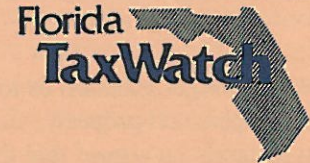


RESEARCH REPORT



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Why Florida Should Not Begin To Apply Tangible Personal Property Taxes to Computer Software

Is computer software something you can hold in your hand? Or is a disc that contains the software only a medium for an intangible intellectual creation of electronic information? This is a question facing the Florida Legislature. Recently, increasing attempts by some property appraisers to assess ad valorem (tangible personal property) taxes on computer software has raised the issue of whether it is subject to the tax as tangible personal property. The legal issue aside, there are a number of other questions the Legislature must address before it decides if the state should authorize taxing software.

Senate Bill 2226 and House Bill 2273 are being considered by the 1996 Florida Legislature. These bills would add language to the property tax laws stating that software is tangible personal property only to the extent of the value of the medium on which it is stored or transmitted and that software does not increase the value of the hardware on which it is installed (see language in box below).

Without legislative clarification, the question of whether computer software is taxable as tangible personal property is one of legal interpretation. There are currently at least three software assessment cases in litigation in Florida. There have been no rulings. After a review of the legal question, this report will focus on other reasons why clarifying legislation is needed: economic competitiveness considerations, tax policy and tax administration.

Background

In 1995, the Florida Department of Revenue, working with a committee of property appraisers, proposed a substantial rewrite to its Manual of Instructions. The manual contains rules and regulations, forms and standard measures of value to be used by local property appraisers to help achieve equity in the mass appraisal of tangible personal property through uniform application of valuation guidelines. Part of the proposed rewrite provided that software, both canned and customized, has a physical existence and is, therefore, taxable as tangible personal property.

After a public workshop was held on the guidelines and taxpayers had an opportunity to voice their objections to this new direction in ad valorem taxation, DOR announced it would withdraw all references to software from the guidelines, until pending litigation on taxing software was settled.

However, property appraisers in some counties have continued to assess computer software for ad valorem taxation. In some cases, appraisers have made retroactive assessments on software for up to three years. Taxpayers have been assessed penalties for failure to report the software's value. Naturally, litigation has been the result.

The contention of the proposed legislation's sponsors and supporters is that there is no legal basis for ad valorem taxation of software, and the bills are meant to clarify the state's policy.

Language proposed to be added to Section 192.001, Florida Statutes

"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 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, computer software does not increase the value of the computer or computers or pieces of computer-related peripheral equipment, or any combination thereof.

Legal Questions

The basic legal question as to whether computer software is subject to ad valorem taxation centers around whether software is tangible personal property. Software is a system of binary codes designed to provide information and direction to computers. It can certainly be argued that this system of electronic impulses is not tangible. Instead, it is intellectual property, not an "article capable of manual possession and whose chief value is intrinsic to the article itself" -- as the Florida Statutes define tangible personal property.

Software may be contained on a tangible medium such as a tape or a disk. The proposed legislation would limit the taxability to the value of that tangible medium based on the premise that the medium is only a means of transmitting the intangible knowledge that is the software. In keeping with this premise the Connecticut Supreme Court ruled that "the fact that tangible property is used to store or transmit the software's binary impulses does not change the character of what is fundamentally a classic form of intellectual property." The fact that the software can be transferred without the tangible medium (such as by modem) supports this contention.

Another consideration is that when a business buys over-the-counter "canned software," it does not actually own the product. Instead, it is buying a license for limited use of the software. For example, the buyer cannot resell the software.

Absent legislative clarification in Florida, this issue will remain up to the courts to decide. It should be noted that numerous courts across the country have held that software (or at least some types of software) is not subject to tangible personal property taxes.

Economic Development

If Florida was to adopt a policy of subjecting all computer software to ad valorem taxation, it would have a chilling effect on economic development in this state. Since only a small number of property appraisers are assessing software, the effect would be a significant tax increase. Not only would it create a barrier to software development companies considering locating in Florida, but it would also create a strong disincentive for virtually all businesses to establish or expand operations in our state.

This is especially true when other states use the fact that they have statutory exclusions for software in their economic development efforts. For example, Georgia passed legislation in 1993 to clarify that software is not tangible personal property (the Georgia legislation was the model for Florida's proposed legislation). It was promoted as an economic development issue and met with no strong opposition. It is being used in that state's efforts to attract software development companies. A Florida policy that software is taxable would be a big help to Georgia's economic development efforts.

Before looking at how other states treat software, a brief overview of terms for software types is presented below. Different types of software are treated differently for tax purposes, often in the same state.

- Embedded:*** software which is an integral component needed for the computer to function. It is contained permanently in the computer system and if removed would terminate the operation of the computer. An example is the Intel chip. The proposed legislation is not intended to exempt this.
- Operating:*** software which controls the computer's internal operations and controls its inputs and outputs. An example is DOS.
- Application:*** software which performs a function for the user, such as word processing, graphics or spreadsheets. An example is WordPerfect.
- Canned:*** software that is massed produced, packaged and available over the counter. This can be application or operating software.
- Customized:*** software that is developed for a particular user or function. This includes software self-generated by a business or developed by a contractor.

A survey of other state laws found eleven states that have addressed the ad valorem taxation of computer software statutorily. All of those states exclude, at least to some extent, computer software from property taxation. These are summarized in the table below. In addition, there are at least five states and the District of Columbia where courts have held that software, at least to some extent, is not taxable. To the best of our knowledge, every state that has addressed this issue has moved toward exempting software.

Property taxation of software in other states

A review of the statutes

CALIFORNIA

limits taxation to the basic operational programs

COLORADO

defines software as intangible personal property exempt from tax

CONNECTICUT

not subject to tax unless the cost of the software is not separately stated

GEORGIA

only taxable to the extent of the value of the medium on which it is stored or transmitted

IDAHO

canned programs are taxed, custom programs are not

MICHIGAN

all software is exempt, unless embedded

MISSISSIPPI

all software is exempt

NORTH CAROLINA

all software is exempt, except embedded software that is capitalized on the taxpayer's books

OREGON

excludes all software from tax, including the medium, as intangible personal property

VIRGINIA

operating software is taxable, application software is not

WASHINGTON

embedded software is taxable, canned software is taxable for two years, other types of software are not taxable

Source: Legal search by the Law Firm of Holland and Knight, March 1996.

Tax Policy

The way this issue arose points out an extremely important concern about setting tax policy in Florida. The Legislature is the body that should determine what should be taxed. Software could not have been contemplated when the property tax laws were initially developed. The nature of software is still not addressed in the statutes. In this case the Department of Revenue, in developing its draft property tax guidelines, made the significant tax policy decision that software should be taxable as tangible personal property. Although DOR has removed the software provisions from its guidelines, some property appraisers continue to subject software to ad valorem taxes. The fact that this has happened without clear legislative direction, supporting case law or guidelines from DOR is a concern. The tax is not only being newly assessed, but in some cases taxpayers are being held liable for retroactive assessments and penalties.

The unequal application among counties is another reason why it is important that the 1996 Legislature take action now. Taxpayers in various Florida counties should not be treated differently just because their property appraisers choose to interpret the law differently.

Tax Administration

The nature of software makes it difficult to effectively, efficiently and consistently administer a tangible personal property tax on it. In fact, a Senate staff analysis of the proposed legislation states that "overall, the assessment of taxing computer software on a local level has posed administrative difficulties as well as challenged the economic feasibility of ad valorem taxation."

The very intangibility of software contributes to assessment and administrative problems. Situs determination can be difficult. Ad valorem tax is assessed where the property is physically present on January 1 unless it has been present in another county at some time during the year. In this case it is supposed to be assessed where it is habitually located or typically present. Software is easily duplicated and transferred to other locations in state, out of state and even internationally. Replicated and transferred software can also result in duplicate taxation by property appraisers working independently in different counties.

Software also presents a number of valuation problems. Changes in software's use, development, distribution and relationship to computer hardware all impact its value. In the case of self-generated and customized software, accurate cost data and information on comparable sales are hard to come by. Further, allocating income generated to specific programs can be difficult. With the speed of technological obsolescence, the useful life of software can also be hard to determine.

Since software is easily acquired, transferred or disposed of, even without a tangible medium, auditing software for ad valorem taxes would also be difficult and costly.

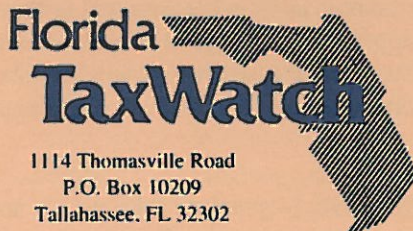
Conclusion

The 1996 Legislature needs to act on this issue. Under current law, the taxpayer, the Department of Revenue and Florida's property appraisers do not know if computer software is subject to ad valorem taxation. If the legislation does not pass, they still will not know. Florida cannot continue to treat tangible personal property taxpayers differently from county to county. The proposed legislation does not really provide a new tax exemption. It establishes a uniform, statewide policy. The question is whether or not it is the policy the Legislature wants.

There are valid legal arguments that software should not be treated as tangible personal property. When economic development and the problems associated with achieving equitable and consistent administration of a tax on software are also considered, clarifying that software, particularly customized software, is not taxable as tangible personal property is the right course.

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