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September 11, 2000

JAMES E. SPEED
Executive Director

Re: *Music compilation compact discs (CDs)*

Dear Mr. _____ :

This is in response to your letter dated November 23, 1999, in which you request our opinion on the property tax consequences of your client's ownership and licensing of certain music compilation CDs. Specifically, you pose two questions: (1) What is the tax treatment of the CDs while in the hands of the taxpayer; and (2) What is the tax treatment of the CDs while in the hands of a licensee?

As set forth more fully below, it is our opinion that, under the facts provided – and absent the application of any exclusion under Board Property Tax Rule 133(b) – the taxpayer's music compilation CDs constitute a part of its business inventory while in its hands. Those CDs that are in the hands of lessees on the lien date, however, are subject to property taxation. Generally, the assessment will be made to the taxpayer as the owner of the CDs. We disagree with your opinion that, for property tax purposes, the CDs should be assessed only at the value of their "physical material." Consistent with California case law and Revenue and Taxation Code section 212, in valuing the CDs, the assessor should assume the presence of those intangible assets and rights necessary to put the property to beneficial or productive use.

Factual Background

The following facts are set forth in your letter:

1. The taxpayer is a producer and distributor of music compilation CDs.
2. The taxpayer uses the CDs as storage media to digitally store a large customized collection of songs and jingles.
3. When a client places an order for certain CDs, the taxpayer signs a licensing agreement for the selected CDs. The licensing agreement states a specified period of use and requires certain monthly payments.

4. The taxpayer then sends the selected CDs via a common carrier to the client.
5. The taxpayer retains ownership of the CDs.
6. As required by the licensing agreement, at the end of the specified period of use, the client must return the CDs to the taxpayer.

Law and Analysis

Question 1: What is the tax treatment of the CDs while in the hands of the taxpayer?

Revenue and Taxation Code section 219 provides that: “For the 1980-81 fiscal year and fiscal years thereafter, business inventories are exempt from taxation and the assessor shall not assess business inventories.”¹ Subdivision (a) of Rule 133 of the Board’s Property Tax Rules elaborates upon this exemption:

(1) “Business inventories” that are eligible for exemption from taxation under Section 129 of the Revenue and Taxation Code include all tangible personal property, whether raw materials, work in process or finished goods, which will become a part of or are themselves items of personalty held for sale or lease in the ordinary course of business.

(A) The phrase “ordinary course of business” does not constitute a limitation on the type of property which may be held for sale or lease, but it does require that the property be intended for sale or lease in accordance with the regular and usual practice and method of the business of the vendor or vendee.

(B) The phrase “goods intended for sale or lease” means property acquired, manufactured, produced, processed, raised or grown which is already the subject of a contract of sale or which is held and openly offered for sale or lease or will be so held and offered for sale or lease at the time it becomes a marketable product....

Subdivision (b) of Rule 133 provides certain exclusions to the business inventory exemption. Of particular importance in this case is subdivision (b) (3), which excludes from the exemption that property that is “actually leased or rented on the lien date.”

The facts presented by you in this matter seem to indicate that the CDs are exclusively held by the taxpayer for lease in its ordinary course of business. While you use the word “licensing,” the taxpayer is not merely licensing intellectual property rights. It is the CDs that are being leased and delivered to the lessees; and the CDs constitute tangible personal property. Thus, it is our opinion that, based upon the facts provided – and absent the application of any exclusion under Rule 133(b) – the CDs constitute a part of the taxpayer’s business inventory while in the hands of the taxpayer. (See *Letter to Assessors* 86/60, cited as Board Property Tax Annotation 205.0340.)

¹ Unless otherwise specified, all further section references are to the Revenue and Taxation Code.

Question 2: What is the tax treatment of the CDs while in the hands of a licensee?

As to those CDs that are in the hands of lessees on the lien date, they are expressly excluded from the application of the business inventories exemption pursuant to Rule 133 (b)(3). Thus, such CDs generally will be assessed to the taxpayer as the person “owning” them on the lien date. (Rev. & Tax. Code § 405(a).)²

As to the valuation of such CDs, however, we disagree with your conclusion that the “licensed music compilation CD is taxable only to the extent of the physical material upon which the intangible data is recorded and stored.” In your letter, you reference *Letter to Assessors* 86/60, which states as follows:

Video cassettes actually rented or leased on the lien date do not qualify for the inventory exemption and are subject to property tax. Their taxability is limited to the full value of the tangible material by Revenue and Taxation Code Section 988. Section 988(a) provides that the value of motion pictures, including prints thereof, is “...the full value of only the tangible materials upon which such motion pictures are recorded.

Section 988, however, applies only to motion pictures. It does not apply to music compilation CDs. Similarly, section 997 applies only to business records. You also cite section 995. Section 995, however, only applies to storage media for “computer programs.” A computer program is a “set of written instructions ... designed to enable the user to communicate with or operate a computer...” (Rev. & Tax. Code § 995.) Data files stored on a CD or other storage medium – such as the instant music data files recorded on the taxpayer’s CDs – do not qualify as computer programs. In fact, without a special computer program, a computer (or CD player) is not capable of reading the data files on the taxpayer’s CDs and sending the musical output to the speakers.

As there is no specific statute that deals with the valuation of music compilation CDs, we must turn to general property tax statutes and principles in order to address the issue. Initially, we note that while section 212 states that intangible assets and rights are exempt from taxation, the statute goes on to provide as follows:

Taxable property may be assessed and valued by assuming the presence of intangible assets or rights necessary to put the taxable property to beneficial or productive use.

In this case, it is our opinion that the taxpayer’s music compilation CDs need to actually be imprinted with the music data files in order to be put to “beneficial or productive use.” The taxpayer’s customers would certainly not be willing to lease or license blank CDs that contain no music data files whatsoever. Thus, in our opinion, the assessor should assume the presence of the music data files on the taxpayer’s CDs – and assume that the lessees will have the right to

² While it is the normal practice of assessors to assess the owner of property, they also are authorized to assess the party in possession. (Rev. & Tax. Code § 405(a); see also Rev. & Tax Code §§ 405(b) and 235.)

make limited use of such files per the licensing agreements – in valuing the CDs for property tax purposes. This conclusion is consistent with the holding of the California Supreme Court in *Michael Todd Co. v. County of Los Angeles* (1962) 57 Cal.2d 684. In that case the court upheld the property tax valuation of certain film negatives (prior to the enactment of section 988) even though the valuation assertedly included the “value of the plaintiff’s copyright in the subject negatives.” (*Id.* at 687.) The court’s opinion is consistent with section 212: “[M]arket value’ for assessment purposes is the value of property when put to beneficial or productive use; it is not merely whatever residual value may remain after the property is demolished, melted down, or otherwise reduced to its constituent elements.” (*Id.* at 696.)

In other words, in assessing the taxpayer’s music compilation CDs, the assessor will not be limited to the value of the physical medium alone. In valuing the CDs for property tax purposes, the assessor should assume the presence of those intangible assets and rights necessary to put the CDs to beneficial or productive use.

I hope the above discussion has answered your questions. The views expressed in this letter are only advisory in nature; they represent the analysis of the legal staff of the Board based on present law and the facts set forth herein, and are not binding on any person or public entity. If you have any questions or comments, please call Robert Lambert at (916) 324-6593.

Sincerely,

/s/ Robert W. Lambert

Robert W. Lambert
Senior Tax Counsel

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