STATE OF CALIFORNIA

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TO INTERESTED PARTIES:

ASSESSORS' HANDBOOK SECTION 502 (AH 502) *ADVANCED APPRAISAL,* PERSONAL PROPERTY CHAPTER

At its meeting on November 18, 1997, the Property Tax Committee directed Board staff to draft a personal property chapter for possible inclusion in AH 502. Enclosed is staff's draft of the chapter. The draft is also available in Adobe Acrobat format on the Board's Web site (www.boe.ca.gov) and on disk, upon request.

Staff anticipates that the Property Tax Committee will hear the issue of whether this chapter will be included in AH 502. The alternative is to address personal property valuation topics in Assessors' Handbook Section 571 (AH 571), *Assessment of Personal Property and Fixtures,* rather than AH 502. (The draft of AH 571 was mailed March 27, 1998.)

Interested parties are encouraged to submit proposed revisions in the form of alternative text for review and possible inclusion in the draft. The procedure for submitting alternative text is identical to the procedure for the remainder of the AH 502 draft. Proposed revisions should reference the page and line numbers of the enclosed document and should be submitted by **July 30, 1998**. If an entirely new chapter is proposed, the new chapter may be presented to the Board as an alternative to staff's draft or a modified version of staff's draft.

If you have any questions regarding the personal property chapter, the AH 571 draft (previously distributed on March 27, 1998) or the timeline concerning the revision of this handbook, please contact Gordon Ferguson at (916) 322-3815 or Paul Lane at (916) 324-5828.

Sincerely,

Rudy G. Bischof, Chief
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Enclosures

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CHAPTER X: VALUATION OF PERSONAL PROPERTY

AH 501, *Basic Appraisal,* includes a chapter that gives a basic overview of the appraisal of personal property. Generally, as indicated in that chapter, the same basic appraisal principles apply to both real property and personal property. This chapter, however, discusses concepts and techniques that are specific to the appraisal of personal property.

APPROACHES TO VALUE

In valuing personal property it is not always necessary, desirable, or even possible to utilize all three of the traditional approaches to value. Since most of the data available with respect to the value of an item of personal property consists of the owner's costs as reported on the annual property statement, the cost approach is usually the preferred valuation method. Conversely, since there is rarely an adequate number of sales of items that would be comparable to a given item of personal property, and since few items of personal property are purchased for their individual income-producing potential, the comparative sales approach and the income approach are usually inapplicable.

COST APPROACH

Chapter 2 discusses the applicability and limitations of the cost approach, traditional concepts of cost, methods of cost-estimating, and depreciation. In general, those discussions are applicable to personal property as well as to real property. The discussion that follows, however, focuses on issues that are of particular import to the appraisal of personal property.

Valid Cost Components

As discussed in Chapter 2, valid components of "full economic costs" include all direct costs, indirect costs, and entrepreneurial profit. Many of these components of costs (e.g., labor, materials, and interest on owner-supplied funds) are germane to appraisals of both real property and personal property. Typically, however, the following components of "full economic costs" arise only in appraisals of personal property.

Sales/Use Tax, Freight, and Installation

The general rule in determining market value is that where price is the basis of value, sales/use tax, freight, and installation costs are elements of that value.[1] Since these costs represent part of the cost of bringing the property to a finished state (i.e., placing the property into use) they should be included as part of the full economic cost of acquiring the property. Moreover, if these costs would have been applicable to a consumer using the equipment at the same *trade level,* they may

[1] *Xerox Corp.* v. *Orange County* (1977) 66 Cal.App.3d 746.

be assessable even when not paid. [2] The costs apply at the same rate that would apply to that consumer, whether actually paid or not.

There are, however, exceptions to the general rule. For example, neither equipment rented to federal instrumentalities nor aircraft used by common carriers have sales tax as an element of value. The reason in both cases is that the consumer (the federal government or air carrier) is never liable for sales tax on purchases of such equipment. Consequently, the replacement cost should not include sales tax, unless or until the property is put to private use or rented to a private party. Instead, when a taxpayer lawfully pays sales tax at a rate below normal, the amount actually paid is the appropriate amount to be included as an element of value, so long as the circumstances that created the special rate continue.

Trade-In Allowances

In some cases, a buyer will pay for property in part or in whole with a trade-in of older property or equipment. The amount allowed in trade, or the *trade-in allowance*, is properly considered an element of value in the cost approach. This allowance represents part (or all) of the price paid for the property, although the price was not paid in cash. Thus, where a trade in allowance has been subtracted from the purchase price or booked cost, the allowance should be "added back" to ensure its inclusion in the cost estimate.

Validation Costs

Validation cost is a term often used in the pharmaceutical industry, although it can be associated with other types of manufacturing. *Validation costs* are those costs incurred in the testing process of the production line. Some of these costs may be properly included in an appraiser's estimate of the full economic cost of the property.

When equipment on a production line is constructed, part of the cost during construction is the testing of the equipment. These costs, which are incurred in the process of verifying that the production line is working correctly, are called *machinery validation costs*. Since these costs are part of the installation process and are necessary to bring the property to a finished state, they are valid components of full economic cost. *Product validation costs*, on the other hand, are costs incurred in the research and development stage of a product, rather than in the construction of the equipment. In the pharmaceutical industry, for example, *product validation costs* would be incurred in the laboratory when a drug (the product) is developed.

Product validation costs should not be included in an appraiser's estimate of the full economic cost of assessable equipment. These costs are part of inventory (i.e., part of the product), and are unrelated to the matter of bringing the manufacturing equipment to a finished state.

[2] Property must be valued at the level situated on the lien date. This is the trade level concept. Thorough discussion of this topic is included later in this chapter.

Research and Development Costs

Research and developments costs (R&D) are costs incurred during product development. Similar to validation costs, they are appropriately included as elements of full economic cost only when they relate to machinery or other assessable property.

For example, in the development of machinery, a certain amount of research costs is incurred in the production of only the first item of equipment of its kind. Even though associated with a single item of equipment, the prototype, these costs should be allocated to all of the items consequently produced.

Trade Level

Consistent with the definition of full cash value, property must be assessed at the proper level of trade based on its location and use on the valuation date (the lien date). An appraiser must recognize that property normally increases in value as it progresses through production and distribution channels whether or not the cost or value added is booked.

The trade level concept is applicable when book cost does not provide adequate information for making a fair market value appraisal. It is a cost component which is most frequently applicable to leased equipment and self-constructed equipment. Rule 10, *Trade Level for Tangible Personal Property*, explains the concept of trade level as follows:

> In appraising tangible personal property, the assessor shall give recognition to the trade level at which the property is situated and to the principle that property normally increases in value as it progresses through production and distribution channels. Such property normally attains its maximum value as it reaches the consumer level.

Under the provisions of the rule, personal property is assessed on the basis of how it is held or used on the lien date rather than at the book cost of the owner. In effect, the rule provides for equal value for properties equally situated.

In essence, the trade level concept allows for adjustments based on what a normal consumer at any particular level would pay. If another consumer of like property at the same level of trade would be subject to a cost (i.e., sales tax), the full economic cost should include that cost component whether or not the cost was actually incurred.

In practice, determination of a trade level adjustment may be complicated by (1) the uniqueness of the equipment, (2) the infrequency of sales, and (3) the unavailability of facts necessary to determine the marketability of the equipment on the lien date. In gathering data to determine a proper trade level adjustment, the use of a property prior to and after the lien date should be considered since it may influence how it is valued on the lien date. For example, if a lessor of copy machines uses a copier before and after the lien date but places the copier in its inventory on the lien date, that copier is properly classified as assessable equipment at the consumer level. The value of the property is based on the level at which it is held or used on the lien date.

While the trade level principle is most frequently relevant when assessing leased and self-constructed equipment, it is also important where book cost is not indicative of costs generally incurred by the market considering the location and use of the property.

Discounts/Adjustments

The purchase price of equipment may reflect discounts allowed due to payment within a pre-determined period, or due to the quantity purchased. For example, a seller may offer a discount (say 2 percent) if the equipment is paid for in full within a short time (say 30 days). If the purchaser takes advantage of this discount and pays timely, the booked value of the asset would reflect the discount. It may also reflect rebates and income tax credits.

Discounts and rebates offered by a seller are a normal part of supply and demand in the process of setting market value, where the prudent buyer pays as little as reasonably possible and the seller charges as much as possible. The price paid for the property after recognition of discounts and rebates represents the amount received by the seller as well as the cost to the buyer.[3] Income tax credits, by contrast, are simply reductions of federal income tax liability. They are similar to depreciation or amortization charges against income for income tax purposes. Other allowances that are treated similarly to income tax credits include energy tax credits and manufacturers' investment credits. These items do not represent legitimate adjustments to the market value of the taxable property. The following chart is an outline of types of adjustments discussed above and the proper treatment for property tax purposes.

Table XXA: Discounts/Adjustments

Description	Adjustment warranted	No adjustment warranted
Quantity discount	X	
Cash discount	X	
Rebates	X	
Income Tax Credits		X
Energy Tax Credits		X
Manufacturers' Investment Credit		X

[3] The price paid by the buyer may include a sales tax component. Sales tax is not part of the compensation retained by the seller.

Other Applicable Costs

Other costs, whether booked or otherwise, should be considered on an individual basis in relation to how they affect a property's market value. Other costs may include, for example, those incurred in a major overhaul of a piece of equipment. If an overhaul extends the life of an asset or increases its utility, the value of the asset may be affected. The costs associated with a major overhaul may be expensed or may be booked as a capitalized asset. In any event, it is important to consider major overhaul costs in the valuation of equipment.

Depreciation of Machinery & Equipment

As discussed in Chapter 2, depreciation may be thought of as the difference between the value of a hypothetical new, similar property and the current value of the subject property. For appraisal purposes, depreciation may also be thought of as a decrease in utility. The decrease in utility occurs in two different ways. First, and probably most important, the remaining economic life of a property may decline. Instead of yielding benefits for ten years as when new, a property may now have only eight years of remaining service. Second, there may be a reduction in net benefits from the property. Fewer benefits may be provided, or the same benefits provided at a higher cost. Thus, a decline in the remaining life or the efficiency of property causes depreciation.

Typical v. Atypical Depreciation

Typical depreciation is that depreciation which is expected for that particular type of property. Typical depreciation for most kinds of machinery and equipment can be determined using the percent good factors supplied yearly in AH 581, *Equipment Index and Percent Good Factors*. *Atypical depreciation*, on the other hand, is unexpected depreciation. Atypical depreciation may be estimated separately using other methods of calculation in combination with percent good factors or as a completely separate calculation in itself.

Methods of Estimating Depreciation and Value

As discussed in Chapter 2, there are several methods of estimating depreciation for appraisal purposes. Appraisers may need to use one or more of these methods while determining depreciation from all causes. Further, the appraiser's methods are not the same as the accountant's methods because an accountant uses depreciation to recover cost over a pre-selected useful life of the property while an appraiser uses depreciation to estimate market value.

Equipment Index Factors and Percent Good Factors

Equipment is usually valued based on information reported on property statements. Rather than separately identifying and valuing each item, the appraiser values equipment as a group based on the type of business and description of the property.[4] The first step in the calculation process is to "trend" the reported original cost of the property to an estimated replacement cost new. This trending is accomplished using equipment index factors (cost x index factor). The next step is to multiply the trended original cost by a percent good factor to estimate the market value of the property, replacement cost new less normal depreciation (RCNLD).

[4] An exception is Form AH 571-F (Agricultural Property Statement). Each piece is listed separately on this form.

As explained in AH 581, *Equipment Index and Percent Good Factors,* and AH 582, *The Explanation of the Derivation of Equipment Percent Good Factors,*[5] equipment index factors are used in estimating replacement cost new, while percent good factors are used in estimating market value. These tables, provided in AH 581, are based upon data for different types of property and have validity to the extent that a subject property has experienced usual, expected depreciation for its age and type. They are meant to reflect normal depreciation, which includes typical physical deterioration and normal functional obsolescence, and external obsolescence.

A discussion of the factors, the equipment index factor and the percent good factor, is included here in a general context. For more detailed information, refer to AH 581 and AH 582.

Equipment Index Factors

Equipment index factors are developed for use in mass appraisals and are generally reliable and practical for converting historical or original cost to estimates of reproduction cost new or replacement cost new. The index factors recommended by the Board, updated and distributed yearly in AH 581, include three separate index factor tables: (1) commercial equipment, (2) industrial equipment, and (3) agricultural and construction equipment. Additionally, the Board staff provides tables to be used in the valuation of computers, related equipment, and semi-conductor equipment; and state assessed properties.[6]

The majority of the index factors published and provided by the Board are designed to estimate replacement cost new (as opposed to reproduction cost new) since the items included in the compilation of the indexes are replacement items. The commercial equipment index factors (Table 1) provided in AH 581 are compiled on the basis of equipment price level change data published by Marshall & Swift Publication Company in their comparative cost indexes listed in *Marshall Valuation Service.* These are indexes designed "for quick computation of present **replacement costs** from dependable historical costs."[7] Similarly, the industrial machinery and equipment index factors (Table 2) and the agricultural and construction equipment index factors (Table 3) are derived using the Bureau of Labor Statistics producer prices and the Producer Price Index as a basis. "The Producer Price Index measures average changes in selling prices received by domestic producers for their output."[8] In developing the indexes, the Bureau of Labor Statistics reflects certain quality adjustments in the prices but does not make adjustments for minor quality adjustments to products.

> ...When a company respondent reports a price that reflects a physical change in a product, the Bureau uses one of several quality adjustment methods. The direct comparison method is used when the change in the physical specification is so minor that no product cost differences result; in this instance, the new price is

[5] AH 581A renumbered as AH 582 (1997).
[6] Valuation tables for computer related and semi-conductor equipment are updated and distributed via Letter to the Assessor (LTA). Index factors for state assessed properties are available upon request.
[7] Marshall & Swift Publication, *Marshall Valuation Service*, Sec. 98, p. 1, January 1997.
[8] U.S. Department of Labor Bureau of Labor Statistics, *BLS Handbook of Methods*, 130.

directly compared to the last reported price under former specifications, and the affected index reflects any price difference.[9]

Thus, the indexes generally reflect replacement cost. If further adjustments are made for technological or design improvements, reproduction cost new may be the result of the application of the indexes to historical or original cost.[10]

When selecting and applying these factors, it is important to properly identify the type of business and (classification of) equipment subject to appraisal. Different index factors and tables apply to different types of equipment. For example, commercial equipment is divided into 12 different "types" according to the commercial index factors provided by the Board. Each "type" is associated with its own set of factors. Similarly, industrial machinery and equipment is divided into six groups. Only after the business and equipment type is identified can the appropriate index factor be identified and applied.

Finally, it must be noted that the index factors in AH 581 apply to *typical* groups of equipment within the identified classifications and therefore are not always appropriate to the specific item of property being appraised. The index factors in AH 581 are intended to be used to provide a time-efficient method of making reasonable estimates of replacement costs for typical properties; they are a tool for estimating fair market value. When reliable evidence of current replacement costs (e.g., catalogs or current selling prices of comparable new equipment) is available, it may be more appropriate to process the cost approach using the market-indicated costs rather than the trended historical costs.

Percent Good Factors

As discussed in Chapter 2, percent good represents the complement of depreciation. For example, if total depreciation is 20 percent, then percent good is 80 percent. The percent good concept is used in the appraisal process for two reasons: (1) it focuses the appraisal on the benefits remaining or the economic life remaining in the property rather than the benefits used; and (2) it saves one arithmetical operation when estimating depreciation.

Derivation of Percent Good Factors

A thorough discussion of the theory and mathematical calculations behind the development of percent good factors is not within the realm of this manual; the subject is covered in-depth in AH 582, *The Explanation of the Derivation of Equipment Percent Good Factors.* Nevertheless, in order to apply and select appropriate factors within the tables using economic life estimates, a brief overview of the discussion is needed here.

Percent good factors and tables are developed based on the present worth of future net operating income (constant terminal income approach) of the existing property versus the present worth of future net operating income for an identical new property, with a small

[9] U.S. Department of Labor Bureau of Labor Statistics, *BLS Handbook of Methods*, 132.
[10] American Society of Appraisers, *Appraising Machinery and Equipment*, 44.

"income adjustment factor" reduction for older property. The remaining and total economic life estimates are based on survivor curves, which express the relationship between total life expectancy and probable remaining life expectancy of property items in all stages of their lives. A survivor curve or table represents the life expectancy at any age for that particular population. The survivor curves used by the Board, based on statistical data regarding a series of equipment mortality studies, were developed by Iowa State University. The R-3 curve is used for the machinery equipment table in AH 581 because, historically, mortality patterns of machinery and equipment most commonly fit this curve.

To use percent good tables, accurate estimates of *average service life* or *remaining economic life* must be made. Therefore, the following terms must be defined:

Economic life: the anticipated service life for a unit when it is new.

Remaining economic life (REL): the expected remaining life of the property on the appraisal date.

Economic life can be determined by an appraiser based on historical usage of property, useful life expectancy as determined by the taxpayer, or other information as available. Obviously in mass appraisal situations, determining economic life for each piece of equipment is not practical, and is not estimated on an individual basis unless necessary. It may occur in practice, however, when the taxpayer files an appeal, when an audit is conducted, or when equipment is self-constructed.

The estimated economic life is used to estimate average service life of the item. In general, average service life is utilized in the percent good tables. When an item is new, average service life is the average economic life of comparable equipment. When an item is not new, the item's remaining economic life is usually *greater* than the original average service life minus age. This occurs because in any group of equipment, some items "die" prematurely, so the life of the remaining items would generally exceed the average service life.

Any percent good table or depreciation schedule, including those published by the Board, can be used only as a guide in the estimation of value. They may reflect more or less depreciation than the actual market indicates. If equipment has experienced abnormal, excessive, or even less-than-typical depreciation, the percent good factors may not be reliable indicators. In this case, a percent good factor could be used in combination with another method of depreciation calculation, or it may be necessary to use another approach to value altogether. This is also true if the equipment is unique, if limited cost information is available, or if age or expected life cannot be accurately determined. Therefore, whenever possible, an appraiser should verify replacement cost new less depreciation by other approaches before accepting a mass-appraisal indicator such as the indicator developed from an AH 581 table as the best indicator.

Other Methods of Calculating Depreciation and Value

Assessors tend to utilize equipment index factors and percent good factors published by the Board for the majority of appraisals concerning personal property because they lend themselves to mass appraisal. However, in certain situations, different methods of estimating depreciation

and value may be appropriate. In other situations, alternative factors and tables will provide more accurate estimates of value.

Following are other methods of calculating depreciation that are commonly used in the appraisal of personal property. Although this is by no means a complete listing, these are methods that may be helpful in determining the market value of equipment when the application of factors from AH 581 do not reflect market value of the property being appraised.

Straight-Line or Age-Life Method

This method, as discussed in Chapter 2, involves dividing the actual or effective age of the property by its estimated economic life. The straight-line or age-life method is based on the relationship between physical age and estimated economic life. Physical life, or age, is the time the equipment has existed. Economic life of a property represents the period of time during which the property has value.

Although straight-line depreciation may have little or no bearing on market value, effective age should be recognized whenever data reasonably indicates that effective age is different than actual age. *Effective age* is the "age indicated by the condition and utility of a structure,"[11] (or property). Because there may be a large variation in the condition of property having the same age, the effective age (as opposed to the actual age) is the best indicator of the market's perception of age.

This approach does not reflect the relationship between the present worth of the future earnings of the property versus the present worth of future earnings of a new replacement property. It ignores the principle that money has a time value (income to be earned in the near future has a greater value than the same amount of income to be earned in the distant future); thus it tends to understate the economic value of older property that is producing a current income comparable the current income that would be produced by a new replacement. Conversely, this method does not reflect additional depreciation that should be recognized if the existing property income is *less* than the income that would be earned by a new replacement.

Observed Condition Method

Using the observed condition method, the appraiser estimates depreciation by estimating the cost to cure depreciation which is in fact curable; i.e., certain items of physical deterioration and functional obsolescence. This method requires an appraiser to have specific knowledge of the equipment being appraised and of the market for that equipment. This method cannot measure incurable functional obsolescence or economic obsolescence.

Production Output or Service Hours Method

The Production Output Method is based on the assumption that an asset is acquired for production, and that it depreciates in relation to units produced. To use this method, an estimate

[11] Appraisal Institute, *The Dictionary of Real Estate Appraisal*, s.v. "effective age".

of total ultimate output is required. This estimate can be in production units or service hours. Full economic cost divided by the ultimate output gives the depreciation charge for each unit of output. Like the straight-line method, this method ignores the economic value of future earnings and thus will understate the value of a property whose net operating income is comparable to a new replacement property. Conversely, the method will overstate value to the extent net operating income is less than a new replacement property.

Utilization Adjustment

A utilization adjustment to a Replacement Cost Less Normal Depreciation (RCLND) estimate may be appropriate when equipment is significantly underutilized—that is, where the equipment is not used for the purpose for which it was designed or at its expected capacity. Underutilization may exist because of functional obsolescence, external obsolescence, or a combination of both, and usually originates with external forces. The condition may also result from errors in initial planning. The adjustment is analogous to an abnormally high vacancy factor used to calculate net operating income for use in the capitalized income approach to value.

Utilization adjustments may be made when there is significant permanent excess capacity that is beyond the control of a prudent operator. Generally, the amount of obsolescence is a function of the difference between the replacement cost new of the existing property versus the replacement cost new of a property with a capacity that is adequate for the foreseen requirements. However, operation at below design capacity will not always translate to an equivalent percentage amount of obsolescence (i.e., operating at 75 percent of design capacity may only equate to a 10 percent increase in obsolescence). An explanation of this seeming incongruity is demonstrated in pipeline valuation. Much of the cost of constructing a pipeline is the same regardless of the design capacity because installation charges do not vary proportionally to the diameter of the pipe. Consequently, a pipeline with a physical utilization of 90 percent of design capacity is considered to be at 100 percent of economic utilization, since the replacement cost new of a pipeline with the lower design capacity would cost essentially the same as the replacement cost new of the existing capacity.

To make a utilization adjustment for significant permanent excess capacity, information should be gathered and an appropriate means for estimating the adjustment should be determined. The Board's Valuation Division, for example, has a formula for reducing the RCLND of pipelines that are clearly oversized for the foreseeable future. The calculation begins with knowledge of the level of the foreseeable physical utilization of a pipeline segment (the "load" factor) which is expressed as a percentage amount. This "load" factor is converted to a "utility" factor which is also expressed as a percentage amount; this calculation is non-linear. The utility factor represents the ratio of needed capacity to design capacity and it is applied to an RCLND estimate to reach an estimate of Replacement Cost Less Depreciation (RCLD).

As mentioned above, this type of adjustment is not appropriate for all or even most types of properties (or equipment). Even when a property operates significantly below design capacity, there may be no under-utilization and a utilization adjustment would not be appropriate.

However, when evidence reasonably demonstrates that a replacement property would have a lower capacity, a utilization adjustment may be appropriate. A study of the facts pertaining to that particular property is necessary to determine how to arrive at any appropriate adjustment.

Following are some suggested items to consider if there is a question of excess capacity.

- Is full capacity ever needed or expected?
- What is the *normal* utilization for similar equipment (what utilization do purchasers of new similar equipment anticipate)?
- What is the cause of the excess capacity? (External obsolescence is a valid reason; seasonal or even daily variations do not constitute excess capacity.)
- Is the problem industry wide or is it the individual owner? (An industry wide excess capacity is indicative of external obsolescence; individual excess capacity may be a business enterprise problem that should not be reflected in the value of the property.)
- Is there evidence that the equipment would be replaced with substitute equipment of lower capacity?
- What is the price differential between the existing equipment and replacement equipment?

Sampling

Indexes published in AH 581 are based on government price indexes derived by sampling. Similarly, the computer valuation tables computed and published by the Board via Letters to Assessors (LTA's) are based on sampling. When necessary, and if resources are available, the assessor may conduct similar studies to derive their own indexes. In developing a sample plan, technique, and program, an assessor should consult a textbook on statistics for information on the theory and application of sampling. For an example, see the Board's *Sales and Use Tax Audit Manual*, Chapter 13: *Statistical Sampling*.

Example Using the Cost Approach

The following example illustrates the valuation of a piece of equipment using the cost approach. Keep in mind, however, that when the cost approach is applied to personal property it is normally applied to groups of equipment rather than on a piece by piece basis. The example illustrates one application of the approach and is used to summarize the discussion in the text.

Example XX.3: Use of the Cost Approach

Company C acquired a bookbinding machine in 1995. Details of the acquisition are as follows:

- Invoice cost (including sales tax) $40,000
- A 1% discount was allowed because payment was made in cash within 30 days.
- Company C's Transportation cost of $1,200 was paid to deliver the machine to the factory
- Cost of installation was $2,430. This included labor, materials, including a raised flooring to accommodate the new machine.
- The chief engineer spent 2/3 of her time during July on trial runs of the new machine. Her monthly salary is $9,000 per month.
- An allowance of $5,500 was granted by the supplier because the machine proved to be of less than standard performance.

What is the machine's assessable value on the 1998 lien date?

A. Computation of Full Economic Cost:

Invoice Cost	$40,000
less: Discount	(400)
Rebate/Allowance	(5,500)
add: Transportation Cost	1,200
Installation Costs	2,430
Machinery Validation Cost ($9,000 salary x 2/3)	6,000
Full Economic Cost	$ 43,730

B. Computation of Value

Using the Board's index factors and percent good factors, the equipment was found to be included in Group 5 - Manufacturing Equipment with an estimated economic life of 15 years. From the tables, the index factor is 1.04 and the percent good factor is .85. Using this information, the full cash value (assessable value) is estimated:

$43,730 x 1.04 x .85 =	$38,657

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COMPARATIVE SALES APPROACH

The comparative sales approach, discussed generally in Chapter 3, may be defined as any approach that uses direct evidence of the market's opinion of value of a property. As applied to the appraisal of personal property, the comparative sales approach may be the preferred approach when reliable sales of comparable items are available. Information about comparable sales may come from the market, costs guides, or other sources. Thus, for personal property, value guides and price schedules which reflect the going market price for comparable equipment and which estimate the current value of specific types of equipment are used as the basis for determining market value of similar equipment. Adjustments should be made when the condition of the subject property is above or below average. Additional elements of value seldom reflected in sales comparison value guides are sales tax and freight. As discussed above, sales tax and freight must be added to the sales price of equipment to arrive at full cash value for property tax purposes.[12]

The comparative sales approach is limited in its application to personal property, and is used less often than is the cost approach to value, because (1) most types of personal property are sold infrequently (limited sales data is available), (2) sales data, when available, is generally limited by comparability, and (3) in many cases, personal property is not sold without affecting other property (whether real or personal property). This approach is, however, applicable to personal property, including agricultural and construction equipment, boats, and airplanes, that is frequently exchanged in the market and when the exchange does not affect other items.

INCOME APPROACH

Valuation of Personal Property Using the Income Approach

In relation to personal property, the income approach has limited application because personal property, in general, is not purchased to independently produce income. However, the income approach may be applied to leased equipment or other personal property appraisal units that independently produce income because expected rental income can be converted to a present value estimate.

When applicable, the income approach may be used to appraise personal property in the same way that it is used to appraise land and buildings. However, there are several aspects of appraising personal property that may differ from those encountered in the valuation of real property. These include:

- It should be verified that the income is truly generated by the property. In many cases, the "rental" or "lease" income is significantly influenced by selling skills, business activity, personal services, sales or services directly related to the rented property (the rental amount could be artificially high or artificially low), or other non-property factors. In such cases the income approach is unlikely to measure the value of the personal property.

[12] *Xerox Corp.* v *Orange County* (1977) 66 Cal.App.3d 746.

- Since personal property usually has a much shorter economic life than real property, an error in the estimate of remaining economic life will have a much greater impact than it will for real property.
- It is more difficult to find direct market evidence for capitalization rates for personal property as compared to real property.

Both direct capitalization methods and yield capitalization methods may be utilized to appraise personal property. When valuing personal property, yield capitalization is the preferred method because information is more readily available and the life span of the property is usually short.[13] In addition, the income stream produced by personal property usually involves a reversionary income from the selling of the scrapped item at the end of the economic life. As discussed below, other issues arise in an appraisal of personal property under the income approach.

Maintenance Charges

If a lessor of equipment is charging a lessee for maintenance under the lease contract, the appraiser must make an estimate of service time, and then relate this to prevailing rates, as shown in Example XX.2.[14]

Example XX.2: Adjusting Income For Maintenance Charges
A machine requires 3 hours of service each month at a rate of $95 per hour: a monthly cost of $285 ($95 x 3 = $285). If the monthly rental is $1500: then, the maintenance is 19% of gross income ($285 / $1500 = .19, or 19%). Gross annual income is then $18,000 ($1,500 x 12 = $18,000), annual expenses are $3420 ($285 x 12 = $3,420), and the net annual income is $14,580 ($18,000 - $3,420 = $14,580).

Vacancy (Idle Time) and Collection Losses

Personal property that is held for lease or sale by a retailer or wholesaler on the lien date may be exempt from taxation. Because these items are exempt for the entire year, it can be argued that it is improper to allow for vacancy (idle time) and collection losses. However, it is also reasonable to take the position that an item may be out on lease on the lien date (and therefore taxable) but returned to the retailer or wholesaler prior to the expiration of the lease period. Consequently, the retailer or wholesaler may very well suffer a loss of income because of vacancy (idle time) or

[13] Direct capitalization is not discussed in this section of the handbook. See Chapter 5 for information regarding direct capitalization and more information regarding the income approach in general.

[14] Service time, rates, costs, and maintenance expenses estimates and percentages may be obtained from various sources in the marketplace (for instance, the lessor may be able to supply the actual service time for the preceding year), and this could serve as a guide when reconstructing the operating statement.

collection loss. An allowance made for vacancy (idle time) and collection loss should be based on the actions of the market place.

Expenses

As with real property, all lessor-borne expenses that are necessary to maintain the income stream may be deducted as operating expenses. If the expenses are paid for by the lessee, they are not deductible from the income stream. Maintenance expense is a good example. Maintenance is often a major expense; however, if the lessee pays the maintenance charges, the lessor will generally charge a lower rent and the expenses are not allowed. If the lessor is responsible for maintenance, the rents will reflect this expense. An adjustment will be necessary similar to that shown in Example 4.5.

Valuation Methodology

Personal property is often valued using a property reversion income method. The rental income is capitalized using direct capitalization techniques. This income is usually constant terminal income and is often called an *annuity*. The reversion income is capitalized using the same procedure that is used in yield capitalization. The reversion income is usually the salvage value of the personal property. It is the *net* amount of money the owner expects to obtain when disposing of the property, not necessarily the price stated in the original contract (estimated residual value). This stated price, the "buy-out cost," is probably not an accurate indicator of value when the property is purchased at the end of the lease (for example, a $1 buy-out cost does not represent residual value). The reversion is usually positive, although it can be a negative amount. Occasionally, it is zero or a nominal amount and has no bearing on market value at the end of the lease.

The total value of the personal property is as follows

PV OF THE ANNUITY

+ PV OF THE REVERSION

TOTAL VALUE

As discussed above, the income approach has limited application to personal property. It can be applied to leased equipment or other personal property appraisal units that independently produce income because it converts expected rental income to a present value estimate, but it is normally not applicable to most types of personal property. Personal property, in general, is not purchased to independently produce income. It is usually impossible to assign or estimate an expected income to that individual property.

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SPECIAL CONSIDERATIONS REGARDING PERSONAL PROPERTY

IDLE, UNUSED, OR OBSOLETE EQUIPMENT

Idle, unused, or obsolete equipment has value, even if only a salvage value.[15] Therefore, the auditor appraiser must estimate value and include it in the assessment. Idle, unused, or obsolete equipment may need to be valued separately from in-use, active equipment of a similar type.

An auditor appraiser must consider why equipment is idle or otherwise not in use. This may or may not influence value for property tax purposes, and it may or may not already be taken into consideration under the cost approach as part of the table factors (or in any other approach to value that was employed). For example, consider a printing press no longer in use because it was replaced by a newer model. The old press is stored in the office break room because there is no other place to put it until sold, donated, or otherwise disposed of. The older model has value even though it is not in productive use. The value can be computed in the same manner as a similar piece of equipment that is in productive use. On the other hand, consider a second example of a printing press no longer in use because it needs repair. Assume the part needed to repair the press is no longer manufactured, that there is no way to repair the part or the printing press, and that it would not interface with modern equipment in use even if it could be repaired. This printing press has value, but the value may only be the salvage value of the property since the printing press in essence is unusable. As illustrated here, to value idle, unused, or obsolete equipment an appraiser must determine the reason(s) for non-use, since those reasons may influence value and the resulting assessment.

EQUIPMENT PURCHASED USED

Valuation of equipment purchased used is peculiar in that the equipment index and percent good factors may or may not produce results reflective of market value. This may be due to the difference between total economic life and remaining economic life, and historical cost (cost to the original owner) and original cost (cost to current owner). The equipment index factors provided by the Board (in AH 581) include separate tables for new and used agricultural and construction equipment, but does not include separate tables for other types of equipment. An appraiser should take care to determine how the results of applying factors, both trending and estimation of depreciation, relate to the actual market value of equipment purchased used. If the results are not indicative of market value, another method of estimating depreciation or another valuation approach should be utilized.

Another method of estimating cost and implementing the equipment index factors and percent good factors, used infrequently but valid in certain situations, is reverse trending. Where application of table factors does not accurately represent market, the factors can be applied (to original cost) in a reverse sense in order to estimate the historical cost (cost to the original owner). Then, the appraiser can apply traditional methodology to estimate value. In order to

[15] This discussion could also be applied to the valuation of back up equipment or to equipment that has been abandoned in place.

utilize this approach, an auditor should be assured that the results are indicative of market value on the lien date.

EXPENSED EQUIPMENT

Equipment expensed by a taxpayer for accounting purposes is considered taxable personal property as is any personal property used in the ordinary course of business. Expensed equipment may include any type of equipment from small hand tools to large machinery. This equipment may go unreported on property statements. In the course of an audit, an auditor appraiser should investigate to determine reporting, classification, and assessment of these items. When discovered, all valuation and assessment procedures are the same as those used for similar types of property.

SUPPLIES

Supplies are classified as personal property. The historical cost of supplies on hand as of the lien date is reportable by the taxpayer on the Business Property Statement.

Normally, the value of supplies is based on cost information and/or physical examination of supplies on hand. The cost approach is an appropriate approach to value because of the relatively short economic life of the property. With a very short economic life, current purchase price often provides the best evidence of market value. In some cases it is necessary to adjust the purchase price or recorded cost to include supplies not included in taxpayer's books, to adjust for trade level, or to adjust for discounts. However, these adjustments tend to be minor and occur primarily as a result of an audit.

When utilizing the taxpayer's accounting records in the cost approach, it is important to ensure that inventory is not misclassified or reported as supplies. Supplies are items used in the ordinary course of business but not incorporated into the product which is sold or leased. Inventory, on the other hand, consists of products held for sale or lease, including items that are incorporated into those products or that transfer with those products.

When appropriate cost information has been gathered and proper classification is determined, then the cost of assessable supplies cost may be estimated by the Percentage of Annual Purchases method. This method summarizes total yearly supplies purchased, and estimates the turnover rate for the supplies based on the frequency of purchases and quantities purchased during the year. Total supplies purchased divided by this supplies turnover rate (Total Supplies / Turnover Rate = Estimated Supplies on Hand) generally results in a reasonable estimate of the value of the supplies on the lien date. This estimate can then be verified in the physical inspection of the business when an audit is conducted.

LEASED EQUIPMENT

Valuation and assessment of leased equipment can be one of the more difficult tasks that an auditor appraiser encounters.[16] Many impediments arise from a lack of complete, up-to-date information. Other complications are inherent in the property itself. Leased equipment is usually easily movable, and it tends to change ownership (or possession) and situs frequently. This can make it difficult to analyze some or all of the factors (taxability, assessee, situs, description, classification, security, and value) necessary to make a valid assessment. At least four of these seven factors tend to change on a regular basis: taxability, assessee, situs, and value.

Taxability

Taxability of leased equipment, or equipment intended for lease, is the first consideration an appraiser encounters. As discussed in Chapter 1, personal property leased on the lien date is taxable unless exempt. However, personal property held for lease on the lien date is inventory. Leased equipment, or property intended for lease, is taxable when:[17]

- property is actually leased or rented on the lien date
- property is being used by the owner for purposes not directly associated with the prospective sale or lease of that property
- property has been used by the owner prior to the lien date, even though "held for lease" on the lien date
- property is intended to be used by the lessor after being leased (or during intervals between leases), even though "held for lease" on the lien date

Assessee

A person who owns, claims, possesses, or controls property on the lien date is the assessee of that property. Under section 405, the assessor may assess leased property to either the lessor or the lessee, or both, whether or not there is a private agreement between the parties to the lease. Section 405 specifically states:

> (b) The assessor may assess all taxable property in his county on the unsecured roll jointly to both the lessee and lessor of such property.
>
> (c) Notices of assessment and tax bills relating to jointly assessed property on the unsecured roll shall be mailed to both the lessee and the lessor at their latest addresses known to the assessor.

In practice, most property. is *not* assessed jointly, although the assessor has that option pursuant to section 405. [18] Property under true lease is usually assessed only to the lessor and property

[16] Leased equipment reported to the State Board of Equalization by public utility companies are assessed at the state level. However, the Board may delegate to a local assessor the duty to assess a property used but not owned by a sate assessee on which the taxes are to be paid by a local assessee.
[17] See Rule 133(b), *Business Inventory Exemption, Exclusions*.
[18] Attorney General Opinion CV 78-58 November 3, 1978, (pg. 475).

under conditional sales contract only to the lessee. Exceptions to this rule mainly occur when the lessor requests to be assessed to ensure the taxes are paid or one of the parties to the lease is an exempt entity.

Leasing with Exempt Entities

Banks and Financials

Tangible personal property owned by banks and financial corporations (commonly referred to as financial institutions or financials) is exempt from property taxation by the in-lieu tax provisions under article XIII, section 27 of the California Constitution, and sections 23154, and 23181-23183 of the Revenue and Taxation Code. Instead, these businesses pay an in-lieu "franchise tax on net income." A listing of banks and financials qualified under these sections is maintained by the Franchise Tax Board with confidential copies distributed to assessors annually by the Board of Equalization. The in-lieu exemption does not apply to banks and financial corporations whose principal activity consists of leasing tangible personal property (see section 23183(b)).

If a lessor bank or financial is shown in the listing, the leased property is taxable to the lessee (unless the lessee is also exempt from property taxation) pursuant to section 235. Section 235 states:

> For purposes of this division, the lessee of tangible personal property owned by a bank or financial corporation shall be conclusively presumed the owner of that property.

However, where personal property is leased to an exempt bank or financial, it is taxable to the owner/lessor (unless the owner/lessor is also exempt from property taxation) since the exempt bank or financial is the lessee. The owner/lessor holds title to the property and does not benefit from the lessee's in-lieu exemption.

Insurance Companies

Personal property owned by insurance companies is exempt from property taxation, regardless of how the property is used by that insurance company, pursuant to article XIII, section 28, of the California Constitution.[19] Property leased to insurance companies, rather than owned by them, however, remains assessable to the lessor (unless the lessor is also exempt from property taxation).

Government Entities

Property leased to or from a federal, state (California), or local governmental (county, city, district in California) entity is not taxable to that entity, although the property may remain taxable to another party. It is not taxable to the governmental entity because:

- The federal government is immune from taxation pursuant to the United States

[19] *Mutual Life Insurance of New York* v. *City of Los Angeles* (50 Cal.3d 402) overturned *Massachusetts Mutual Life Ins. Co.* v. *City and County of San Francisco* 129 Cal.App.3d 876

Constitution; "it is a governing constitutional principle that the properties, functions, and instrumentalities of the federal government are immune from taxation by state and local government."[20]

- The California Constitution, article XIII, sections 3 through 5 expressly exempt from taxation all property *owned* by the state or local governments, except as provided in section 11(a) of the California Constitution, article XIII (which applies only to land and improvements outside the boundaries of the local government).

Personal Property

Personal property owned by the government is immune (federal) or exempt (state or local) from all taxation, as discussed above, and it is not subject to possessory interest as is real property (with one exception).[21] "The legislature has not defined personal property as including a right to its possession as it has real property".[22]

Privately owned personal property leased to and held by the government is *not* immune (federal) or exempt (state or local) where title remains with the lessor. In such cases, the property is taxable to the owner/lessor, even if its situs is located on government-owned land. (The exceptions are Congressional grants of immunity for the privately held personal property of Indians located on Indian reservations and personal property located on federal enclaves.)

Frequently in cases where federal immunity or state/local exemption is claimed regarding leases of property with the government, the question is whether the property is actually "owned" by the government. Whether the government is the lessor or the lessee, the question is one of fact; who "owns" the property? In one case, for example, a court found that title to tools, equipment, and material owned by federal government but used by a private contractor doing government construction remained with the government and were therefore immune from taxation.[23] In another case, a court found that title to personal property consisting of materials and inventory used by a private contractor doing government construction never vested in the government, even though the government fully reimbursed the costs to the contractor. The nature of the property involved was mere overhead, "the common staples of any ongoing business; the contractor was the owner."[24]

Where the question of ownership is not clear, proper analysis of the lease agreements and other sales or financing documents is important. In establishing ownership for tax purposes, the assessor should determine who holds the *essential indicia of ownership.*[25]

A title clause standing alone is not conclusive of ownership for tax purposes when

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[20] *TRW Space & Defense Sector* v. *County of Los Angeles* (1996) 50 Cal.App.4th 1703, p. 1704(1).
[21] See section 201.5.
[22] *General Dynamics Corp*. v. *Los Angeles County* (1958) 51 Cal.2d 59. An exception is set forth in section 201.5 for personal property owned by or for the California Pollution Control Financing Authority.
[23] *General Dynamics Corp*. v. *Los Angeles County* (1958) 51 Cal.2d 59.
[24] *TRW Space & Defense Sector* v. *County of L.A.* (1996) 50 Cal.App.4th 1703.
[25] *Mayhew Tech Center Phase II* v. *County of Sacramento* (1992) 4 Cal.App.4th 497

> it appears that the taxpayer retains the *essential indicia of ownership*... Accordingly, it is necessary to examine the terms of the contracts to determine whether plaintiffs retained rights in the property inconsistent with its ownership by the United States for tax purposes.[26] (Italics Added)

Several factors have been identified by the court(s) under the *essential indicia of ownership* test as evidence that the government holds title. The tests can be applied when the government is either the lessor or the lessee to the contract if title is not physically held by the government. When the government is a lessee, for example, *essential indicia of ownership* may be apparent if:

1. title automatically passes to the government (lessee) at the end of the lease term (the title clause of the lease agreement);

2. the property itself is used as security for any unpaid lease payments (in the event of default, the lessor would sell the property to pay off the debt and the remainder would go to the government);

3. the government (lessee) has full authority to alter the property at will;

4. the government (lessee) is required to maintain the property.

Again, no one factor standing alone is indicative of *essential indicia of ownership*, or proper owner for property tax purposes. The ultimate decision must be made on consideration of all the facts.

Fixtures (and other real property)

Fixtures owned by the federal government and leased to a private party are immune (federal) or exempt (state or local) from property taxation, to the same extent as other real property. Fixtures are not assessable to the government owning the property, but are assessable to the lessee as a *possessory interest* as any other type of real property leased from the government. The assessment is on the interest of the lessee based on the value of the entire leased property, excluding personal property. It is a *possessory interest* in real property.[27] A possessory interest within an area in which the United States has exclusive jurisdiction (so-called "federal enclaves") is excluded from the meaning of "taxable possessory interest" and is immune from taxation.

Thus, determination of ownership becomes less of an issue; the property is either assessable as an improvement value or a possessory interest value. If, however, ownership does become an issue, it should be determined based the *essential indicia of ownership* as discussed above.

Summary of Leases with a Governmental Agency as Lessor of Lessee

The following table summarizes the discussion regarding leases with the federal, state, or a local government agency as either lessor or lessee. The table is not controlling in all situations and,

[26] *General Dynamics Corp*. v. *County of L.A.* (1958) 51 Cal.2d 59.
[27] Section 107.

again, *essential indicia of ownership* (referred to as *owner (title with)* in the table) should be determined based on all facts.

Table XXB: Assessability of Leases Involving Government

LESSOR	LESSEE	OWNER (TITLE WITH)	TYPE OF PROPERTY	ASSESSEE
Private Party	Government	Lessor	Personal Property	Private Party
Private Party	Government	Lessee	Personal Property	No assessment (Immune or Exempt)
Private Party	Government	Lessor	Fixtures (and other real property)	Private Party
Private Party	Government	Lessee	Fixtures (and other real property)	Private Party (Possessory Interest)
Government	Private Party	Lessor	Personal Property	No assessment (Immune or Exempt)
Government	Private Party	Lessee	Personal Property	Private Party
Government	Private Party	Lessor	Fixtures (and other real property)	Private Party (Possessory Interest)
Government	Private Party	Lessee	Fixtures (and other real property)	Private Party

Other Exempt Entities or Institutions

Property leased to other exempt entities and institutions may be eligible for exemption, but each situation must be considered individually. In some cases the property may be automatically exempted; in others, claim forms must be filed in order for the applicable exemption or reduction to be granted. For example, a lessor who leases equipment to public libraries, museums, schools, community colleges, state colleges, and the University of California is not automatically exempt from taxation on the property. The lessor may file a claim for exemption if (1) the leased equipment is "used exclusively" by an aforementioned entity as lessee and (2) it is demonstrated that the benefit of the exemption has inured to the lessee institution. Where the lessor does not claim the exemption, the lessee must file a claim in order to receive the refund of tax that the lessor has paid to the county (Section 202 et seq. and 203).

A comprehensive discussion of exemptions is not appropriate for this section of the Assessors' Handbook. Reference to exemptions' handbooks and code sections governing exemptions (sections 202, 203, 214 et seq.) is necessary to determine whether equipment leased to qualifying entities is automatically eligible or if a claim must be filed.

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Situs

Physical situs of leased equipment may change frequently, as previously discussed in Chapter 3. Determination of taxable situs of this property is generally governed by Rule 204 and section 623.

Prior to January 1, 1997, Rule 204, *Leased Equipment*, was the sole authority governing this determination. It requires a determination of a *precise* situs for each piece of equipment (a time consuming process in many cases). However, a recent amendment to section 623 has made *precise* situs of leased equipment less important by allowing a single assessment for leased personal property:

> The assessor *may* place a single assessment on the roll for all leased personal property in the county that is assessed with respect to the same taxpayer. Any property assessed pursuant to this section shall, in the absence of evidence establishing otherwise, be deemed to be located at the taxpayer's primary place of business within the county. (Italics Added)

Description: Types of Leases

A lease is generally defined as any contract that gives rise to a lessor and lessee relationship in real or personal property. There are many different types of leases and lease situations. To properly determine property tax reporting and assessment questions, it is important to define and consider each type of lease, and the terms associated with them: short-term leases, extended-term leases, true leases, and financing leases or conditional sales contracts.

Short-Term Leases

Leases or rentals of property on a daily, weekly, or other short-term basis (defined as a period of less than 6 months) are short-term leases. The property is assessable to the lessor at the lessor's principal location, regardless of actual location or control on the lien date.[28] The lessor is considered the owner, and value is estimated by reference to the owner's cost of the property.[29]

Extended-Term Leases

An *extended-term lease* (commonly referred to as *long-term lease*) is any lease whose duration is six months or more. Many of this leased property will eventually become the property of the lessee. For example, a lessee leases a computer for five years. At the end of the five-year lease period, the lessee has the option to buy the computer for $1. Essentially, from the start of the lease, the lessee is the owner of the equipment whether or not title has actually passed. These leases may be assessable by the assessor to either the lessor or the lessee, and their situs is generally their actual location.

[28] Rule 204.
[29] See trade level discussion in Chapter 4.

Extended-term leases, business property leased for a term of more than six months or for an extended (even though unspecified) period, must be valued as if in the hands of the lessee, after all costs of production, including marketing costs, profits, and sales tax, have been added. The lessee is considered the consumer of the property, and the property is therefore valued at the consumer trade level. In the example above, the lessee may record a $1 buy-out cost on their books. The actual value for property tax purposes should be based on the total acquisition cost at the inception of the lease (if the cost approach is utilized) or total payments made during the lease (if the income approach is utilized).

True Leases

True leases, whether short-term or extended-term as defined above, are agreements under which an owner gives up possession and use of his property for valuable consideration and for a definite term and at the end of the term, the owner has the absolute right to retake, control, or convey the property.[30] It is an agreement under which there is no intention of transferring ownership. At termination of the lease, the property will be returned to the lessor.

Conditional Sales Contracts or Financing Leases

Conditional sales contracts or financing leases (agreements) are purchases rather than true leases. They can be short-term or extended-term agreements whereby the seller (vendor) agrees to periodic payments on account of the purchase price while retaining legal title to the property. Possession of the property transfers to the buyer (vendee) without full legal title until payment of the purchase price or a predetermined date occurs.[31]

They are contracts that provide use and control to a buyer with the seller retaining title as security for payment. The buyer or lessee is the beneficial owner of the property, and therefore becomes the proper assessee, regardless of whether they hold title.

Differentiating Between a True Lease and a Conditional Sales Contract

It is often difficult to distinguish between a true lease and a conditional sales contract, and no precise formula has been devised for separating the two types of contractual arrangements.[32] An agreement identifying itself as a lease may, in actuality, be a conditional sales contract and vice-versa. The distinction, however, may be of prime importance. Taxability, exempt status, and appropriate assessee may be based on the distinction (and thus ownership).

According to the Uniform Commercial Code, in determining whether an instrument is a lease or a sales contract, the contract form is not as important as the intent of the parties. Following are some issues related to the lease contract that will help determine the intent of the parties of the contract. In any contract, some of the issues may be indicative of a true lease while others may be indicative of a conditional sales contract. The intent of the parties should be determined by the express terms of the contract. Some terms such as liability for insurance, taxes, and other

[30] *Blacks' Law Dictionary*, Sixth Edition, p. 890.
[31] Miller & Starr, *California Real Estate* 2d "Specific Real Estate Contracts, section 2:42.
[32] Attorney General Opinion No. CV 78-58 - November 3,1978, page 472.

expenses may not establish ownership. These terms are, therefore, not considered in the table below.

Table XXC: Issues to Review when Verifying Lease Type (True Lease v. Conditional Sales Contract)			
ISSUE		**True Lease**	**Conditional Sale**
Lease Period	• Lease period is approximately the same as the anticipated life of the property.		X
	• Lease is for a fixed period with a nominal option payment (i.e., $1) required to transfer title.	X	
	• Lease is cancelable on a monthly or annual basis.		X
	• Optional purchase clause is at market value.	X	
Rent	• Contractual rental payments are equal to or greater than the current purchase price.		X
	• Contractual rental payments are considerably less than the purchase price.	X	
Ownership Terms	• The contract contains specific provisions retaining ownership with the lessor.	X	
	• The contract transfers all ownership responsibility, with the exception of title, to the lessee.		X
Accounting Treatment By Lessor or Lessee (FASB 13)	• Lessor is treating the property as a depreciating asset.	X	
	• Lessor is treating the property as an account receivable.		X

As mentioned earlier, like any factual determination, analysis of any one item cannot determine lease type. All evidence must be weighed. Reliance on any one factor may lead an appraiser to the wrong conclusion. For instance, treatment (by either the lessor or the lessee) for financial accounting purposes can be misleading.

Statement Of Financial Accounting Standards No. 13 (FASB 13)

Accounting for leases can be a controversial area of financial accounting. Many lessees structure their lease agreements to avoid capitalization for financial accounting purposes or to improve their financial position. The Statement of Financial Accounting Standards No. 13 (FASB 13) was developed to govern accounting for leases. This standard, FASB 13, provides lessees and lessors with an established criteria for classifying leases and also requires reporting and disclosure of leases on financial statements based on the classification made by the lessor and/or the lessee. Thus, when an audit is conducted, or taxpayer's records are reviewed, leased equipment can be identified. The nature of the leasing arrangement and activities must be disclosed regardless of the lease type.

Recognition of these requirements for classifying and reporting leases for financial accounting purposes under FASB 13 is useful in that a substantial amount of information about the property may be discerned. However, such information does not necessarily determine property tax classification, assessability, or value. Accounting records alone are not conclusive, although they may greatly assist the auditor appraiser in gathering and evaluating all of the facts. A lease, for example, does not necessarily need to be capitalized for it to be assessed to the lessee. Possession, claim, or control alone may determine the assessee (section 405). Thus, accounting treatment is not necessarily a conclusive factor when considered alone based on FASB 13.

Valuation of Leased Equipment

When valuing leased equipment, all three approaches to value should be considered: the replacement or reproduction cost approach, the comparative sales approach, and the income approach. Regardless of which approach(es) is used, leased property must be valued at the proper trade level, which in turn depends on the term of the lease. Under extended-term leases (six months or more), the lessee is considered to be the consumer of the equipment and thus is assessable at his level, the consumer trade level. The appraiser should determine the selling price new of the equipment to consumers, plus sales tax and delivery and installation costs; then adjust for depreciation. In short-term leases or rentals (less than six months), the lessor is considered to be the consumer of the equipment, and the value is determined at the lessor's trade level.

CONSTRUCTION IN PROGRESS

Construction in progress (CIP) is also an item required to be reported on the Business Property Statement. CIP is assessable at full cash value on the lien date.[33] Costs incurred as of the lien date are included in the total assessable cost, including preliminary direct and indirect costs such as planning and engineering charges. The cost may be more or less than the actual market value on the lien date. Ultimately, the value should be based on what the property in its partially-constructed condition would bring in the market place involving a willing buyer and seller.

[33] Construction-in-progress regarding personal property is assessable only when actual construction has begun by the lien date. If actual construction has not yet begun, any costs incurred (i.e., engineering fees) are exempt from taxation for the entire year.

The instructions on the Business Property Statement request an attachment of an itemized listing of costs for construction in progress for improvements to land, machinery, equipment, furniture, buildings or other improvements, or leasehold improvements. Reported CIP may include both real property and personal property items which may be hard to distinguish depending on the stage of completion. Reported costs may also include direct and indirect costs which may or may not influence value. It is important to review the costs included in CIP to determine assessability, classification, and contribution to value. Coordination between the real property appraiser and the auditor appraiser is important to correctly categorize the reported cost and to avoid duplicate assessments and escaped assessments.

COMPUTERS AND RELATED EQUIPMENT

Computer and related equipment must be reported separately from other types of personal property on the Business Property Statements. This equipment includes non-production computers (excluding computer operated machinery and equipment), monitors, printers, scanners, disk drives, and cables. All of these items have relatively short lives, and are influenced by rapidly changing technology and user needs.

Production computers (computer operated machinery and equipment or computers embedded in machinery) are not reported, considered, or valued with other computer equipment on Schedule A, column 5, *Computers*. Rather, they are valued as other types of machinery and equipment specific to that industry, and are normally reported on Schedule A column 1, *Machinery and Equipment for Industry, Profession, or Trade*. Production computers may have a shorter, equal, or longer life and/or value than non-production computers. In some cases, computer-driven equipment depreciates more quickly than traditional equipment. In other cases, computer-driven equipment has made traditional equipment obsolete. Therefore, when computerized equipment is encountered, a special study of the equipment and the industry it serves may be required to determine the appropriate valuation method.

General Valuation

Valuation of computers and related equipment, non-production computers, has become increasingly important and difficult in many business property assessments due to rapid changes in technology and changing needs of users. Because of the typically short lives, rapid depreciation, and little salvage value in many circumstances, the Board has provided three separate valuation tables to aid the appraiser using the cost approach to value. These tables segregate computers by original cost, and apply different factors based on past value trends. As with most equipment, these factors are not appropriate for all computers. In some cases, other approaches to value will be more appropriate.

Software

California statutes require computer software to be classified as either basic operational programs or processing programs. Basic operational programs are taxable when they are contained on storage media; processing programs are exempt.

Section 995 describes the valuation of storage media and defines the terms "storage media" and "computer program." Section 995 requires that storage media be valued as if there were no software programs on it. The one exception is that storage media may include the value of basic operational programs when those programs are stored on it. Section 995.2 defines the terms "basic operational program" and "processing program." Rule 152 explains how to properly determine the classification of computer software.

Basic Operating Programs

Basic operational programs are those programs that are "fundamental and necessary to the functioning of a computer." They are, according to section 995.2:

> that part of an operating system including supervisors, monitors, executives and control or master programs which consist of the control program elements of that system.

The assessable value of basic operational programs includes the value of the storage media *and* the value of the program embedded on it. Examples of basic operational software are basic input output system (BIOS) and licensed internal code (LIC).

In many transactions computer equipment is purchased or leased at a single price. When the price is not segregated, or able to be segregated, between taxable and nontaxable property and programs, the total purchase price may be used as an indicator of taxable value or assessable cost.[34] Pursuant to Rule 152(f), when a taxpayer can identify and segregate the costs (and supply information to support such separation) the value must be adjusted appropriately.

The proper assessee is determined by the ownership and control of the storage media. It is the "storage media" and the basic operational programs contained on it that are the "taxable property". The value is assessable to "the person owning, claiming, possessing, or controlling the storage media on the lien date."[35] Storage media shall not be assessed to the owner of the copyright of the computer program embodied or stored on the media unless the owner of the copyright also owns, claims, possesses, or controls the storage media on the lien date. If the licensee of a basic operational program owns the storage media on which a program is stored, then the licensee is the proper assessee. If the storage media is leased, then the assessor has the option of making the assessment to the owner (lessor), the lessee, or to both according to section 405(b).

Processing Programs

A processing program is a program used to develop and implement the specific applications which the computer is to perform. Its operation is possible only through the facilities provided by the basic operational program (or control program). By itself, a processing program is not fundamental and necessary to the functioning of a computer.

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[34] Rule 152(e).
[35] Section 405.

The assessable value of these programs is only the value of the "storage media", as if there were no computer programs on them. This value is assessable to "the person owning, claiming, possessing, or controlling on the lien date."[36]

[36] Section 405.