Personal Property Tax Notes

High-Technology Equipment

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PROPERTY TAX CLASSIFICATION and the valuation of high-technology equipment are evolving almost as quickly as the technology itself and have presented significant challenges for property tax professionals and assessors. The classification of property as tangible, intangible, or even real is becoming more complex. Further, vast changes in technology present taxpayers with an opportunity to reconsider the value of their reported business tangible personal property, in spite of state-mandated valuation approaches. As states and localities struggle to apply varying legislative, judicial, and administrative authorities, local tax assessors acknowledge that the general depreciation schedules have not kept pace with technological changes. This column examines how these challenges to property classification and valuation present opportunities for taxpayers to reduce business tangible personal property tax assessments.

SECURING THE PROPER CLASSIFICATION AND VALUATION OF TANGIBLE PERSONAL PROPERTY

Some 40 states subject business tangible personal property to property tax. Like other areas of state taxation, differences among state laws makes compliance difficult, often resulting in the overvaluation and misclassification of business tangible personal property. In addition, technological changes and advances raise a host of valuation and classification issues. Technological equipment, including computers and peripherals, software, automated teller machines, and telecommunications licenses and equipment, are frequently misclassified or overvalued. The revolutionary pace of technology advances increases tax compliance burdens, yet these same developments offer many opportunities to positively influence overall property tax liabilities.

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CLASSIFICATION ISSUES: TANGIBLE PERSONAL PROPERTY VERSUS REAL PROPERTY

For taxpayers in jurisdictions that do not tax business tangible personal property or that have different tax rates for personalty and realty, proper classification of property is critical. Traditional definitions of personal property commonly provide that "personal property is everything that is the subject of ownership that is not real property and not permanently affixed to real property."[1] Personal property includes inventory, machinery and equipment, furniture, and intangibles.[2] Issues arise related to personal property that is affixed to real property and may be designated a fixture.[3] The following three-pronged approach is often used in determining whether property is a fixture:

1. The actual physical annexation of the property to real property, determined by the nature and use of the article;
2. The property's appropriation or adaptation to the use for which it was annexed; and
3. The intention of the party making the annexation.[4]

Despite long periods of affixation to real estate, an opportunity may exist to classify or re-classify property as personal property and secure a reduced tax assessment or outright exemption. For example, the New Hampshire Supreme Court recently held that certain communications equipment is personal property and, therefore, not subject to real property tax as a fixture.[5] The equipment in question included telephone poles, underground conduits, frames, and switches. The court determined that the equipment was readily removable, transportable, and capable of performing its intended functions elsewhere. Further, removal of the equipment would not render the realty unfit for use. Thus, the court classified the poles and other equipment as personal property despite their life expectancy of over 40 years.

The classification of automated teller machines (ATMs) provides another insightful example of the evolving nature of property classification. ATMs affixed to real estate are often deemed a fixture. Recent developments in California indicate that taxing authorities may be prone to depart from this presumption. The State Board of Equalization amended its regulation defining "fixtures."[6] According to the amended regulation, an ATM will be classified as tangible personal property "if it can be removed or relocated for use at another location without material damage to the

1 Institute of Property Taxation, *Property Taxation* § 10.01 at 536 (2d ed. 1993).

2 *Id.*

3 A fixture is defined as "[a]n article in the nature of personal property which has been so annexed to the realty that it is regarded as a part of the land." BLACK'S LAW DICTIONARY 574 (5th ed. 1979).

4 *See Teaff v. Hewitt*, 1 Ohio St. 511 (1853). This three-part test, while widely used, has not been immune from criticism. *See* R.W. Polston, *The Fixtures Doctrine: Was It Ever Really the Law?*, 16 WHITTIER L. REV. 455 (1995).

5 New England Telephone & Telegraph v. City of Franklin, 685 A 2d 913 (N.H. 1996).

6 Cal. Code Regs. tit. 18, Rule 122.5 (1997).

ATM or the realty with which it is being used."[7]

CLASSIFICATION ISSUES: TANGIBLE PROPERTY VERSUS INTANGIBLE PROPERTY

High-technology industries have spawned numerous issues regarding the classification of property as tangible or intangible. For example, taxation of computer software is a muddled, definitional quagmire as states and localities struggle to apply varying legislative, judicial, and administrative authorities.

Software is classified as either operational or applicational, canned or custom.[8] Some states have subjected computer software to property tax on the basis of the canned versus custom distinction or have treated software as a nontaxable intangible regardless of the medium in which it is contained.[9] Nonetheless, most states and courts have traditionally focused on whether the software is applicational or operational, reasoning that operational software is an essential portion of the computer hardware and is taxable, whereas applicational software is an intangible not subject to personal property tax.[10] Notwithstanding the historical disparities in software classification for property tax purposes, the current trend appears to focus on the operational versus applicational distinction. For example, the California State Board of Equalization recently adopted amendments to Property Tax Rule 152, which states that computer programs other than basic operational programs are exempt from property tax and only the storage media that contains the programs are taxable as personal property.[11] Similarly, recent Maryland legislation exempts applicational software and data-base storage and management computer programs from personal property tax.[12] An exception exists, however, for computer software that is either embedded or sold for stock in business in a tangible medium ready for use.

The determination of what constitutes taxable personal property is being extended into other high-technology industries such as telecommunications. In *Ohio Cellular RSA L.P. v. Board of Public Works of W.Va.*,[13] the West Virginia Supreme Court

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[7] *Id.*

[8] Canned or prewritten software is computer software having general applicability or that has not been prepared to meet a user's particular needs. Conversely, custom software is specialized to meet the user's particular needs. Applicational and operational software can be canned or custom. Applicational software is designed to solve a particular problem or perform a particular task (e.g., word processing software). Operational software is computer software that is used by a computer to operate (e.g., a computer's operating system).

[9] *See,* e.g., Opinion of Virginia Attorney General (Sep. 8, 1993). *See also* Conn. Gen. Stat. § 12-71(e)(1) (software is exempt from property tax, regardless of whether it is canned or custom, unless the cost of the software was included in the cost of the computer hardware); and Or. Rev. Stat. § 307.020 (software of any kind is treated as nontaxable intangible property).

[10] *See,* e.g., CompuServe Inc. v. Lindley, 535 N.E.2d 360 (Ohio Ct. App. 1987); *In re* Protest of Strayer, 716 P.2d 588 (Kan. 1986).

[11] Cal. Rev. & Tax Code Regs. tit. 18, § 152 (Nov. 3, 1996).

[12] Md. Code Ann. Tax-Prop. § 7-238 (1996).

[13] 481 S.E.2d 722 (W. Va. 1996).

held that the statutory definition of "personal property" does not include a telecommunications license granted by the Federal Communications Commission (FCC) and such license is not subject to personal property tax.[14] Applying a more novel argument, the State Board of Public Works argued that an FCC license is taxable because the right to use the airwaves in a commercial enterprise constituted a property right which is subject to property tax. According to the court, although an FCC license may be construed as a property right in general terms, the legislative intent underlying the statutory definition of personal property did not support including such licenses in the meaning of taxable personal property.[15]

THE EFFECT OF OBSOLESCENCE ON MARKET VALUE

Rapid changes in technology affect almost every industry. A variety of fixed assets are quickly being replaced with a genre of assets that operate far more efficiently. As newer assets come on the market, the outdated assets become, in real terms, less valuable. However, state-mandated valuation approaches do not always take these changes into account.

Tangible personal property is generally reported at cost or a percentage of cost and adjusted to reflect market value through state- or locality-established depreciation schedules. The depreciation schedules are intended to reflect the decline in value resulting from wear and tear caused by ordinary use of the property. However, economic or technological influences may cause some property to lose its value faster than the decline in value due to ordinary wear and tear. Since most state personal property tax statutes assess tax on the "true value" or fair market value of tangible personal property, pre-set depreciation schedules established only to capture reductions based on ordinary use are subject to challenge to the extent the value determined under these schedules does not represent fair market value. Recent developments indicate that taxpayers are increasingly successful in taking economic and technological obsolescence into account in valuing tangible personal property.[16]

A California court of appeal recently held that assessors are required to take economic obsolescence into account when valuing property.[17] Economic obsolescence, or external obsolescence, is defined as "a loss in value caused by factors outside a property."[18] Economic obsolescence can

[14] The statute in issue defined "personal property" to include, *inter alia,* intangible property. W. Va. Code § 11-5-3.

[15] In a petition pending before the FCC, a telecommunications provider is alleging that the Telecommunications Act of 1996, Pub. L. No. 104-104 preempts state property taxation of telecommunications licenses. In the Matter of Western PCS I Corp. File No. WTB/POL 96-3.

[16] *See,* e.g., Board of Supervisors v. Telecommunications Indust. Inc., 436 S.E.2d 442 (Va. 1993); County of Jefferson v. IBM Credit Corp. 888 P2d 250 (Colo. 1995); IBM Credit Corp. v. Grand Rapids, No. 172989 (Dec. 2, 1994); Scott Noble, King County Assessor v. IBM Credit Corp, Nos. 40738-40739 (Wash. Bd. Tax Apps. 1993). But see IBM Credit Corp. v. Pulaski County, 873 S.W.2d 161 (Ark. 1994) (technological obsolescence as measured by comparable sales is not to be taken into account in determining market value).

[17] Treasure Chest Advertising v. Los Angeles, No. 5 Civil B094758 (Feb. 8, 1997) (unpublished).

[18] The Appraisal Institute, *The Appraisal of Real Estate* (11th ed. 392 1996).

be attributable to such influences as political and social factors, insufficient demand, changing technology, costs attributed to governmental regulations, and negative economic conditions. The taxpayer-owned printing presses that significantly fell in value due to technological changes. The court held that the assessor was required to recognize the economic obsolescence even though the equipment continued to function in its intended use.

Taxpayer successes in recent years appear to have had a persuasive effect on state and local tax assessors, leading to their own acknowledgment that the general depreciation schedules have not kept pace with technological changes.

In response to litigation, states have begun to adjust useful lives of computer equipment. Maryland recently amended its personal property depreciation rate regulation to allow for mainframe computers costing $500,000 or more to be depreciated at 20 percent per year and certain data processing equipment and software to be depreciated at 30 percent per year to a minimum of 10 percent.[19] In addition, several states have recognized the need for lowered residual values for computer hardware and related peripherals. For example, Michigan reduced the residual value for computers from 30 percent to 10 percent.[20]

CONCLUSION

Property tax classification and valuation of high-technology equipment is evolving almost as quickly as the technology itself. Taxpayers should be cognizant of the opportunity to achieve tax savings by carefully scrutinizing a jurisdiction's application of its assessment policies and procedures.

[19] Md. Regs. Code tit. 18, § 18.03.01(1996).

[20] Bulletin No. 9, State Tax Commn., Dept. of the Treasury (Dec. 30, 1992).