

**STATE BOARD OF EQUALIZATION**

Assessment Standards Division
450 N Street, MIC: 64, Sacramento, California
(P. O. Box 942879, Sacramento, CA 94279-0064)

Telephone: (916) 445-4982
FAX: (916) 323-8765

JOHAN KLEHS
First District, Hayward

DEAN F.
Second District, Stockton

ERNEST J. DRONENBURG, JR.
Third District, San Diego

BRAD SHERMAN
Fourth District, Los Angeles

KATHLEEN CONNELL
Controller, Sacramento

E. L. SORENSEN, JR.
Executive Director

October 29, 1996

Dear Ms. .

This letter is in response to your letter of June 24, 1996. In your letter you describe and present opinions concerning one of your clients and request our opinions in regard to your conclusions.

The situation of your client is as follows: the client sells and/or leases biomedical equipment in addition to selling consumables and spare parts. Some of the equipment that your client sells or leases is placed with the customer for a period of time as demonstration equipment. The time period could be for as long as 15 to 18 months. A piece of equipment being used for demonstration may-or may not-be sold or leased to the customer with which the equipment was first placed. The equipment may be sold or leased to another customer. You indicated that under certain circumstances your client also enters into contracts with customers which allows some equipment to be used by the customer. The use of this equipment is dependent upon the customer's compliance to an agreement to purchase a specified quantity of consumables over a period of time. The period of time is usually three to five years.

You then ask for our opinion on four points (paraphrased):

1. What is the appropriate trade level adjustment to the equipment subject to written leases with customers?
2. Would our opinion be that the "demo inventory" intended for sale or lease is exempt from taxation?
3. What is our opinion concerning the treatment of the equipment provided to customers with the agreement to purchase a set amount of consumables?
4. If the equipment in 3 above is taxable, what is our opinion regarding a trade level adjustment?

I will respond to your questions in the same order as above.

Question Number One: Trade Level Adjustment of Leased Equipment.

You state in your letter that the taxpayer "designs, manufactures, sells and services its biomedical equipment," but then add that, in your opinion, the taxpayer's "primary line of business is manufacturing, because it only acts as a retailer in the selling of its own manufactured products."

Regardless of the taxpayer's primary line of business, the assessor is required to find value according to how the property is situated on the lien date. In situations where the taxpayer's cost of equipment is not indicative of the value that would be found for equipment that is similarly situated, the assessor is required to make a "trade level" adjustment so the equipment will be assessed at fair market value at the appropriate level. Thus, two items of identical equipment in identical use will be assessed at the same value even though one of the items is owned by the manufacturer and is shown in the accounting records at manufactured cost, while the other item was purchased from a retailer and is shown in the accounting records at full retail cost (including applicable taxes, freight-in, installation, etc.).

The manner of determining trade level is governed by Rule 10 (Section 10 of Title 18, California Code of Regulations). Subdivision (e) of Rule 10 provides:

"Tangible personal property in the hands of a person who holds it for consumption shall be valued in accordance with section 4, 6, and 8 of this subchapter. When, however, such property is leased or rented for a period of less than six months so that its tax situs, as provided in section 204 of this chapter is at the place where the lessor normally keeps the property, it shall be valued in accordance with the last sentence of subdivision (d)."

If the equipment is leased or rented for a period of six months or longer, the equipment will be valued at the consumer level (pursuant to Rules 4, 6, and 8) and will be assessed at the place where the lessee normally keeps the property. The value will be estimated as though the lessee owned the equipment and had paid the normal retail price including appropriate sales taxes, freight-in, installation, etc.

In determining whether a lease or rent is for a period of six months or longer, the assessor will consider the total length of the lease--including options and other evidence regarding the length of the lease--as opposed to the remaining time of the lease at the lien date.

If the equipment is leased or rented for less than six months, it will be valued pursuant to the last sentence of subdivision (d) of Rule 10:

"This value shall be estimated (1) by reference to the property's cost to the merchant, including freight-in and deducting trade, quantity, and cash discounts, with reasonable allowance based on proper substantiation for damaged, shopworn, out-of-style, used, or overage stock, or (2) by reference to the price at which the merchant is expected to sell the property less his experienced gross profit."

Pursuant to Rule 10, equipment you loan to potential customers for periods of 15 months or more, if taxable, would be valued at the consumer level, by reference to Rules 4, 6, and 8.

Question Number Two: Demonstration Equipment Exempt as Business Inventory.

Property eligible for the Business Inventory Exemption (BIE) is defined by Section 129 of the Revenue and Taxation Code (hereafter all "Section" references mean the Revenue and Taxation Code), and Rule 133 provides clarification as to the types of property and their use that meet or do not meet the Section 129 definitions. Unfortunately, neither Section 129 nor Rule 133 specifically addresses demo equipment. Also, there have been no appellate court decisions dealing with demo equipment.

The question of whether demo equipment qualifies for the inventory exemption has been raised on only a very few occasions. Board staff has consistently opined that demo equipment *may* be eligible for the inventory exemption, but only under specified circumstances.

The most comprehensive opinion on the subject is an October 17, 1985 opinion by Assistant Chief Counsel Richard H. Ochsner (copy enclosed). In that memo, Mr. Ochsner advised that ". . . inventory held for sale can qualify for the exemption even though it may be temporarily used for demonstration or display purposes. We concluded, however, that if the probabilities were that the property would not be sold after the use as a demonstrator, then it could not be said that the property is held for sale or lease and therefore could not qualify for exemption. . . ." [With regard to the equipment discussed in the memo] "it appears that the probabilities are that the property will not be sold. The letter indicates that there are three or four possibilities for the equipment removed from the display area. Sale of the item as a used unit seems to be a low probability. Thus, we find it difficult to conclude on the facts presented that the equipment would qualify for the inventory exemption."

Also enclosed is a copy of the text of a December 15, 1976 letter by Assistant Chief Counsel J. J. Delaney. Mr. Delaney concluded that demonstrators used by sales agents for periods of six to twelve months solely to sell new equipment of the same type and then sold at reduced prices should be eligible for exemption. He emphasized that "our conclusion refers only to property held for sale since the law applicable to leasing transactions does not allow exemption if there is any use other than leasing."

In evaluating the use of the equipment in this instance, one obvious concern is the length of time the equipment is used for demonstration. We have not previously rendered any opinions on trial periods longer than the 12 month period mentioned in the Delaney letter. Upon consideration, our view is that the length of time a potential customer has the demo equipment is not the determinative factor so long as the trial period is consistent with the "means normally employed by vendors or lessors of the product" as required by Rule 133 (a) (3). However, the length of time that the equipment is held by the customer for demonstration use may not equal or exceed the economic life of the equipment. This limitation follows from the general scope of the BIE set forth in Rule 133 (a) (1) which exempts tangible personal property "held for sale or lease in the

ordinary course of business." At the termination of the demonstration period, if the economic life of the equipment is exhausted, then that equipment is not available for sale. Thus, in our view, the length of the demonstration time period, so long as it does not equal or exceed the economic life of the equipment, is not determinative of whether or not the equipment qualifies for the BIE provided your client can establish that the trial period, whatever it may be, is a normal industry practice for the type of product sold by your client and its competitors.

There remain three major concerns as to whether the equipment qualifies for the BIE.

The first major concern is the one raised in the Delaney letter, above. That is, is the equipment being used as a demo for *sale* or for *lease*? Rule 133 (b)(4) excludes from business inventory "Property which has been used by the holder prior to the lien date, even though held for lease on the lien date." Thus, if on the lien date the equipment is in the hands of the potential lessee (the "holder") who is or has used it in connection with any purpose other than a potential lease of the equipment, the equipment does not qualify for the inventory exemption.

The second concern is whether the customer is holding the property purely for evaluation ("demo") or is actually using the equipment as a lessee. For example, if the customer is obligated for any kind of payment on the equipment (e.g. maintenance, repairs, etc.), we believe the equipment is effectively leased or rented for use (and, therefore, is not "inventory"). Such an arrangement suggests that, rather than being shown to the customer as demo equipment, the customer has agreed to provide upkeep of the equipment in return for its use. Also, if the potential customer receives compensation for the use of the equipment, we do not believe the equipment qualifies for the inventory exemption. Again, this type of financial relationship would lead one to conclude that the equipment was being used for other than demonstration purposes. The assessor would need to review the details of the agreements between the vendor and the customer to determine whether the customer is holding the equipment purely for evaluation or is using the equipment in the manner of a lessee or in some other manner.

The third concern is whether, after the demo period, the equipment will ultimately be sold. On page 1 of your letter, you stated that if the demo equipment ". . . is not purchased or leased by said customers, the demo inventory may be transferred to other customers for their trial use or may be placed in a company location where the customers may come to use said inventory on a trial basis." The Ochsner memo concludes that if the equipment *is not likely to be sold* after the demo period, "we find it difficult to conclude" that the equipment qualifies for the BIE. Therefore, it would be necessary to determine whether, historically, the equipment is "likely" to be sold eventually (and therefore qualifies for the BIE) or whether it is more likely that the equipment will be scrapped when it is worn out or becomes obsolete (and therefore does not qualify for the BIE when it is being used).

A final concern is classification. If the demonstration equipment is affixed to real property and thereby becomes a fixture, it cannot be eligible for the BIE during the time it is so affixed because the BIE is applicable only to personal property. We have no information as to whether the subject equipment is personal property or fixture. See Rule 122.5 for information on the factors that determine whether an item is personal property or a fixture for property tax purposes.

Question Number Three: Equipment Used by the Customer Under Agreement to Purchase a Set Amount of Consumables.

Rule 133 (b) states that "Property eligible for the 'business inventories' exemption does not include: Property of any description in the hands of a vendee, lessee or other recipient on the lien date which has been purchased, leased, rented, or borrowed primarily for use by the vendee, lessee or other recipient of the property" (Emphasis added.) From the description you provided in your letter, it is apparent that the equipment is held by the "vendee, lessee, or other recipient" for use and not in connection with a potential sale or lease of that equipment. Therefore, the equipment is not eligible for the BIE.

The *Wyse Stipulation* has no bearing on your client's situation. Stipulations are not legal precedent and we are not familiar with all the circumstances pertaining to the *Wyse Stipulation*.

Question Number Four: Trade Level Adjustment to the Equipment Described in Question Number Three.

A trade level adjustment to the consumer (customer) level would be appropriate in the situation described. Please see our response to Question Number One for determining the appropriate trade level.

On page 9 of your letter you state that the "[t]axpayer consistently classifies its demo inventory as inventory in its financial books and records compiled in accordance with Generally Accepted Accounting Principles" However, how your client classifies equipment on its books is not binding upon the county assessor who may reasonably conclude that, despite an "inventory" accounting classification, some equipment does not qualify as business inventory under Section 219, Rule 133, and other applicable laws. In a case involving a similar situation in which there arose federal income tax questions relating to inventory procedures, the United States Supreme Court held that a taxpayer's reliance on inventory accounting was not necessarily a valid indicator of inventory value for federal income tax purposes. In that case, *Thor Power Tool Company v. Commissioner of Internal Revenue*, 439 U.S. 522, 58 L.Ed.2d 785 (1979), the taxpayer argued that the applicable Treasury Regulations "created a presumption that an inventory practice conformable to 'generally accepted accounting principles' is valid for income tax purposes." Rejecting the taxpayer's argument, the Court stated that "the presumption [taxpayer] postulates is insupportable in light of the vastly different objectives that financial and tax accounting have. The primary goal' of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested The primary goal of the income tax system, in contrast, is the equitable collection of revenue." 439 U.S. 542, 58 L.Ed.2d 802. After analyzing the ways in which the two accounting systems differed, the Court concluded that "[g]iven this diversity, even contrariety, of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable." 439 U.S. 542-543, 58 L.Ed.2d 802.

You also expressed a legitimate concern about uniformity in treatment between similar taxpayers and among the various counties. The State Board of Equalization has the duty to establish rules,

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some of which have been referred to herein, and to provide advisory services and instructions in order to maintain uniformity of assessments among counties. The Board and its staff do so through the adoption of Property Tax Rules, the distribution of Letters to Assessors, and the rotating survey program whereby once every five years the Board's staff audits the procedures of each county assessor's office. Although the Board and its staff are charged with promoting uniformity in property tax assessment, much of our work is advisory only and is not binding on county assessors.

Lastly, you reference Section 5909. This section pertains to written advice by assessor's offices. It is not applicable to the Board of Equalization.

To briefly recap, demonstration equipment may be eligible for the inventory exemption dependent upon the circumstances. Circumstances include the length of the demonstration period and whether that period conforms to the prevailing custom in the industry, whether the demonstration period equals or exceeds the economic life of the equipment, whether the equipment has been used by the holder prior to execution of the lease, whether the customer is obligated to pay for maintenance or repairs or is receiving compensation for using the equipment, and whether the equipment will be sold after the demonstration use. Trade level adjustments are appropriate when the product reverts from exempt inventory to taxable equipment upon reaching the consumer level. A trade level adjustment would also be appropriate for equipment loaned to a customer for its use as part of an agreement to purchase consumables from the vendor, especially when there is no likelihood that the equipment would be available for sale or lease upon termination of the contract (i.e. not returned to the inventory pool).

The views expressed in this letter are, of course, only advisory in nature. They are not binding upon the assessor of any county. If we can be of any further help, please contact our Business Property Technical Services Section at (916) 445-4982.

Sincerely,



Charles G. Knudsen
Principal Property Appraiser
Assessment Standards Division

CGK:mis
Enclosures

BC; Legal Section

Memorandum

: Mr. Eric J. Miethke

Date : October 17, 1985

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Division of Assessment Standards
SACRAMENTOFrom : Richard H. Ochsner *AKO*

Subject : Corporation Letter Re Business Inventory Exemption

This will respond to your request for advice on the letter Mr. Dronenburg received from Mr. of requesting advice on whether certain demonstration equipment would qualify for the California property tax exemption for business inventories.

Business inventories are exempted from property taxation by Section 219 of the Revenue and Taxation Code. The term "business inventories" is not defined in the statute, however. Board Rule 133 implements Section 219. Basically, it provides that the exemption applies to all tangible personal property held for sale or lease in the ordinary course of business. The regulation further provides, in part, that the exemption does not apply to property being used by its owner for any purpose not directly associated with prospective sale or lease of that property. This seems to suggest that the use of property for demonstration or display purposes would not take it out of the business inventory exemption classification if it is otherwise held for sale. In a letter dated December 15, 1976, we ruled that property used for demonstration purposes for six to twelve months and then sold at reduced prices qualifies for the exemption. Further, our assessor's letter 80/69, Item No. 9, provides that display items are eligible for the exemption unless they have been altered to the point where it is unlikely they will be sold.

I discussed this matter with Gordon Adelman and Bob Gustafson and we concluded that property which would otherwise normally be considered inventory held for sale can qualify for the exemption even though it may be temporarily used for demonstration or display purposes. We concluded, however, that if the probabilities were that the property would not be sold after the use as a demonstrator, then it could not be said that the property is held for sale or lease and therefore could not qualify for exemption. With respect to

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the facts presented in Mr. W's letter of September 9, 1985 (p. 2, para. 2), it appears that the probabilities are that the property will not be sold. The letter indicates that there are three or four possibilities for equipment removed from the display area. Sale of the item as a used unit seems to be a low probability. Thus, we find it difficult to conclude on the facts presented that the equipment would qualify for the inventory exemption.

I received a call on this matter from Mr. David Lucero in the Assessment Standards Division. He expressed some reservations regarding our conclusions and I have, therefore, taken the liberty of transmitting the materials you sent to me to Verne Walton for further advice on this matter.

RHO:cb

cc: Mr. James J. Delaney
Mr. Gordon P. Adelman
Mr. Robert H. Gustafson
Mr. Verne Walton-w/attach.
Mr. David Lucero

Memorandum

To: Mr. Richard Ochsner

Date: December 10, 1985

From: Verne Walton *VW*

Subject: Question of Business Inventory for Demo Machines

We concur with the content of your memo to Eric Miethke, dated 10-17-85, on the above subject.

My only concern regarding the business inventory exemption (BIE) for machines used for display purposes is in regards to the machines that are subsequently sold either (1) as is, or (2) remanufactured and sold. Our opinion, in the past, has been that this type of property is eligible for the BIE.

The other subsequent dispositions of display/demo products would rule out the BIE, i.e., those products that are subsequently leased or used internally (becomes office machinery and equipment) by

Property Tax Rule 133(b)(5) states that property eligible for the "business inventories" exemption does not include property which has been used by the holder prior to the lien date, even though held for lease on the lien date. This would rule out the exemption for display/demo equipment that is subsequently leased.

It seems that property which subsequently becomes used internally in one of Xerox's offices is not really property that is intended for sale or lease and therefore would not be eligible for the BIE.

Another problem is raised, however, on the display/demo products that are subsequently sold. The information attached to 's letter states that hands-on demonstration is provided to prospective (and subsequent?) customers. If this is so and the machines are used for training purposes, then, none of the property in question would be eligible for the BIE because under Rule 133(b)(3) the BIE would not extend to "property being used by its owner for any purpose not directly associated with the prospective sale or lease of that property."

VW:cl

cc: Mr. Gordon Adelman
Mr. Robert Gustafson
Mr. David Lucero