

70 Days and Counting: Clock Is Ticking to Claim Embedded Software Tax Exemption

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The amount of non-taxable embedded software being taxed in California is a staggering number. While companies own assets with millions of dollars of embedded software, few companies are maximizing their property tax savings through the embedded software exemption. The good news is that it is not too late to dig in and maximize your potential tax savings. Most businesses have until May 7, 2014¹ to file their annual Business Property Tax Statements (Form 571-L) with California counties.

Embedded software is everywhere—computers, phones, servers, network equipment, ATMs and credit card machines, tracking devices, security and alarm equipment, robotic and other electronically controlled manufacturing equipment, semiconductor manufacturing equipment, industrial process monitoring and control equipment, medical equipment and telecommunications equipment. Assets containing embedded software now fill many companies' fixed asset listings. Like patents, trademarks, copyrights and other intangible assets, embedded software is exempt from property tax assessment in California.²

In light of the current economic difficulties in many California counties, it is no surprise that county assessors are not widely publicizing this exemption. However, the exemption for embedded software has been on the books since 1972 and, as recently as 2008, was upheld by a California Court of Appeal in the leading case of *Cardinal Health 301 v. County of Orange*, 167 Cal. App. 4th 219. (*Cardinal Health* was represented by Richard Nielsen of Pillsbury Winthrop Shaw Pittman LLP.)

Moreover, a recent study by the State Board of Equalization ("BOE") reveals that, of the 48 counties across California that responded to its survey, 20 counties made adjustments to exempt embedded software.³ The BOE's report further shows that most post-assessment adjustments made at the county level were applied to medical equipment, which suggests that this may be a result of Cardinal Health's

¹ While the deadline under California Revenue & Taxation Code § 441(b) is technically April 1st, in practice most companies file by May 7th as this is the deadline to avoid delinquency penalties.

² California Revenue & Taxation Code §§ 995, 995.2; Property Tax Rule 152.

³ For a copy of the State Board of Equalization's *Report on Bundled Nontaxable Software: Embedded Software* published in January 2014 visit http://www.boe.ca.gov/proptaxes/pdf/ES_report.pdf.

successful defense of its embedded software claim. The report further confirms **property tax savings of up to 51%** for certain equipment with embedded software.

How to Quantify the Amount of Software Eligible for Exemption?

Consider any type of equipment that includes software. All software (except basic operational software) that comes preloaded at the time of purchase in any computer or other electronic equipment (and not priced separately) is likely ripe for embedded software savings. Obviously, assets that are highest in value or in abundant supply (e.g., large quantities of computers or electronically controlled manufacturing equipment) are likely to be the best places to start your analysis. Due to the prevalence of electronic equipment, almost every industry can benefit from the embedded software exemption. The amount of tax savings associated with embedded software depends upon the nature of the property involved and the value attributable to the exempt software. If, for example, a company has \$40 million in assessed value of assets containing embedded software and they establish that 25% of that value is attributable to embedded software, the annual property tax savings would be approximately \$100,000 (or \$1,000,000 over the next ten years).

Building a record to support this exemption requires strategic planning and careful documentation. The savviest taxpayers are meeting with their tax advisors now and working to identify and document their embedded software.⁴ By May 7, 2014, these taxpayers will have a detailed approach and a final calculation of their embedded software exemptions in hand. This, in turn, will result in a Business Property Statement with reduced reported costs.

Whatever the level of your potential embedded software claim, one thing is certain: until you affirmatively raise this issue, your tax savings will be zero.

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⁴ For an outline of possible ways to prove the value of embedded software, visit the BOE's website at http://www.boe.ca.gov/meetings/pdf/102213_a_Panel_Outline_Larry_Hoenig.pdf. [NB: Panel is intentionally misspelled here to track the BOE's URL.] It should be noted that county assessors often contest the validity of the taxpayer's proof of value.

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