errors made in valuation require the timely filing of an assessment appeal . Remember, if you are not chosen for audit, this annual review may be your only opportunity to correct your assessed values. Issues involving extraordinary obsolescence are generally not considered at the time of processing. It's more important than ever to file an appeal timely if the value on the tax bill appears to be incorrect.

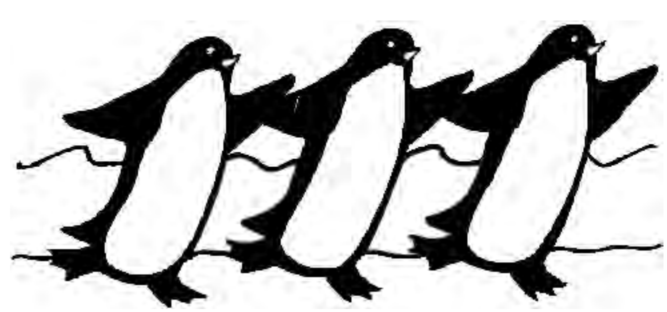
Continued from front page - Cardinal Health 301, Inc. v. County of Orange

Continued from front page - Cardinal Health 301, Inc. v. County of Orange

The Assessor's argument was that the proprietary software was not sold or leased separate from the equipment, and the software was "embedded" to the equipment, making it impossible to segregate the values. However, since neither section 995 or 995.2 mention bundling or embedding at all, the only possible support for the Assessor's position can be found in section 152 of title 18 of the California Code of Regulations (referred to as Rule 152).

The majority of the Assessor's case is built around subdivision (e) of Rule 152, which allows the assessor, "lacking evidence to the contrary", to regard the total amount charged as indicative of the value of the taxable tangible property." Using this subdivision, the Assessor argued that because the taxpayer's proprietary software was included in the price of the computer equipment, and because the customer did not have the option to accept or reject the software separately from the equipment, the software was "embedded" to the equipment, and that it was not possible to segregate the value for each. However, this position ignores the following subdivision (f), which goes on to permit the taxpayer to provide information which segregates the values to be ascribed to taxable and nontaxable components of the equipment, allowing the assessor to make an informed judgement. This subdivision is in clear contradiction to the Assessor's argument, with the reasonable burden of providing the necessary information put on the taxpayer.

In reversing the decisions of the Assessment Appeals Board, the Court of Appeal held that the value of the non-BIOS software was not to be included in the taxable value of each MedStation unit. This case has a far reaching impact because much of the equipment in use today is computerized, and most of this equipment has embedded application software which should not be taxed. It may be worthwhile for a taxpayer to go through the exercise of determining the value of application software which is embedded in their computerized equipment.



Quotes

Sideshow
"Jewelry takes people's minds off your wrinkles."
—Sonja Henie

Commitment
"A New Year's resolution is something that goes in one year and out the other."
—Author unknown

Exit strategy
"An optimist stays up until midnight to see the new year in. A pessimist stays up to make sure the old year leaves."
—Bill Vaughn

Lightening up
"The reason angels can fly is because they take themselves lightly."
—G. K. Chesterton

Fools in love
"The greatest pleasure of a dog is that you may make a fool of yourself with him and not only will he not scold you, but he will make a fool of himself too."
—Samuel Butler

Pet smarts
"Cats are smarter than dogs. You can't get eight cats to pull a sled through snow."
—Jeff Valdez

Getting educated
"The first thing you learn in law school is people are crazy."
—Annette Gordon-Reed

Property Tax Update

Economic Lives from State Board of Equalization

Kris Chacko, Esq. Sr. Tax Consulatant

The California State Board of Equalization (SBE) is considering the possibility of including economic lives for various equipment categories of equipment in the Assessor's Handbook (AH) Section 581. Personal Property in California is generally assessed using the Cost Approach to Value. The acquisition cost is multiplied with an index factor generating the Replacement Cost New (RCN). This RCN is then applied to a percent good factor (the inverse of depreciation) resulting in "Fair Market Value". The economic lives are used to determine which percent good factors should be used to determine the Fair Market Value.

The majority of the economic lives that the SBE is considering are not generated by a detailed life study. The resulting valuations are not tested against the market. The majority of the lives are identical to those recommended by the California Assessor's Association (CAA). The CAA is an organization made up of the various Assessors in all the counties within California. Currently most of these counties adhere to whatever directives the CAA puts forth even though they still fall under the auspices of the SBE. The CAA has not employed any studies to determine economic lives. In most instances these guidelines are generated from the various collective experiences as "assessors" rather than actual studies.

The adoption of these lives by the SBE does create some concern.

1. It will give some official credence to lives created by individuals whose motivations are suspect.
2. It is almost a forgone conclusion that the lives used will produce values higher than market value.
3. Assessors through out the state will use the guidelines as fact rather than the guide that it is meant to be.
4. It will make working with various deputy assessors, to get to a proper value, that much harder.

The Assessors prefer to value equipment based on an industry assumption rather than the valuation of the individual equipment. As a result, property is lumped together with other industries and assessed as a group. The adoption of these lives by the SBE makes filing of appeals imperative. An appeal forces the Assessor to evaluate additional factors, not considered by the tables .

Start the New Year Off Right!

Tough Economic Times

Tim Brown, Sr. Tax Consultant

Currently we are in one of the worst economic climates of recent history. How bad it is, or will be, we don't know yet. Given the tough times though, there may be an opportunity to reduce your property tax liability. And right now is the perfect time to start thinking about it. Your property might be affected by economic obsolescence and since the lien date in California is January 1, you may want to make sure that if your property is suffering from economic obsolescence, you know what it is and how to demonstrate it to the assessor's office.

Assessor's Handbook Section 504 of the California State Board of Equalization defines economic obsolescence, or external obsolescence, as a "loss in value resulting from adverse factors external to the property that decrease the desirability of the property."

Section 110 of the California Revenue and Taxation Code defines value as "the amount of cash or its equivalent that property would bring if exposed for sale in the open market..." Value can also be thought of as the present worth of future benefits. The assessor's office values property each year as of January 1. Therefore, the value of your property should be based upon the anticipated future income derived from the property as of the first of each year.

So, what if the demand for your product drops precipitously. Wouldn't it make sense then that the machinery and equipment that produces the product would drop in value? What would happen to the stock of a company if sales fell significantly from previous years? If the value of the business were affected, then wouldn't the machinery and equipment that is used in generating revenues drop in value as well? The answer is, it depends. If the problems that are affecting the business are unique to the particular company then the machinery and equipment probably isn't going to lose its value due to economic obsolescence. However, if the problems effect the entire industry and are not unique to any particular company then the machinery and equipment would probably lose some of its value.

Now that we know what economic obsolescence is, how can you demonstrate to the assessor the amount of obsolescence? There are many ways to be able to demonstrate obsolescence and its effects to the assessor. The first way is to show that the machinery and equipment is not producing as much as it has or could. One way this can be done is with a yearly production history. If the production has dropped in recent years the drop can be used to quantify economic obsolescence. Or if you don't have many years of production to rely upon, you can look at the rated capacity of the equipment (i.e. the total amount the equipment could produce in ideal conditions) and compare that with the actual production of the equipment. The difference could be used to develop an economic obsolescence adjustment to the value of the equipment.

Other items that could help demonstrate economic obsolescence would be revenues, operating costs, and income. P&L statements can tell a lot. However, sometimes it is difficult to attribute the P&L numbers to a particular piece of equipment, but financial statements can be helpful in supporting an economic obsolescence adjustment. Other information that would be helpful is if any equipment has been taken offline and is sitting idle. Or maybe the number of shifts working a production line has been scaled back, say from 2 shifts daily to 1 shift daily. The reduction in the number of production workers, or labor hours, would also demonstrate economic obsolescence. As was discussed above, it may also be necessary to show that the entire industry is experiencing the same economic troubles.

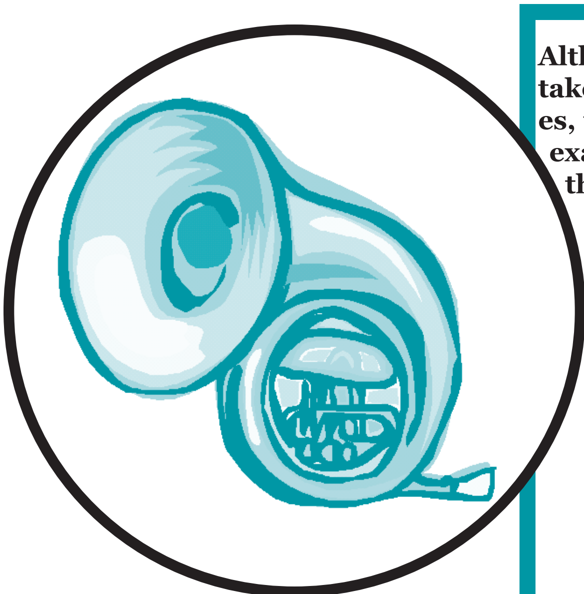
There are many reasons for economic obsolescence and factors that go into quantifying it. The above offers only a couple examples of economic obsolescence. Other factors that might effect the value of property that is outside the control of a company are higher interest rates, inflation, government mandated costs (e.g. environmental costs), and a shift in customer preferences.

Given the tough economic conditions we are now in it is a good time to review the value of your property, and one of the areas to take a look at is economic obsolescence. It may just payoff in a reduction of your property taxes.

Looking forward to getting older

British Prime Minister Winston Churchill will always be remembered for his quick wit and lively comebacks. Someone once remarked to him, “Who would want to live to be 90?” And Churchill is rumored to have replied: “Everyone who is 89.”

TOOTING OUR HORN!



Although this is an informational newsletter, we would like to take the opportunity to brag about a sampling of our successes, from various industries, in the last quarter. These are a few examples of the refunds that our clients have received from the county, due to our work.

Clothing Manufacturing	*$55,636.39*
Colocation Data Center	*$1,118,576.00*
Commercial Printer	*$44,448.62*
Data Center	*$1,429,818.00*
Grocery Stores	*$187,078.51*
Photocopy Machines Mfr.	*$111,247.54*
Post Production	*$81,293.16*
Printing Company	*$51,943.53*
Semiconductor Mfr	*$26,539.33*
Textiles	*$146,898.00*

TaxTidbits

California is Country's Biggest Spender

A new Census Bureau report reveals that California's total state spending last year was $233.6 billion, making it the country's biggest spender. In second place is New York, at roughly half California's spending, and Texas is third, at less than half of California's total. The figures include general fund spending, borrowed money, and spending of federal funds and special fund revenues such as gasoline taxes. (Source: U.S. Census Bureau report, November 26.)

Art Bennet, New Councilman

Art Bennet, the VP of National Property Tax Services for Property Tax Assistance Co., Inc. has just been elected to serve on the Chino Hills City Council. Art has worked in the property tax profession for the past 37 years as a consultant and corporate tax manager. He has also been involved in every piece of development for Chino Hills City for the last 15 years. PTA is proud of Art's accomplishments.