



Current Developments in Property Taxation

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I. Constitutional Changes

A. Split Roll—Initiative and Legislative Change

1. Split roll initiative.
 - a. This initiative was submitted by Rob Reiner and the California Teachers Association in November 2003 as the “Improving Classroom Education Act.”
 - b. According to the supporters, commercial buildings, unlike single-family residences, produce income for their owners. Also, they argue that since business property supposedly changes ownership less often than houses, the share of property taxes paid by businesses has supposedly been declining. Moreover, they argue California commercial real property tax rates are among the lowest in the nation. Therefore, they say it makes sense to tax commercial real property at a higher rate than private homes.
 - c. The purpose of the initiative was to increase commercial real property tax rates to 1.55%, and not to increase or affect in any way the property taxes by homeowners on noncommercial property.
 - d. On April 7, 2004, Cal-Tax held a press conference to discuss a huge flaw in the draft of the initiative. Specifically, Cal-Tax pointed out that the language as drafted made it possible for a judge to conclude that although owner-occupied, single-family dwelling units were excluded from the new tax, the residential land upon which they were situated would be subject to the new tax. This drafting flaw could have cost homeowners more than \$3.5 billion in new taxes.
 - e. On April 8, 2004, Rob Reiner and the California Teachers Association withdrew the initiative from the November ballot, citing “the complicated nature of the November ballot.” However, the proponents of this initiative have not given up. They are studying the possibility of bringing it back for the 2006 election.

*This bulletin contains the outline of a presentation at the Silicon Valley Chapter of the Institute for Professionals in Taxation at Santa Clara, California on May 27, 2004 by **Lawrence L. Hoenig**, a tax partner in the Palo Alto office, and **Annie H. Huang**, a tax associate in the San Francisco office of Pillsbury Winthrop LLP. This outline also can be found on the world wide web as part of the **Pillsbury Winthrop LLP Tax Page** at:*

<http://www.pfstax.com/state/caprop0406.shtml>

2. SB 1404 (Soto).
 - a. This bill would allow, until 2012, the establishment of Multifamily Improvement Districts to impose assessments on business and rental residential property within such districts to finance certain improvements and activities. Many of the things that the assessment can be used to fund are normally supported by general taxes.
 - b. Status of the bill as of May 25: Senate third reading.
3. SB 17 (Escutia).
 - a. This bill would require a person or entity that obtains a controlling or majority ownership interest in a legal entity, or an entity that makes specified transfers of ownership of interests in the legal entity, to file a change in ownership statement, as specified, with the board within 60 days of specified transactions. Penalties would apply if the statement is not timely filed or contains misrepresentations.
 - b. This bill would also require a publicly traded company to file an annual property statement with the State Board of Equalization that lists all of the real property owned or leased in the state by the company and would also require the board to transmit information from these statements to local assessors. A penalty equal to 10% of the current year's taxes required to be reported will be imposed for failure to timely file a complete statement.
 - c. While this bill does not provide for a change in the assessment of business property as of now, it is believed that the bill is setting the groundwork for a split roll.
 - d. Status of the bill as of May 25: Has been placed on inactive file in the Assembly since September 8, 2003. However, there are rumors that the author may try to bring the bill back to life again.

B. ACA 22 (Dutra) California Tax Board

1. This constitutional amendment would consolidate the Franchise Tax Board and the State Board of Equalization into one state agency.
2. Status of the bill as of May 25, 2004: In Assembly Rev. & Tax. Committee. Held under submission.

3. This constitutional amendment does not appear likely to pass, but the idea of such tax agency consolidation may still be found in the California Performance Review's final recommendations, which is due to the Governor by June 30, 2004.

II. Revenue and Taxation Code

A. Recently Enacted Statutes

1. AB 1744 (Committee on Revenue and Taxation)
 - a. Among other changes to various property tax laws is the extension of the requirement to make available for examination by the county assessor information or records regarding personal property that becomes part of new construction performed by an owner-builder or owner-developer, if that new construction is sold to a third party, is constructed on behalf of a third party, or is constructed for the purpose of selling that property to a third party.
 - b. The new law would also require the lessor of property that is leased under a conditional sales agreement to list that leased property on the lessor's property statement.
 - c. Chaptered by Secretary of State on September 5, 2003.

B. Proposed Legislation

1. AB 1850 (Cohn). Business records retention (amending R&TC section 470 *et seq.*)
 - a. This bill would require any business that owns an interest in property subject to local property tax to maintain and to produce business records to support values claimed on property tax returns.
 - b. This bill would require that records be maintained for a period not less than four years from July 1 of the lien date for which the assets were taxable, or until the final disposition of all audits and all administrative or judicial proceedings relating to that lien date, whichever is later.
 - c. "Business records" are defined as "the books of account ordinarily maintained by the average prudent business person, including, but not limited to, accounting policies and procedures, chart of accounts, purchase orders, bills, receipts, invoices, shipping documents, contracts, capital

- expenditure proposals and authorizations, tapes, microfiche, or other documents of original entry supporting the entries in the books of account, and schedules or working papers used in connection with the preparation of federal, state, local, and property tax returns.”
- d. The penalty for failing to maintain the records as required is \$10,000 for each taxable year that failure occurs. Penalty may be abated if the failure is due to factors beyond the control of the taxpayer.
 - e. The penalty for failing to produce records as required is \$10,000 for each 30-day period after 90 days of the notice from the assessor. The maximum amount of penalty that may be levied for failure to produce is \$50,000 (if the failure to produce is not willful). Penalty may be abated if the failure is due to factors beyond the control of the taxpayer.
 - f. The biggest concern with this bill is the scope of the definition for “business records.” It is very broad and all-encompassing.
 - g. Status of the bill as of May 27: The Assembly rejected this bill on May 17, but reconsideration was granted on May 27. The bill passed the Assembly upon reconsideration and is now in the Senate.
2. AB 2442 (Harman). Assessment of qualified electric generation facilities.
 - a. This bill, as initially introduced on March 25, 2004, would have allowed local jurisdictions (*i.e.*, cities and counties) to participate in state assessment of a qualified electric generation facility.
 - b. The latest amendment to the bill on April 22, 2004, stripped the language allowing participation by local jurisdictions in state assessments. Instead, the bill now requires that the Legislative Analyst’s Office conduct a study to determine the effect a certain statute (*i.e.*, the one that requires state assessment of electrical generation facilities) has on *ad valorem* property taxes.
 - c. The concern raised by the initial draft of this bill was that the assessors are becoming more aggressive in their power grab and that the Legislature appears to be more willing to accept such behavior.
 - d. Status of the bill as of May 25, 2004: In Senate. To Rules Committee for assignment.
 3. AB 2857 (Laird). Assessment Reduction Applications (amending R&TC section 1604).
 - a. This bill provides that:
 - i. if a taxpayer files an application requesting a reduction of the base-year value and the county board has not issued a decision within the section 1604(c) two-year statute of limitations, the applicant’s opinion of value remains on the roll until the county board makes a final determination on the application; and
 - ii. if a taxpayer files an application requesting relief other than a reduction in base-year value and the county board has not issued a decision within the two-year statute of limitations, the applicant’s opinion of value shall be enrolled on the assessment roll only for the tax year or years covered by the pending application.
 - b. This bill is sponsored by the California Assessors’ Association and is meant to address the decision by the California Courts of Appeal in *FlightSafety International, Inc. v. Los Angeles County Assessment Appeals Board*, 105 Cal. App. 4th 620 (2003). The court in *FlightSafety* held that an applicant’s opinion of value for an appeal of a personal property assessment, contrary to the language in Property Tax Rule 309(c), remains on the roll until the appeals board hears and decides the application.
 - c. Status of the bill as of May 25, 2004: In Senate. To Rules Committee for assignment.
 4. SB 1424 (Burton) and AB 2472 (Wolk). California Tax Court.
 - a. Both of these bills would create a California Tax Court to replace the State Board of Equalization as the administrative forum to hear and determine appeals from taxpayers with respect to: (1) sales and use tax determinations, (2) specified insurance tax determinations, (3) personal income tax deficiency assessments and (4) corporation tax deficiency assessments.
 - b. Both bills would do away with the State Board of Equalization’s role as an administrative tax tribunal. Instead, the “tax court” would be composed of five judges appointed by the Governor for 12-year terms. Judges must be attorneys who have been engaged in the practice of law with a primary focus on taxation within five of the last ten years.

- c. Opponents state that there are several provisions in the bills that negatively affect taxpayers in significant ways. For instance, taxpayers would not have the right to “appeal” a “tax court” decision to superior court. Instead, the taxpayer (and the tax authority) would have a right to file a writ with the Court of Appeal.
 - d. Also, despite the discussions in SB 1424 and AB 2472 about fairness, the need to streamline, and the desire to provide resolution of tax disputes that are consistent with federal tax resolution procedures, neither bill offers *de novo* review for property tax cases.
 - e. Status of SB 1424 as of May 25: In Senate Rev. & Tax. Committee.
 - f. Status of AB 2472: The bill was killed by the Assembly Appropriations Committee on May 19.
 - g. It also appears that SB 1424 is unlikely to pass because there is strong opposition from business groups and individual members of the State Board of Equalization.
5. AB 2000 (Dutton). Governmental Reorganization.
- a. This bill would abolish the Franchise Tax Board and transfer its powers and duties to the State Board of Equalization.
 - b. Status of the bill as of May 12, 2004: In Assembly Rev. & Tax. Committee. Held under submission.
 - c. As with ACA 22, this bill does not appear likely to pass, but the idea of such tax agency consolidation may still be found in the California Performance Review’s final recommendations, which is due to the Governor by June 30, 2004.

III. Cases

A. *County of Orange v. Bezaire*, 117 Cal. App. 4th 121 (2004)

1. Issue: Whether Proposition 13’s two-percent cap should be calculated based on the original purchase price of the property or whether it always applies against any intervening previous year’s reassessed value.
2. The trial court ruled in favor of the taxpayers and held that under Proposition 13, a property tax increase could not ever exceed two percent over the previous year’s assessment (in the

absence of a change of ownership or new construction).

3. The Court of Appeal reversed the trial court’s decision and held that the intent of the drafters of Proposition 13 is that the two-percent cap is calculated against the original base year value set at the time of the pertinent change of ownership or new construction. Thus, Proposition 8 works on a year-by-year basis and does not provide any permanent relief. Specifically, if a property is valued under Proposition 8 for a particular tax year, that value will be relevant for only that year and will not become a base year value for subsequent years.

B. *Amdahl Corp. v. County of Santa Clara*, 116 Cal. App. 4th 604 (2004)

1. Issue: Whether the taxpayer’s spare parts pool is exempt from taxation under the business inventories exemption under Revenue and Taxation Code section 219.
2. In connection with its service and repair functions, Amdahl maintained a pool of spare parts. The spare parts are used for two purposes: (a) for replacement parts in fulfilling its maintenance and repair duties under extended service contracts with its customers and (b) to diagnose and isolate problems with particular computer equipment, through a trial and error method of replacing various parts to determine which part was nonfunctioning.
3. Amdahl treated the spares pool as fixed assets, rather than as inventory, in connection with its income tax reporting and financial accounting. Amdahl capitalized the spares pool, and claimed depreciation deductions on those parts.
4. The Court of Appeal affirmed the trial court’s granting of the county’s summary judgment motion. The court reasoned that the spares were not goods “intended for sale or lease” because: (a) customers were not charged for the replacement parts; (b) there was no reduction in the spares pool when there was a transfer of property from Amdahl to the customer because there was only a swap of good part for defective part; and (c) Amdahl treated the spares as fixed assets and not inventory for income tax purposes.

5. The court further found that Amdahl did not hold or intend the sale or lease of its spares “in the ordinary course of business.”

IV. Property Tax Rules

A. Rules Recently Adopted

1. Rule 462.180. Change in Ownership Legal Entities.
 - a. The rule was amended in order to clarify that for purposes of determining transfers that constitute changes in ownership, limited liability companies (LLCs) should be included in subsection (d)(1)(B), which provides that partnership interests are to be treated as capital and profits interests.
 - b. The rule was also amended to clarify that there is no attribution of stock, partnership, LLC or other legal entity interests between spouses.
 - c. The amended rule became effective on October 15, 2003.

B. Proposed Rules in the Pipeline

1. Rule 138. Exemption for Aircraft Being Repaired, Overhauled, Modified or Serviced.
 - a. On September 29, 2003, the California Assessors' Association petitioned the State Board of Equalization proposing that the Board commence the rulemaking process to amend Rule 138.
 - b. On May 20, 2004, the State Board of Equalization's Property and Special Taxes Department issued LTA 2004/032 notifying interested parties of the regulatory project. The Department also provided a matrix showing the change to Rule 138.
 - c. Interested parties must submit comments by June 25, 2004.
2. Rule 305.3. Application for Equalization under Revenue and Taxation Code 469.
 - a. On September 29, 2003, the California Assessors' Association petitioned the State Board of Equalization proposing that the Board commence the rulemaking process to amend Rule 305.3.
 - b. The proposed amendment would add language to subsection (b)(2) so that a section 469 appeal is triggered by the existence and disclosure of property “of material value” subject to escape assessment.
 - c. Another proposed amendment would change the definition of “result of an audit” by deleting the

final phrase in subsection (b)(3) which currently refers to issues identified in writing by the taxpayer.

- d. Staff released an agenda matrix summarizing suggestions and comments on May 21, 2004. The interested parties meeting is on June 25, 2004.
3. Rule 461. Real Property Value Changes.
 - a. On September 29, 2003, the California Assessors' Association petitioned the State Board of Equalization proposing that the Board commence the rulemaking process to amend Rule 461.
 - b. Under the current rule for determining declines in value, it is provided that land and improvements constitute an appraisal unit except when measuring declines in value caused by disaster. However, fixtures and other machinery and equipment classified as improvements constitute a separate appraisal unit.
 - c. The proposal would amend subsection (e) of Rule 461 to say that fixtures and other machinery and equipment classified as improvements “may” constitute a separate appraisal unit. In essence, the amendment would give assessors the discretion to decide what they want to treat as one appraisal unit.
 - d. Staff released an agenda matrix summarizing suggestions and comments on May 21, 2004. The interested parties meeting is on June 25, 2004.
 - e. The County of Los Angeles is litigating this exact issue in *BP West Coast Products, LLC v. County of Los Angeles*, LASC Case No. BC 269200. The taxpayer argued that Rule 461 mandates that fixtures are a separate appraisal unit when measuring declines in value, while the County of Los Angeles treated fixtures, land and structures as one appraisal unit. The trial court judge ruled from the bench that Rule 461 was valid and that the taxpayer was entitled to the lower base year value on land after a determination of the fair market value of the land separate from the fixtures. The parties are still waiting for the court's statement of decision.
- #### V. Other Miscellaneous State Board of Equalization Matters
- ##### A. Special Topic Survey—Change in Ownership and New Construction
1. On April 13, 2004, the Property and Special Taxes Department recommended to the Board that the survey be adopted and authorized for publication, and that staff be directed to work

with interested parties to formulate possible solutions to procedures identified in the survey as problematic.

2. The Board approved the publication of the survey and instructed staff to come back on May 25 to provide a report on how to best address the issues raised in the survey.

VI. Pending Appeals and Audits

A. Rotables—The Disputes Continue

1. There are a number of audits right now in which the reach of the *Amdahl* decision is likely to be tested.
 - a. For example, what if the company included all rotables in its regular inventory? Will the county argue that some portion of inventory should be segregated and treated as non-inventory and therefore taxable property?
 - b. What if the rotables are kept in one pool, but the company will “dip into” regular inventory when there are not sufficient rotables in that pool?
2. There will be numerous valuation and non-value issues not really addressed in *Amdahl*.
 - a. The county is becoming increasingly difficult about requiring proof as to the portion of rotables which are maintained in locations outside the county.
 - b. Assuming the county continues to allow a portion of the rotatable pool to be excluded as necessary to meet the original warranty claims, how will companies prove this percentage to be so excluded?
 - c. What proportion of the rotables are unrepairable?
 - d. How should the repaired and unrepaired rotatable parts be valued?

B. Network vs. Computer Equipment

1. *3Com* case. The taxpayer said that its peripherals were to be treated as computers under LTA 96-19. The Assessor said that such LTA was never intended to cover anything other than the computers which were analyzed in the study leading to the issuance of such LTA. The Santa Clara County Assessment Appeals Board

has had the matter under submission since it was argued on March 10, 2004.

2. Other taxpayers may take up the matter as well. In a recent Assessment Appeals Board hearing in which the Cisco appeal was continued, we mentioned that we are attempting to study the values of Cisco’s switches, routers and other internally manufactured equipment.

C. Intel

1. In *Intel*, the Assessment Appeals Board issued a decision on February 4, 2004, in which it indicated that it would apply a mathematical formula to determine the economic obsolescence for Intel’s semiconductor manufacturing equipment for the 2001 and 2002 lien dates. The formula looks to underutilization statistics in the worldwide chip-making industry.
2. The decision is not specific to Intel’s facts, and the resulting percentage reductions for economic obsolescence would seem to apply to any company with substantial amounts of semiconductor manufacturing equipment.

D. R&D Expense and Prototypes

1. The auditors in Santa Clara County have become decidedly more aggressive in reviewing taxpayer accounts reporting R&D and prototype expenditures.
2. The auditors are asserting that if the taxpayer is using these expenditures to construct or have constructed any tangible equipment (betas, prototypes and the like), the entire amount of such expenditures should be capitalized and treated as tangible business property.
3. We have been and are involved in several audits where the taxpayer needs to prove that the expenditures were used to acquire intangibles only, or to construct assets which were actually inventory, or that the betas/prototypes had extremely short lives, or had little or no value.

E. Aggregation Issue

1. This involves the situation where a taxpayer has booked a number of personal computers (or even mid-range computers) into a single

fixed asset on its books. Doing so may cause such computers to be valued using an incorrect value curve, because the aggregated total cost amount in effect moves the computers from the personal computer value table (more favorable) to the mid-range or mainframe computer value table (less favorable). The dollar amounts may be substantial if the taxpayer owns numerous personal computers.

2. The taxpayer should be careful to correct this aggregation problem in filing the business property statements in the first place. However, if the problem is not corrected at that stage, the taxpayer should raise the matter during the audit or appeal as an “offensive” issue to offset or reduce the final escape assessment(s) or perhaps even cause a refund of tax.

