OPINION NO. 1090

DISTRICT COLUMBIA TAX COURT

FILED

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District of Columbia Tax Court

UNIVERSAL COMPUTER ASSOCIATES, INC. SUCCESSOR TO COMMERCIAL VENTURES, INC.	)	
Petitioner,	)	
v.	)	DOCKET NO. 2075
DISTRICT OF COLUMBIA,	)	
Respondent.	)	

FINDINGS, CONCLUSIONS, and OPINION

The question presented is one of fact; the answer is important to those who own computers in the District. Does our personal property tax reach (a) all of the values inherent in the ownership of a computer, or (b) only the values attributed to (estimated to be inherent in) the machinery itself? In general, the undisputed evidence shows that computers are made up of two elements: (1) the hardware (the physical machinery, with its tapes, spools, and electrical circuits) and (2) the so-called "software", which are the instruction codes carried on punch-cards, or on reels of tape or disks by way of magnetic spots, telling the machine how to operate and what to do. It is common knowledge that either element is essentially worthless standing by itself. The machine means nothing without the instruction codes. The latter, put together at great cost, are valuable only as they are fed into the machine. Machine plus codes equals personal property of great, sometimes immense value. What is to measure our tax?

The direction, inevitably, is set by our statute, vintage 1902. The only specific reference in the statute is to "all tangible personal property and all general merchandise or stock in trade." Code sec. 47-1203. The other references define

nothing; e.g. Code sec. 47-1202, "personal property in the District of Columbia subject to taxation", and cf. Code sec. 47-501. It is of critical importance to note that the tax on intangible personal property, apparently in effect between 1922 and 1939, was eliminated in 1939. See compiler's note following Code sec. 47-501.

Background. Petitioner*/ bought from IBM a Data Processing Unit 360 Model 30 on May 1, 1966 for $289,836. On its personal property tax return for the period 7/1/66 - 6/30/67, petitioner reported the value of the computer (cost less depreciation on a 5-year life, accepted by the assessors and not here in controversy) as $280,173.30. For the period 7/1/67 - 6/30/68, the value was stated at $222,207.60. In its claims for refund, filed November 28, 1968, petitioner stated that its "correct value" for the two periods, respectively, was $28,017.33 and $27,051.06. As a result of the evidence adduced at the trial, petitioner computes values of $56,034.96 and $44,441.52. The revision results from the elimination of the values attributed to the "software" element of the 360 computer from taxable personal property, and the issue is, whether or not this element is taxable.

The evidence. Three witnesses appeared; one an employee of petitioner, one from IBM, and one an independent contractor engaged in developing software. The testimony is clear that petitioner bought three properties in its purchase of the 360 Model 30: "the hardware * * *, the normal software that is provided all IBM users and the third thing we are speaking of is the tax project development." (Tr. 23.) The latter was a

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*/ Actually, petitioner's predecessor, identical in interest. Both will be referred to as "petitioner".

new project under which individual income tax returns would be prepared by the computer. An IBM systems engineer worked seventy-six weeks and two other IBM systems engineers worked a total of twenty-four weeks on this project, at a value of services estimated to amount to $106,560. The "tax program" was an essential part of the deal between petitioner and IBM.

Normal software, above referred to, comprised all the programs previously developed by IBM for use in its 360 computer. It is indicated, without dispute, that these programs cost IBM over $100 million, and were freely available to petitioner for use if and when its 360 was not preempted by the tax program. There is no written evidence of petitioner's license to use such previous programs, but the trade practice is clear from the record, as well as petitioner's receipt of a "mortgage loan accounting program", which was "not actually used", although furnished. (Tr. 32.) The software -- the tax project and the other IBM programs available for petitioner's use -- is clearly part of the May 1, 1966 purchase and purchase price, and is clearly intangible personal property not subject to tax. The question then is, the relative values of the software and the taxable hardware, sold to petitioner as one package.

The evidence on the percentage of the $289,836 allocable to software -- the prior programs and the tax program -- is not, and by its very nature cannot be, made definite and certain. Respondent stresses the fact that IBM "presented no direct evidence whatsoever as to the method of allocation, if any" of the purchase price of the 360 between hardware and software. "Indeed, petitioner's expert witness testified that IBM makes no such breakdown of the prices to its purchasers." (Br. 7.) Respondent seems to admit that IBM might have put dollar values on its hardware and software, respectively, "with a reasonable

degree of certainty" (id.). However, the reasonable and logical method by which such an apportionment could be made is not indicated or apparent. The vast IBM complex produces a tangible machine inseparable from the intangible instructions which make the machine work; internal cost accounting would necessarily be based on arbitrary assumptions amounting in the end to an exercise in futility.

The testimony on allocation was by the IBM witness, and in full is as follows (Tr. 36 - 37) --

> You can actually say the computer will be worthless without the software. The relationship is more like ammunition is to the gun, the gun will function and it will click but it will not perform it's task without ammunition in it. Computer hardware and computer software operate in a similar fashion. If you were just to say what is the value of the hardware and the software and had to divide the price up, the hardware generally would account for somewhere between ten and twenty percent of the total purchase price. The software in some cases goes up as high as fifty or fifty-five percent of a total purchase price.

Note that this testimony is inherently contradictory. The witness first says that the hardware is 10% - 20% of the purchase price (inferentially, software is 80% - 90% thereof), then that software may be 50% - 55% of the purchase price (inferentially, hardware is 50% - 45% thereof).

Discussion. 1. On the issue whether software is tangible personal property, respondent cites D. C. v. Norwood Studios, Inc., 118 U.S. App. D.C. 358, 336 F.2d 746. This case covers a distinctly different tax and subject-matter unrelated to the case at bar. It was there held that the production and delivery of a series of motion pictures to the AFL-CIO for television showing (for a price of over $700,000) was a retail sale, subject to sales tax as a "production, fabrication, or printing of tangible personal property on special order for a consideration." (Code 47-2601 - 14(a)(2).) The transaction which occurred and which

was taxed was a sale (not, e.g., a personal service), just as, in the case at bar, the conveyance of a software program on cards for a consideration might (although no ruling is intended) be a sale, and therefore subject to sales tax. The essence of the sales tax is the sale transaction, the essence of the personal property tax is the existence of tangible personal property.**/

2. Passing to the second and more difficult problem, respondent argues that "in the absence of concrete evidence as to the percentage of the whole that should be allocated to software * * * the software herein must be considered inseparable from the hardware, and the full and true value of the whole is subject to District personal property taxation." (Br. 9.) Such a result would be palpably unjust, when the fact that software does have an important value has been established. See Allen, 39 T.C. 817, 828, where the court worked out the "fairest method" of arriving at estate tax when petitioner understandably could not prove exact amounts; Orvilletta, 47 B.T.A. 10, 15, where the Board found it "impossible to determine separate cost bases for the component parts of the inseparable units of * * * stock"; Piper, 5 T.C. 1104, 1111, holding that where value of certain warrants has been established but measurement thereof is impossible, the Commissioner's determination to treat them as if they had no value is arbitrary and to be set aside; United Mercantile Agencies, 23 T.C. 1105, 1117; Kraft Foods Co., 21 T.C. 513, 591 (reversed on another issue, 232 F.2d 118 (CA 2)), patents and patent applications held to have a value of $8 million out of gross $78 million purchase price, as a matter of Tax Court judgment rather than concrete evidence.

**/ As to personal service creations where the value of the property used is inconsequential, see Washington Times-Herald v. D. C., 94 U.S. App. D.C. 154, 213 F.2d 23 (en banc).

It being clear that an allocation must be made, the allocation rests in the judgment of the Court. Allocation in this case, as in other circumstances, is "not a matter for the slide-rule. It involves judgment * * *." Colorado Interstate Gas Co. v. F. P. C., 324 U.S. 581, 589.

We may well adapt to the situation at bar the much-cited words of the Federal Power Commission in the Atlantic Seaboard case, 11 FPC 43, 56, modified on another issue, 201 F.2d 568 (CA 4) —

> The determination of how much * * * [value] is assignable to each * * * [type of property] involves judgment. It can only be done by judgment inasmuch as the facts upon which the determination must be made are not susceptible to mathematical computation. We know that both * * * [types of property] are very significant. This is not a case where one form of joint use greatly predominates. It is our opinion that these significant * * * [property values] should be weighted equally, that is to say * * * [50 - 50].

Conclusion of fact. On the evidence here presented, without prejudgment of other records and opinion evidence which may be adduced therein, 50% of the purchase price of petitioner's computer is allocable to taxable "tangible personal property" and 50% of such purchase price is allocable to non-taxable intangible values.

Computation of refund. (1) It is conceded that any recovery on account of $2,801.98 tax paid for the first half of the fiscal year ended June 30, 1967 is barred by the Statute of Limitations. (2) Statutory interest on the refund to be computed hereunder has been waived for the period July 30, 1969 - November 13, 1969, and is to be excluded. (3) A recomputation of tax is to be made, starting with a taxable value of petitioner's computer of $144,918 (one-half of purchase price, $289,836) as of date of purchase (May 1, 1966), depreciated straight-line at 20%

per annum to arrive at a taxable value as of July 1, 1966 and July 1, 1967, and a tax at the applicable rate. (4) The difference between (a) one-half such computed tax and (b) tax actually paid for the second half of fiscal 1967, and the difference between (a) the entire tax so computed and (b) tax and penalty actually paid for fiscal 1968 shall be refunded, with statutory interest less the amount waived.

Decision for petitioner to be entered under Rule 30.

Robert M. Weston
Judge

Served as follows:

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Phyllis R. Liberti, Clerk

***/ In Memoriam: Robert C. Findlay, the able and dedicated young Assistant Corporation Counsel who tried this case, died suddenly and unexpectedly from a heart ailment on July 16, 1970. He will be sorely missed.