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Executive Director

December 5, 2008

Re: *Application of Revenue and Taxation Code section 129*
Assignment No.: 08-137

Dear Mr.

This is in response to your July 11, 2008, letter in which you requested our opinion regarding the applicability of the business inventory exemption of Revenue and Taxation Code¹ section 129 and Property Tax Rule 133 to research and development costs associated with the manufacture of chipsets used in mobile wireless devices and wireless communication systems. As explained in further detail below, the business inventory exemption applies only to research and development costs that are related to a product that is held for sale or lease in the ordinary course of business.

Facts

In your letter, you state that your client is a developer and manufacturer of software and chipsets used in mobile devices and wireless communication systems. You define chipsets as "a group of integrated circuits, or chips which are designed to work together, and are usually marketed as a single product." You further state that the county assessor assigned a property tax value to the software and chipsets based on the tangible elements of the research and development process based on the raw material cost incurred.

You contend, however, that all costs that are "consumed" in the research and development effort should be exempt from taxation based on the business inventory exemption. You define "consumed" as any cost that is not for an otherwise assessable tangible tool or machine.

¹ All further statutory references are to the Revenue and Taxation Code unless otherwise specified.

Law and Analysis

The assessor has the duty to prepare the local assessment roll and to assess all property subject to general property taxation at its full value. (Rev. & Tax. Code, § 401; see §§ 110, 110.1, 110.5, 405, 601; see also Cal. Const., art. XIII, § 1, art. XIII A, § 1, 2.)

The business inventory exemption is set forth in section 129 and Property Tax Rule 133. Section 129, states, in relevant part:

'Business inventories' shall include goods intended for sale or lease in the ordinary course of business and shall include raw materials and work in progress with respect to such goods.

Property Tax Rule 133 states, in relevant part:

- (a) Scope of Exemption.
- (1) 'Business inventories' that are eligible for a partial 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 . . .

Statutes granting exemption from property taxation are "to be strictly construed to avoid enlarging or extending the concession beyond the plain meaning of the language used in granting it." (*Sterigenics Int'l v. County of Orange* (1996) 47 Cal.App.4th 1541, 1545.) Further, ". . . the party claiming an exemption bears the burden of showing it clearly comes within the terms authorizing exemption, and any doubt must be resolved against the right to an exemption." (*Id.*)

As stated above, the county assessor has the duty to assess all taxable property. The assessor properly includes research and development costs when they relate to machinery or other assessable property. However, the assessor should not assess research and development costs that relate to the design or development of a tangible product that is held for sale or lease in the ordinary course of business. Such costs are related to property exempt from taxation by the business inventory exemption and are therefore exempt themselves.

You inquire specifically about research and development costs of software and "chipsets" used as components in wireless communications devices, stating only that the costs in question are related to developing a potentially marketable product. You have, however, given no indication as to whether or not the costs incurred are related to goods intended for sale or lease in the ordinary course of business. Thus, your letter does not provide sufficient evidence to conclude that the research and development costs incurred are exempt pursuant to the business inventory exemption.

Furthermore, we do not agree with your contention that all "consumed" research and development costs should be exempt under the business inventory exemption. While we do agree with your statement that costs related to assessable tangible tools or machines are

assessable, it does not necessarily follow that all other research and development costs are non-assessable simply because they are "consumed" as part of any research and development process intended to develop a product that eventually may or may not be held for sale. We also believe that in many cases, it would likely be inappropriate for an assessor to tax all product development research and development costs. Assessors' Handbook section 504, *Assessment of Personal Property and Fixtures*, pages 59-60 states, in that regard, a number of factors that assessors should consider when including research and development costs:

Research and development (R&D) costs are appropriately included as elements of full economic cost only when they relate to machinery or other assessable property. Even then, R&D may be assessable or non-assessable depending on the specific set of facts involved. For example, R&D relating to design or development of a tangible product which the taxpayer intends to sell is inventory and therefore non-assessable.

R&D costs may be appropriately included in assessable property when they relate specifically to the successful development and construction of machinery or other assessable property used to produce a product. However, the appraiser must carefully scrutinize these R&D costs to determine the appropriate value added rather than simply including the total cost incurred. R&D often involve a trial and error process, with success following a number of failed attempts. Moreover, the appraiser must be careful not to include in the value of assessable tangible personal property the value of non-assessable property created by the R&D, such as patents, trade secrets, etc.

Finally, there may be timing and allocation questions to consider. For example, R&D costs may be incurred to successfully design, develop, construct, and test a piece of equipment to be used in a manufacturing or testing process. To the extent that R&D is properly includable in the cost of the tangible personal property, some reasonable method should be used to recognize the contribution of the includable R&D to the value of the initial and each subsequent machine. It would be inappropriate to allocate includable R&D costs to the first such self-constructed piece of equipment where the taxpayer plans to build additional machines of the same or similar type utilizing such R&D information.

There is nothing in section 129, Rule 133, or AH 504 to suggest that all "consumed" research and development costs are nontaxable. Rather, the correct inquiry is whether or not those costs are related to a product that is held for sale or lease in the ordinary course of business, and the taxpayer must show that such is the case. That inquiry is a question of fact that must be answered by the county assessor on a case-by-case basis taking into account all the facts and circumstances.

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.

Sincerely,

/s/ Daniel Paul

Daniel Paul
Tax Counsel

DP:cme

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